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The Bankruptcy Code's Safe Harbors for Settlement Payments and Securities Contracts: When Is Safe *Too* Safe?

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SUMMARY

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INTRODUCTION

This Article addresses insolvency law-related issues in connection with certain financial-markets contracts. These include securities contracts, commodity contracts, forward contracts, repurchase agreements (repos), swaps and other derivatives, and master netting agreements. The rights of a party to one of these contracts when its counterparty enters an insolvency proceeding is an important consideration for regulators of markets and for regulators and supervisors of market participants. In the United States, the Bankruptcy Code[1] provides special treatment—safe harbors—for these contracts (collectively, qualified financial contracts or QFCs).[2] This special treatment is considerably more favorable for nondebtor parties to QFCs than the rules applicable to nondebtor parties to other contracts with a debtor. Several scholars have aimed criticisms at these safe harbors in recent years. During and since the financial crisis that emerged in earnest in 2008, these critiques have increased in number and sharpness. Yet even some strong critics of the safe harbors concede that *some* special treatment may be warranted, even while maintaining that the package of benefits provided by current law is excessively protective. In particular, this Article offers a critique of the safe harbor for settlement payments, as expansively interpreted by several courts, and the safe harbor for transfers in connection with securities contracts that is clearly written into the Bankruptcy Code.[3]

This Article addresses one aspect of a larger project that explores more broadly the international harmonization of the insolvency-related aspects of legal regimes for intermediated securities, which are financial assets that are credited to securities accounts on the books of securities intermediaries, such as stockbrokers and banks.[4] The collateral provided by parties to QFCs addressed by the safe harbors mainly consists of such intermediated securities. Although this Article focuses primarily on the safe harbors under U.S. law, the issues it addresses are relevant to law reform efforts in all developed financial markets. The market for QFCs is global in scope.

Following this introduction, Part I of this Article addresses the Bankruptcy Code's safe harbors for QFCs. It provides an overview of the legislative history and describes the scope and operation of the statutory components of the safe harbors. It

1. 11 U.S.C. §§ 101–1532 (2012).

2. "Qualified financial contracts" is the term used for these financial contracts in the Federal Deposit Insurance Act and in Title II of the Dodd-Frank Act, which also contain safe harbors. The Bankruptcy Code contains no such universal term. Accordingly, discussions of the provisions of the Bankruptcy Code in this Article usually refer to the types of contracts separately defined there. For the definitions, see *id.* § 101(25) (forward contract); *id.* § 101(38A) (master netting agreement); *id.* § 101(47) (repurchase agreement); *id.* § 101(53B) (swap agreement); *id.* § 741(7) (securities contract); *id.* § 761(4) (commodity contract).

3. *See infra* Part II.

4. *See generally* Charles W. Mooney, Jr. & Guy Morton, *Harmonizing Insolvency Law for Intermediated Securities: The Way Forward*, *in* TRANSNATIONAL SECURITIES LAW 2014.

also briefly describes the various academic critiques and offers my general views on revisions that should be made to the safe harbor provisions. Part I then explains some of the consequences of modifications of the safe harbors, intended and perhaps unintended. Part II features the heart of my critique. It first questions the quite expansive interpretation given by some courts to the safe harbor for settlement payments. It then explains how the safe harbor for transfers made in connection with security contracts could be used to protect from the avoidance powers payments and collateralizations of ordinary debt, transactions that have nothing to do with the QFC markets.

I. THE SAFE HARBORS

A. Legislative History and the Rationale for the Safe Harbors

The Bankruptcy Code safe harbors began modestly in 1978. Section 362(b)(6) of the original 1978 Code exempted from the automatic stay setoff with respect to various sorts of commodity-related contracts, and Section 764(c) prevented the trustee from avoiding certain types of transfers involving commodity contracts.[5] Interestingly, neither the Senate Report nor the House Report discusses Section 362(b)(6).[6] With respect to Section 764(c), the Senate report, without citing to the section specifically, noted that one of the main objectives of the commodity broker liquidation subchapter, of which Section 764 was a part, "is the protection of commodity market stability."[7] This objective, to achieve "commodity market stability," or, more broadly, market stability, is one that is repeatedly invoked as a justification for expanding the scope and number of the safe harbor provisions.

The 1982 amendments were intended, in part, to rectify the conspicuous omission in the 1978 Code of special treatment for securities contracts in view of the special treatment for commodity contracts.[8] Congress applied the same policy rationale of the 1978 commodity safe harbors to these amendments: "Several of the amendments are intended to minimize the displacement caused in the commodities and securities markets in the event of a major bankruptcy affecting those industries."[9] While Congress did not use the term "systemic risk," that was its concern: "[C]ertain protections are necessary to prevent the insolvency of one

5. 11 U.S.C. §§ 362(b)(6), 764(c) (1978) (amended 1982).

6. S. REP. NO. 95-989 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787; H.R. REP. NO. 95-595 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5963.

7. S. REP. NO. 95-989, at 8.

8. *See Bankruptcy of Commodity and Securities Brokers: Hearings before the Subcomm. on Monopolies and Commercial Law of the H. Comm. on the Judiciary*, 97th Cong. 239 (1981) [hereinafter *Hearings*] (testimony of Bevis Longstreth, Comm'r, Sec. & Exch. Comm'n)

> (The resulting discrimination in treatment [between commodities and securities] appears to have been inadvertent. It plainly is not supportable on policy grounds. It is further the Commission's view that the amendments now under consideration present an effective solution to these problems by assuring equality of treatment as between the securities and commodities industries.).

9. H.R. REP. NO. 97-420, at 1 (1982), *reprinted in* 1982 U.S.C.C.A.N. 583, 583.

commodity or security firm from spreading to other firms and possible [sic] threatening the collapse of the affected market."[10]

The 1982 amendments also added Sections 546(e) (then 546(d)) and 555 to the Code. Section 546(e) replaced 764(c) and expanded the language of 764(c) to cover securities contracts.[11] As a result, except in cases of intentional fraudulent transfer, the trustee could not avoid margin or settlement payments "made by or to a commodity broker, forward contract merchant, stockbroker, or securities clearing agency . . . ."[12] Section 555 allowed stockbrokers and securities clearing agencies to liquidate securities contracts if the contracts in question allow for liquidation upon a counterparty insolvency or bankruptcy.[13] Ordinarily, the use of such clauses, so-called *ipso facto* clauses, would be rendered ineffective by Section 365(e)(1).[14]

Two years later, in 1984, Congress altered Sections 546(e) and 555 to broaden their applicability.[15] Congress also introduced Section 559.[16] As enacted in 1982, Section 546(e) prevented a trustee from avoiding a margin or settlement payment "made by or to a commodity broker, forward contract merchant, stockbroker, or securities clearing agency . . . ."[17] Section 555 originally only protected the use of *ipso facto* clauses by stockbrokers and securities clearing agencies.[18] In 1984, Congress added "financial institution" to the list of protected counterparties in Sections 546(e) and 555.[19] The Code defined "financial institution" as "a person that is a commercial or savings bank, industrial savings bank, savings and loan association, or trust company and, when any such person is acting as agent or custodian for a customer in connection with a securities contract, . . . such customer."[20] Section 559 mimics Section 555, but it applies to repo participants.[21]

10. *Id.*

11. *Compare* 11 U.S.C. § 764(c) (1978) *with* Act of July 27, 1982, Pub. L. No. 97-222, sec. 4, § 546(d), 96 Stat. 23 (codified as amended at 11 U.S.C. § 546(e) (2006)).

12. 11 U.S.C. § 546(d) (1982) (amended 1984). Again, the change was made to ensure equal treatment for commodities and securities contracts: "An additional conforming amendment is made to [§ 546(e)] in order to include stockbrokers and securities clearing agencies, thereby avoiding an unintended potential disparity in treatment [as between securities and commodities contracts]." *Hearings*, *supra* note 8, at 371 (Additional Material).

13. 11 U.S.C. § 555 (1982) (amended 1984).

14. *Id.* § 365(e)(1). Section 555, in combination with the exemption from the automatic stay, was specifically meant to address the following situation: if open trades of a bankrupt customer could not be liquidated immediately, then the broker could have to wait days or weeks to obtain bankruptcy court approval to do so, if such permission were granted at all. During that time, the market would continue to move, and if the market moved in the wrong direction, the broker's losses would increase. *See Hearings*, *supra* note 8, at 3 (statement of Philip F. Johnson, Chairman, Commodity Futures Trading Comm'n) ("[S]ince the bankrupt is unlikely to be able to pay these losses, other carrying brokers must pay them. This is unfair . . . and it could even be dangerous, by placing the other carrying brokers and the clearing organizations in financial jeopardy.").

15. *See* 11 U.S.C. §§ 546(e), 555 (1984) (amended 1990).

16. *Id.* § 559.

17. 11 U.S.C. § 546(d) (1982) (amended 1984).

18. *Id.* § 555.

19. Act of July 10, 1984, Pub. L. No. 98-353, sec. 461(d), 469, §§ 546(e), 555, 98 Stat. 333 (codified as amended at 11 U.S.C. §§ 546(e), 555 (2006)).

20. 11 U.S.C. § 101(19) (1984) (amended 1986).

21. 11 U.S.C. § 559 (1984) (amended 1994). Section 559 and changes to § 362(b) and other parts of the Code were meant to bring the same protection to repurchase agreements that had already been afforded to commodity and securities contracts. S. REP. NO. 98-65, at 45.

The next major revisions came in 1990 and were focused on swap agreements.[22] These revisions were meant to bring the treatment of swaps under the Bankruptcy Code in line with the Code's treatment of security contracts, commodity contracts, and repos.[23] The main users of swaps, financial institutions, had three central concerns: the possibility of a bankruptcy trustee assuming favorable swap transactions and rejecting unfavorable ones, loss from market exposure if a swap contract could not be terminated immediately upon bankruptcy of a counterparty, and the enforceability of netting.[24] If these concerns were not addressed, the International Swap Dealers Association (ISDA) contended, "the potential exposure for all swap counterparties [would be] materially increased, and this could undermine the basic foundation of the swap market," which, even at that time, had a notional value near $2 trillion.[25]

All three of ISDA's concerns were addressed. Section 362(b)(17) (then Section 362(b)(14)) prevented the automatic stay from applying to swap agreements,[26] and Section 546(g) prevented a trustee in bankruptcy from avoiding a transfer under a swap agreement.[27] Finally, Section 560 extended the Sections 555 and 559 protections to swap participants; that is, swap participants could now make use of *ipso facto* clauses without fear that a bankruptcy trustee would declare them unenforceable.[28] If the automatic stay does not apply to swap agreements, if the trustee cannot avoid transfers made pursuant to swap agreements, and if swap participants can liquidate pursuant to the contract, then the trustee cannot "cherry-pick" which agreements to keep and which to discard. Additionally, these provisions ensured that netting would not be avoidable as a transfer.

Major change would not come again until 2005 with the passage of the Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA). Though focused on consumer and small business bankruptcies, BAPCPA contained a number of significant changes to the safe harbors—changes that once again were declared to be designed to thwart systemic risk.[29] These amendments were a response to the near-failure in 1998 of the hedge fund Long-Term Capital Management (LTCM).[30]

In the wake of LTCM's near-collapse, the President's Working Group on Financial Markets (PWG), which consisted of members of the Department of the Treasury, the Board of Governors of the Federal Reserve, the SEC and the CFTC,

22. Bankruptcy: Swap Agreements and Forward Contracts, Pub. L. No. 101–311, 104 Stat. 267 (1990) (codified as amended at 11 U.S.C. §§ 101–556 (2006)).

23. *Bankruptcy Treatment of Swap Agreements and Forward Contracts: Hearing on H.R. 2057 and H.R. 1754 Before the Subcomm. on Econ. and Commercial Law of the H. Comm. on the Judiciary*, 101st Cong. 14 (1990) (statement of Mark C. Brickell, Chairman, Int'l Swap Dealers Ass'n).

24. *Id.* at 16.

25. *Id.* at 14, 16.

26. 11 U.S.C. § 362(b)(17) (2006) (originally codified as 11 U.S.C. § 362(b)(14) (1990)).

27. *Id*. § 546(g).

28. *Id*. § 560.

29. *See* H.R. REP. NO. 109-31, at 3 (2005) *reprinted in* 2005 U.S.C.C.A.N. 88, 89 ("In addition, [BAPCPA] contains provisions designed to reduce systemic risk in the financial marketplace.").

30. Rhett G. Campbell, *Financial Markets Contracts and BAPCPA*, 79 AM. BANKR. L.J. 697, 698 (2005).

issued a report exploring the causes of LTCM's failure and recommending policy changes based on their findings.[31] The PWG specifically recommended "expanding and clarifying the definitions of the financial contracts eligible for netting and . . . allowing eligible counterparties to net across different types of contracts" in order to "reduce the likelihood that the procedure for resolving a single insolvency will trigger other insolvencies due to the creditors' inability to control their market risk."[32]

Congress heeded the PWG report in enacting BAPCPA.[33] The report recommended "expanding and clarifying the definitions of the financial contracts eligible for netting."[34] BAPCPA did exactly that by altering the Bankruptcy Code definitions for forward contracts,[35] repurchase agreements,[36] securities contracts,[37] and swap agreements.[38] Significantly, the definition of repurchase agreement was expanded to include repos on mortgage-related securities and mortgage loans.[39]

Congress addressed the issue of cross-product netting by defining a new type of agreement, a "master netting agreement" (MNA).[40] An MNA is an agreement that can provide for the exercise of netting, setoff, liquidation, termination, acceleration, or close-out rights with respect to securities contracts, commodity contracts, forward contracts, repos and swap agreements.[41] That is, rather than rely on a different agreement for each separate type of financial instrument, a MNA specifies a counterparty's rights with respect to all these different types of financial instruments within one document. Consequently, it can provide for netting among all the financial instruments that arise between counterparties.

MNAs receive the same protections as other derivatives contracts and repurchase agreements. Section 362(b)(27) exempts the operation of MNAs from the automatic stay[42] while Section 546(j) prevents a trustee from avoiding transfers "made by or to . . . a master netting agreement participant under or in connection with any master netting agreement."[43] Section 561 allows for the effective use of *ipso facto* clauses in MNAs.[44]

31. THE PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS, HEDGE FUNDS, LEVERAGE, AND THE LESSONS OF LONG-TERM CAPITAL MANAGEMENT (1999) [hereinafter PWG REPORT], *available at* http://www.treasury.gov/resource-center/fin-mkts/Documents/hedgfund.pdf.

32. *Id.* at 26, 40.

33. H.R. REP. NO. 109-31, at 20, 2005 U.S.C.C.A.N. at 106 (citing to the PWG as a source of the enacted provisions).

34. PWG REPORT, *supra* note 31, at 40.

35. *Compare* 11 U.S.C. § 101(25) (2006) *with* 11 U.S.C. § 101(25) (2004) (amended 2006).

36. *Compare* 11 U.S.C. § 101(47) (2006) *with* 11 U.S.C. § 101(25) (2004) (amended 2006).

37. *Compare* 11 U.S.C. § 741(7) (2006) *with* 11 U.S.C. § 741(7) (1994) (amended 2006).

38. *Compare* 11 U.S.C. § 101(53B) (2006) *with* 11 U.S.C. § 101(53B) (2004) (amended 2006). For a discussion of the changes to these definitions, see Campbell, *supra* note 30, at 701–05.

39. 11 U.S.C. § 101(47) (2006).

40. *Id.* § 101(38A).

41. *Id.* §§ 101(38A), 561(a).

42. *Id.* § 362(b)(27).

43. *Id.* § 546(j).

44. *See id.* § 561(a) (allowing eligible parties to cause the "termination, liquidation, or acceleration" of the eligible contracts based on the debtor's bankruptcy or insolvency without limitation).

BAPCPA also defines a new type of counterparty, a "financial participant."[45] A financial participant is an entity with at least $1 billion in notional or principal amount outstanding or $100 million in mark-to-market securities contracts, commodities contracts, swap agreements, repurchase agreements, or forward contracts, with the debtor at the time of filing or on any day during the fifteen month period preceding filing.[46] Sections 362(b)(17), 546(e) and (g), 555, 559, and 560 extend their protection to financial participants.[47] By doing so, Congress sought to reduce systemic risk by allowing entities that meet the financial participant dollar requirements, but would not otherwise qualify as a protected counterparty (e.g., because the entity is not a commodity broker or stockbroker), to close out and net derivatives contracts and repurchase agreements.[48] Congress also sought to reduce systemic risk by including "clearing organizations" in the definition of "financial participants," which means they too can take advantage of the Bankruptcy Code's safe harbors.[49] Congress felt this would "further the goal of promoting the clearing of derivatives . . . as a way to reduce systemic risk."[50]

Finally, BAPCPA altered Section 553. Section 553 states when creditors can offset mutual debts owing between the creditor and debtor.[51] The automatic stay and the avoidance and liquidation exceptions for derivatives and repurchase agreements are designed, in part, to ensure that creditors can offset their debts with the debtor without interference from the bankruptcy court.[52] BAPCPA made changes to Section 553 to reflect this result.[53]

One year later, Congress enacted the Financial Netting Improvements Act of 2006. Section 362(b)(17) was substantially reworded to conform it to the parallel provisions in the Federal Deposit Insurance Act and Federal Credit Union Act.[54] Section 362(b)(27) was also changed to resemble the phrasing of the newly reworded 362(b)(17).[55] Sections 546(e) and (j) were expanded in scope to shield from the trustee's avoidance power not only transfers made by or to one of the listed types of entities but also transfers made for the benefit of such protected entities.[56] In addition, 546(e) was further expanded so that it not only protects from avoidance margin payments and settlement payments but also protects all types of transfers made "by or to (or for the benefit of) a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities-

45. 11 U.S.C. § 101(22A) (2012).

46. *Id*. § 101(22A).

47. *See* H.R. REP. NO. 109-31, at 130–31 (2005) *reprinted in* 2005 U.S.C.C.A.N. 88, 191 (discussing extension of sections 362 and 555); 11 U.S.C. § 546 (2006); *id*. § 546; *id*. §§ 559, 560.

48. H.R. REP. NO. 109-31, at 130–131, 2005 U.S.C.C.A.N. at 191.

49. *See id.* at 131, 2005 U.S.C.C.A.N. at 191 ("[This inclusion] will allow clearing organizations to benefit from the protections of all the provisions of the Bankruptcy Code relating to the contracts and agreements.").

50. *Id.*

51. *Id.* at 134, 2005 U.S.C.C.A.N. at 194.

52. *Id.*

53. *Id.*

54. H.R. REP. NO. 109-648, pt. 1, at 7 (2006), *reprinted in* 2006 U.S.C.C.A.N. 1585, 1591.

55. *Id.* at 22–23, 2006 U.S.C.C.A.N. at 1593.

56. *Id.* at 8, 2006 U.S.C.C.A.N. at 1592.

clearing agency, in connection with a securities contract . . . commodity contract . . . or forward contract."[57]

B. *Scope and Operation of the Safe Harbors*

This subpart briefly summarizes the current scope and operation of the safe harbors.

1. Exceptions to Automatic Stay and Effectiveness of *Ipso Facto* Clauses

A debtor's counterparty may terminate a QFC and offset and net out the parties' obligations (including enforcement against collateral) under one QFC or multiple QFCs free of the restraints of the automatic stay.[58] Moreover, it may terminate the transaction based on the debtor's bankruptcy petition, insolvency, or financial condition under an *ipso facto* clause.[59]

2. Avoidance Powers

The safe harbors also include broad protections from avoidance (e.g., as a preference or a constructive fraudulent transfer) for transfers made in connection with QFCs. The transfers that generally are protected from avoidance (other than as an intentional fraudulent transfer) are transfers made before the commencement of a case by, to, or for the benefit of: a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency, in connection with a securities contract, commodity contract, or forward contract,[60] a repo participant or financial participant in connection with a repo,[61] a swap participant or financial participant in connection with a swap agreement,[62] or a master netting agreement participant in connection with a master netting agreement.[63] The exercise of rights to terminate QFCs also is protected from avoidance.[64] Finally, settlement payments and margin payments are protected from avoidance if made to a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency.[65]

57. 11 U.S.C. § 546(e) (2012).

58. 11 U.S.C. § 362(b)(6) (2012) (commodity contract, forward contract, or securities contract); *id.* § 362(b)(7) (repo); *id.* § 362(b)(17) (swap agreement); *id.* § 362(b)(27) (master netting agreement); *id.* § 555 (securities contract); 11 U.S.C. § 556 (2012) (commodity contract or forward contract); *id.* § 559 (repo); *id.* § 560 (swap agreement); *id.* § 561 (master netting agreement).

59. *See id.* §§ 555–556, 559–561 (allowing eligible parties to cause the termination, liquidation, or acceleration of the various QFCs based on the debtor's bankruptcy, insolvency, or financial condition without limitation).

60. *Id.* § 546(e).

61. *Id.* § 546(f).

62. 11 U.S.C. § 546(g) (2012).

63. *Id.* § 546(j).

64. *Id.* §§ 555–556, 559–561.

65. *Id.* § 546(e).

C. The Critiques

The stunning largesse granted by the Bankruptcy Code to certain financial-market participants has drawn substantial criticism, in particular from legal academics.[66] Several, probably most, critics recognize that some special treatment for QFCs may be warranted.[67] But they explain and argue that the current treatment is far more generous than what would be necessary to address the overarching goal of the safe harbors: the reduction or elimination of systemic risk.[68] Others have called for their outright repeal, arguing that they simply do not achieve their intended purposes.[69]

The broad exemptions from the automatic stay and the related right to terminate QFCs based on *ipso facto* clauses have been criticized in part because these provisions deprive the debtor of the ability to assume valuable executory contracts such as swap agreements, thus contravening a fundamental bankruptcy policy.[70] Several have observed that massive close-outs can destroy substantial value and can lead to liquidation of assets at fire-sale prices.[71] Some have explained that bankruptcy law mimics nonbankruptcy law inasmuch as selective breach is always a party's option outside of bankruptcy and, consequently, cherry-picking is not the evil to be avoided at all costs as argued by supporters of the safe harbors.[72]

Some critics observe that not only did the current safe harbors fail to thwart systemic risk during the recent financial crisis but they can actually *increase* systemic risk.[73] For example, the ability of a systemically important debtor's counterparties to demand increasingly greater value of collateral as the debtor's financial condition

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66. This brief précis does not do justice to the depth and richness of the literature; a more detailed discussion can be found elsewhere. *See generally* Douglas G. Baird & Edward R. Morrison, *Dodd-Drank for Bankruptcy Lawyers*, 19 AM. BANKR. INST. L. REV. 287 (2011) (discussing Bryan G. Faubus, Note, *Narrowing the Bankruptcy Safe Harbor for Derivatives to Combat Systemic Risk*, 59 DUKE L.J. 801 (2010)); Stephen J. Lubben, *Derivatives and Bankruptcy: The Flawed Case for Special Treatment*, 12 U. PA. J. BUS. L. 61 (2009) [hereinafter Lubben, *Flawed Case*]; Mark J. Roe, *The Derivatives Market's Payment Priorities as Financial Crisis Accelerator*, 63 STAN. L. REV. 539 (2011); David A. Skeel, Jr. & Thomas H. Jackson, *Transaction Consistency and the New Finance in Bankruptcy*, 112 COLUM. L. REV. 152 (2012); Richard Squire, *Shareholder Opportunism in a World of Risky Debt*, 123 HARV. L. REV. 1151 (2010); Michael H. Weiss, *Using Derivatives to Create Bankruptcy Proof Loans*, 30 CAL. BANKR. J. 207 (2010).

67. *See*, *e.g.*, Skeel & Jackson, *supra* note 66, at 177–79, 183–85 (discussing the role of repo buyers and discussing potential consequences for special treatment of swaps).

68. *See* Stephen J. Lubben, *Repeal the Safe Harbors*, 18 AM. BANKR. INST. L. REV. 319, 328–32 (2010) (criticizing ISDA justifications for safe harbors) [hereinafter Lubben, *Repeal*].

69. *See*, *e.g.*, *id.* at 322 (calling for repeal of safe harbors). Following repeal, Lubben would support appropriate amendments to Chapter 11 to accommodate special characteristics of financial firms. *Id.* at 332–34. Lubben earlier argued that the safe harbors should apply only to financial firms and to Chapter 7 debtors (for whom derivatives are unlikely to have going concern value). Lubben, *Flawed Case*, *supra* note 66, at 76–77.

70. Skeel & Jackson, *supra* note 66, at 183–85.

71. *See*, *e.g.*, *id.* at 163 (discussing the circumstances surrounding the decision to prevent Bear Stearns from filing bankruptcy); Randall D. Guynn, *Are Bailouts Inevitable?*, 29 YALE J. ON REG. 121, 127 (2012) (describing "disorderly liquidations" during financial panic).

72. Lubben, *Flawed Case*, *supra* note 66, at 61–62.

73. Lubben, *Repeal*, *supra* note 68, at 329–30.

declines, without fear of preference avoidance, can create a "run" on the debtor.[74] It is generally accepted that this is exactly what happened to AIG in 2008.[75] In addition, massive terminations and close-outs affecting one of the few major derivatives players could force the financial firm into liquidation, which also could cause major damage to the markets.[76] Moreover, because the safe harbors provide incentives for a major player to increase its QFC business and reduce counterparty monitoring, they may contribute to the firm becoming "too big to fail."[77]

Mark Roe, in particular, has sought to shift the focus from the time when a derivative-heavy debtor is on the brink of collapse to the period long before the collapse.[78] He argues that the safe harbors diminish the incentives for counterparties to monitor other counterparties, to properly ration credit, and to prudently manage counterparty risk.[79] He also argues that the safe harbors induce financial firms to use short-term (mostly overnight) repo financing to an excessive extent; examples are The Bear Stearns Companies, Inc. and Lehman Brothers Holdings, Inc.[80]

D. Unpacking the Safe Harbors and Striking a Balance

This subpart offers a sketch of some of my views on the safe harbors and their discontents (albeit with a minimum of analysis and explanation). In general, I agree with the academic critics who have argued that, as a package, the safe harbors are overbroad for their announced purposes, even if some special treatment for QFCs may be necessary. But my prescription for reform nonetheless differs from earlier proposals in some respects.

74. *See*, *e.g.*, Roe, *supra* note 66, at 550–51, 564–67, 573 (supporting the idea that by decreasing counterparty risk, the Code has negatively impacted the debtor's standing.); Skeel & Jackson, *supra* note 66, at 166–68 (emphasizing the limited options the debtor has to bargain about collaterals under the new rules).

75. *See*, *e.g.*, Roe, *supra* note 66, at 550–51, 573 (detailing AIG's counterparties increasing their collateral demands to AIG's detriment); Lubben, *Repeal*, *supra* note 68, at 319–20 (echoing that increased collateral demands from counterparties contributed to AIG's "downward spiral").

76. *See*, *e.g.*, Baird & Morrison, *supra* note 66, at 312–13 (discussing the market and individual firm implications of ensuing liquidations).

77. *See*, *e.g.*, Roe, *supra* note 66, at 543–44, 556, 558–59, 561–62, 570–72 (supporting the idea that safe harbor provisions allow financial firms to trade off close monitoring of debtors' financial stability for collaterals, which allows them to do more business and increase the likelihood of becoming too-big-to-fail).

78. *Id.* at 544–45 ("I seek to shift policymakers' focus from the moment just prior to the institution's collapse to the months and years well before collapse.").

79. *Id.* at 555–58, 560, 562 (supporting the notion that safe harbor provisions reduce the need for counterparties to screen and monitor other parties financial dealings). *Cf.,* Skeel & Jackson, *supra* note 66, at 155, 166–68 (asserting that safe harbor provisions reduce the need for counterparties to screen and monitor other parties' financial dealings).

80. Roe, *supra* note 66, at 552–53 (supporting the idea that safe harbor provisions result in riskier transactions, which result in more short-term repos).

1. Exceptions to Automatic Stay and Effectiveness of *Ipso Facto* Clauses

a. Repos

Repos on liquid financial assets that have been delivered by a debtor to a counterparty (or to a third party on its behalf) should remain entirely excepted from the automatic stay. In this connection, it would be necessary to determine a standard for "liquidity" of financial assets.[81] To achieve the necessary certainty ex ante, however, liquidity should be tested at the inception of a transaction. The exception from the stay would permit the repo counterparty to terminate and accelerate the transaction and enforce the debtor's payment obligation against the collateral. Assuming the nondebtor counterparty was fully collateralized, termination and enforcement might have little impact on the debtor's liquidity. The debtor would retain the cash that it otherwise would have used to repurchase the collateral and would receive any return of the surplus collateral.[82] Other repos, including those on liquid financial assets that were not delivered by the debtor to or for the benefit of the counterparty, should be subject to a simplified and accelerated process for relief from the stay.

b. Other QFCs

I favor repeal of the complete exception from the automatic stay for the termination of QFCs and the related enforcement against collateral.[83] Instead, I support a short (e.g., one-day or three-day) duration of the automatic stay, within which time the debtor could assume (and assign, if it chooses) all of its QFCs with any one or more of its counterparties. The debtor could cherry-pick its counterparties, but could not cherry-pick the contracts it has with any particular counterparty. If it assumes its QFCs with a counterparty, that should eliminate the counterparty's right to terminate based on the *ipso facto* clause. If it fails to assume, the counterparty would be relieved of the stay and free to terminate and pursue its remedies against collateral. The extent of the benefits for the debtor of such a short stay may turn on whether the period of the stay would be sufficient for most debtors to undertake and complete the analysis necessary for a decision to assume and assign

81. One might draw on well-understood wording in the Uniform Commercial Code (UCC) to describe liquid financial assets "of a kind that is customarily sold on a recognized market or the subject of widely distributed standard price quotations." UCC § 9-610(c)(2) (2010) (describing collateral as to which a secured party may be a purchaser at a private disposition following default). Or qualifying assets might be limited to "cash-like" assets (e.g., U.S. Treasuries), as the appropriate standard is whether they can be easily and accurately valued and disposed of.

82. Of course, if the repos were subject to a terminated MNA, it would be impossible to generalize about the impact of termination.

83. I am open to the possibility of retaining the complete exception to the stay for QFCs that are cleared through a clearinghouse in the case of a debtor that is a member-participant. *See* Darrell Duffie & David Skeel, *A Dialogue on the Costs and Benefits of Automatic Stays for Derivatives and Repurchase Agreements*, *in* BANKRUPTCY NOT BAILOUT: A SPECIAL CHAPTER 14, at 133, 165–72 (Kenneth E. Scott & John B. Taylor eds., 2012) (discussing the fact that Duffie favors no stay for cleared derivatives and Skeel favors a short stay for all derivatives, cleared and not cleared).

or reject all of the QFCs with each counterparty. One would expect that the resolution plans (living wills) of SIFIs (and ongoing business planning of other significant market participants) would involve pre-failure monitoring and post-failure decision-making structures so as to permit either cherry-picking of counterparties for assumption or rejection by the debtor-in-possession or termination of the firm's entire QFC book.[84]

At any point in time either the debtor or its counterparty is in the money on a given QFC between the parties. If the nondebtor counterparty chooses not to terminate the QFC (probably because the debtor is in the money), as is its option, the nondebtor counterparty should not be relieved of its obligation to make payments to the debtor. Judge Peck so held in the Lehman cases in the Southern District of New York.[85] Metavante Corporation owed substantial sums to Lehman Brothers Special Financing (LBSF) under an interest rate swap but had ceased making payments to LBSF following the Chapter 11 filing. Judge Peck held that Metavante had waived its right to terminate the swap and ordered it to make all past due and future payments to LBSF pending a decision by LBSF to assume or reject the swap.[86]

Judge Peck's decision seems appropriate. What does not seem appropriate is the ability of a debtor (in or out of the money) to leave its counterparties twisting in the wind for a substantial amount of time before making a decision to assume or reject. Under the approach suggested above, however, the debtor would have a very short time to make the decision.

Although exceptions from the automatic stay for repos and other QFCs are discussed separately above, in many cases a debtor and its counterparty to repos and other QFCs will have entered into an MNA that covers both repos and the other QFCs. I support treatment of contracts covered by MNAs like the treatment of other nonrepo QFCs discussed above. The debtor would be required to assume or reject the MNA and all of the contracts it covers within the short window of time. Properly conceptualized, there is no cherry-picking to be had—or avoided—under an MNA. The parties have established a single, indivisible relationship under non-bankruptcy law.[87] That comprehensive close-out termination calculations are not actually undertaken by the parties on a minute-by-minute basis is beside the point. Moreover, even if rejected, permitting a debtor's counterparty to terminate, close-out, and liquidate collateral, that does not bind the debtor's estate to agree with all of the calculations under MNA. A final determination would require either an amicable settlement or litigation, as illustrated by the experience in the Lehman Brothers Chapter 11 cases.[88]

84. *See* Dodd-Frank Act § 165(d), 12 U.S.C. § 5365(d) (2012) (establishing a resolution-plan requirement).

85. *In re Lehman Bros. Holding, Inc.*, No. 08–13555 (JMP), 2009 WL 6057286, at *1 (Bankr. S.D.N.Y. Sept. 17, 2009) (order compelling performance of Metavante Corporation's obligations under an executory contract and to enforce the automatic stay pursuant to §§ 105(a), 362, and 365 of the Bankruptcy Code).

86. *Id.*

87. In May 2013 The International Institute for the Unification of Private Law (UNIDROIT) completed its project to promulgate a set of principles on the enforceability of close-out netting provisions. UNIDROIT, *Principles on the Operation of Close-out Netting Provisions* (2013), *available at* http://www.unidroit.org/instruments/capital-markets/netting.

88. *See* Steven J. Fink et al., *Lehman Derivative Litigation Still Looms Large*, LAW 360 (June 14, 2013, 6:21 PM), http://www.law360.com/articles/450530/lehman-derivative-litigation-still-looms-large

As for repos secured by liquid collateral, I have suggested a complete exception from the automatic stay. If the repos are covered by an MNA, they might be terminated and collateral liquidated before the stay expires for the umbrella MNA. If the MNA were rejected, calculations from the repo transaction could then be added to the mix for netting upon expiration of the stay (assuming no assumption of the MNA).

2. Avoidance Powers

As explained above, the current safe harbors include a broad protection from avoidance (e.g., as a preference or a constructive fraudulent transfer) for transfers made in connection with QFCs. Settlement payments and margin payments deserve this special protection, as discussed below. But the open-ended protection of all types of transfers by, to, or for the benefit of the identified players in connection with the relevant QFCs does not seem warranted. For example, it is not evident just how generally protecting from avoidance a payment or transfer of collateral *from* a financial firm made *to* a nonfinancial firm or natural person contributes to market stability or deters systemic risk.[89]

To the extent that the obligations of parties to QFCs are adequately collateralized, the financial markets benefit from stability and may be protected from the worst effects of default and insolvency. But more targeted protection, for example, of transfers for the purpose of maintaining necessary collateral value would be more plausible. This approach would protect transfers to satisfy top-up obligations and mark-to-market transfers to the extent these are not already protected as margin payments. It would not provoke AIG-like runs, demanding collateral or additional collateral upon the downgrading of the credit rating of an obligor on uncollateralized or under-collateralized obligations. In a similar vein, David Skeel and Thomas Jackson have proposed that a two-point net-improvement test be enacted for repo and swap collateral.[90]

Protecting settlement payments and margin payments from avoidance in an insolvency proceeding is important. At least as to settlement payments, this has been emphasized and reiterated in many reports by expert committees working under the auspices of organizations such as the Bank for International Settlements, the International Organization of Securities Commissions, and the Group of 10 Countries.[91] Moreover, it is telling that the criticism of the safe harbors that has

(discussing Lehman Brothers bankruptcy cases).

89. The protection of margin payments and settlement payments may provide a special case. *See infra* Part II.A.

90. Skeel & Jackson, *supra* note 66, at 190–91; c*f.* 11 U.S.C. § 547(c)(5) (2012) (two-point net-improvement test for receivables and inventory).

91. *See* COMM. ON PAYMENT AND SETTLEMENT SYS., BANK FOR INT'L SETTLEMENTS & TECHNICAL COMM. OF THE INT'L ORG. OF SEC. COMM'NS, RECOMMENDATIONS FOR SECURITIES SETTLEMENT SYSTEMS 4–6, 8–9 (2001), *available at* http://www.bis.org/publ/cpss42.pdf (discussing the importance of supporting security settlement systems); INT'L ORG. OF SEC. COMM'NS, OBJECTIVES AND PRINCIPLES OF SECURITIES REGULATION 47–49 (1998), *available at* http://www.iosco.org/library/pubdocs/pdf/IOSCOPD82.pdf (discussing how to operate settlement systems effectively); COMM. ON PAYMENT AND SETTLEMENT SYS., BANK FOR IN'T SETTLEMENTS, CORE PRINCIPLES FOR SYSTEMICALLY IMPORTANT

emerged has generally left the protections for settlement payments and margin payments unscathed.[92] But ultimately the benefits of protecting settlement payments depend on what constitutes a settlement payment.

3. Intended and Unintended Consequences?

Some critics of the safe harbors have recognized and acknowledged that eliminating (or shrinking) these protections would reduce the number of QFCs and generally shrink the market. There would be fewer swaps and fewer repos. It would be folly to think that such drastic changes in the rules of the road would leave the financial markets just where they are today. Moreover, it may be quite difficult to assess the aggregate effects of such changes in law. To the extent that the transactions that remain would be safer and more efficient and that moral hazard would be reduced, the result might be positive. On the other hand, without the safe harbors as they currently exist, considerably more risk might exist for transactions that do get booked.

The point here is that material modifications of the safe harbors would have consequences for the financial markets. Some transactions that take place today would not take place. Some of the consequences of modifications may be beneficial, some may be harmful, and some may be unintended. But shrinking the market and reducing the number of transactions cannot be considered an unintended consequence. Certainly the behavior of market participants would be affected.

4. Transition

Given the importance and size of the QFC markets, appropriate transition provisions for material changes to the safe harbors would be crucial.[93]

5. Concluding Observations

Many, probably most, of my views of the safe harbors expressed here are similar to (and benefited from) those expressed by others. Much of the treatment of non-repo QFCs that I would support bears substantial similarity to the treatment of QFCs afforded by the Federal Deposit Insurance Act for resolving depository institutions[94] and by the Orderly Liquidation Authority (OLA) framework for resolving SIFIs under Title II of the Dodd-Frank Act.[95] Further convergence of the Bankruptcy Code and OLA regimes would have the benefit of relieving pressure on regulators to opt for OLA when a choice is presented.

PAYMENT SYSTEMS Foreword 3 (2001), *available at* https://www.bis.org/publ/cpss34e.pdf (highlighting the input of the Group of 10 in the report).

92. *See infra* Part II.B (discussing avoidance protection for settlement payments).

93. *See* Roe, *supra* note 66, at 584–85 (stressing the need for smooth transitions and arguing against abrupt changes).

94. *See* 12 U.S.C. § 1821(e)(8)–(11) (2012) (providing for the treatment of QFCs).

95. *See* Dodd-Frank Act §§ 201–214, 12 U.S.C. §§ 5381–5394 (2012) (providing the role of courts and treating systemic risk determinations in an orderly liquidation).

II. APPLICATION OF SECTION 546(e): SETTLEMENT PAYMENT AND OTHER PROTECTED TRANSFERS

A. *The Statutory Framework*

This part deals with the safe harbors provided by Bankruptcy Code Section 546(e). In particular, it focuses on settlement payments and transfers in connection with securities contracts. Section 546(e) currently provides:

> Notwithstanding [S]ections 544, 545, 547, 548(a)(1)(B), and 548(b) of this title, the trustee may not avoid a transfer that is a margin payment, as defined in [S]ection 101, 741, or 761 of this title, or settlement payment, as defined in [S]ection 101 or 741 of this title, made by or to (or for the benefit of)[96] a commodity broker, forward contract merchant, stockbroker, financial institution,[97] financial participant,[98] or securities clearing agency, *or that is a transfer made by or to (or for the benefit of) a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency, in connection with a securities contract, as defined in [S]ection 741(7), commodity contract, as defined in [S]ection 761(4), or forward contract,*[99] that is made before the commencement of the case, except under [S]ection 548(a)(1)(A) of this title.[100]

As reflected by the quoted text, settlement payments generally are protected from avoidance under Bankruptcy Code Section 546(e) if made by, to, or for the benefit of one of the specified types of entities.[101] The Bankruptcy Code defines (in admittedly circular fashion) "settlement payment" as "a preliminary settlement payment, a partial settlement payment, an interim settlement payment, a settlement payment on account, a final settlement payment, or any other similar payment commonly used in the securities trade."[102] Part II.B examines the scope of the

96. In 2006, this parenthetical and the identical parenthetical that appears later in Subsection (e) were added. Financial Netting Improvements Act of 2006, Pub. L. No. 109-390, sec. 5(b)(1)(A)-(B), § 546(e), 120 Stat. 2692, 2697–98 (2006).

97. In 1984 the term "financial institution" was added to Subsection (e) along with a definition of that term. Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L. No. 98-353, sec. 421(j), 461(d), § 546(e), 98 Stat. 333, 368, 377 (1984).

98. In 2005 the term "financial participant" was added to Subsection (e) along with a definition of that term. Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, sec. 907(o)(3), § 546(e), 119 Stat. 23, 181–82 (2005).

99. In 2006 the italicized text was added to Subsection (e). Financial Netting Improvements Act of 2006, Pub. L. No. 109-390, sec. 5(b)(1)(B), § 546(e), 120 Stat. 2692, 2697–98 (2006) (emphasis added). I refer to this text as the "second clause" of Subsection (e).

100. 11 U.S.C. § 546(e) (2012) (emphasis added).

101. Note that the avoidance protection does not extend to so-called "intentional" fraudulent transfers under 11 U.S.C. § 548(a)(1)(A) (2012).

102. *Id.* § 741(8). Subsection (e) also protects "margin payment[s]," a term that is similarly defined in circular fashion. *Id.* § 741(5). The focus here is on settlement payments inasmuch as existing case law reflects more disagreement in that context.

avoidance protection provided for settlement payments under Section 546(e). However, it does not address broadly and generally what constitutes a settlement payment. Instead, it focuses primarily on the treatment of payments made by an issuer of securities in respect of the issuer's own securities. Such payments would include, for example, a payment by an issuer of stock in connection with the redemption of the stock or a payment by the issuer of a debt security in satisfaction of the debt evidenced by the security. As explained below, such payments should not be treated as settlement payments that are protected from avoidance by Section 546(e).

Part II.C then explores the protection afforded by the second clause of Subsection (e). As discussed below, while the second clause appears to extend avoidance protection beyond protection provided for settlement payments, it may be that the protection for settlement payments (as the definition is properly construed) actually is subsumed by the second clause. That is to say, the second clause may shield all settlement payments (without the need to consider what constitutes a settlement payment), thus rendering the protection for settlement payments as such largely superfluous—at least in the context of securities contracts.[103]

B. Avoidance Protection for Settlement Payments

The avoidance protection for settlement payments, unlike the other safe harbors, has been the subject of relatively little criticism.[104] However, I question the expansive interpretation of the term "settlement payment" given by some courts, as explained below.

In *Enron Creditors Recovery Corp. v. Alfa, S.A.B. de C.V.*, the Second Circuit held that voluntary payments made by Enron Corporation in order to retire its commercial-paper debt were settlement payments that were protected from avoidance (either as preferences or constructive fraudulent transfers).[105] There was a strong dissent by District Judge Koeltl, who was sitting by designation.[106] As Enron's financial condition and prospects were falling precipitously in late 2001, it appeared that Enron would not be able to repay its maturing commercial paper with the issuance of new commercial paper (i.e., by "rolling" it).[107] Enron drew down $3

103. The same can be said concerning the protection of margin payments.

104. A notable exception is Samir D. Parikh, who proposes entirely eliminating the settlement payment avoidance protection in securities transactions (as well as eliminating the second clause of Section 546(e) entirely) through arguing against settlement payments in the context of sheltering from fraudulent transfer avoidance the payments made to shareholders in connection with leveraged buyouts). Samir D. Parikh, *Saving Fraudulent Transfer Law*, 86 AM. BANKR. L.J. 305 (2012). His proposal, at least in its breadth, seems unwise and poses the specter of untoward and unanticipated consequences. Consequently, I do not consider the proposal in detail here.

105. Enron Creditors Recovery Corp. v. Alfa, S.A.B. de C.V, 651 F.3d 329, 336–38 (2d Cir. 2011). I should disclose that I submitted to the bankruptcy court an expert report and gave expert deposition testimony on behalf of the successor to Enron's preference and fraudulent transfer claims. *E.g.*, Transcript of Partial Testimony of Charles W. Mooney, Enron Creditors Recovery Corp. v. Alfa, S.A.B.de C.V., 651 F.3d 329 (2d Cir. 2011) (Nos. 01-16034, 03-92677, 03-92682). The gist of this testimony was that, as understood in the securities industry, a payment by an issuer to retire its debt securities is not a settlement payment. *Id.*

106. *Enron Creditors Recovery Corp.*, 651 F.3d at 339–47.

107. *See id.* at 331 (describing the events that resulted from Enron's inability to roll its commercial paper).

billion from its "backup" bank credit facilities (which were in place for just such an eventuality) and embarked on a "buyback" or "repurchase" (Enron's characterizations) program to retire its commercial paper with the proceeds of the bank loans.[108] Under the terms applicable to the commercial paper, Enron had no contractual right to "redeem" or "prepay" the commercial-paper debt.[109] During this period—shortly before Enron filed its Chapter 11 petition—Enron retired about $1.1 billion of its commercial-paper debt.[110]

The majority rejected Enron's argument that the limitation "commonly used in the securities trade" modifies all of the terms preceding it in the definition, and that it thereby excluded uncommon payments (such as, according to Enron, the commercial-paper retirement payments).[111] As the court explained, "Under the rule of the last antecedent, . . . a limiting clause or phrase . . . should ordinarily be read as modifying only the noun or phrase that it immediately follows."[112] The majority also rejected Enron's argument that the payments were not settlement payments because the underlying transaction was not a purchase and sale of securities but instead consisted only of payments to retire debt.[113] The majority adopted the test used in some cases that settlement is "the completion of a securities transaction" and need not involve a purchase and sale.[114] It emphasized that nothing in the definition itself or elsewhere in the Bankruptcy Code limits settlement payments to purchase and sale transactions.[115] Finally, the majority rejected Enron's argument that the retirement payments were not settlement payments because the payments "did not involve a financial intermediary that took a beneficial interest in the securities during the course of the transaction."[116] I disagree with the reasoning and analysis presented by the majority, largely for reasons expressed in the dissenting opinion and in Enron's petition for rehearing en banc.[117] Additionally, as explained below, I question the majority's view that the retirement payments in question were settlement payments based on a more targeted critique.

Consider next how the retirements, or "redemptions" as the court described the transactions, actually were achieved.[118] As is the case for most issuers of commercial paper, Enron participated in the commercial-paper program operated by The Depository Trust Company (DTC), the principal central securities depository in the United States. Enron had retained an issuing agent and a paying agent to act on its

108. *Id.*

109. *Id.*

110. *Id.*

111. *Id*. at 335.

112. *Enron*, 651 F.3d at 335 (quoting Barnhart v. Thomas, 540 U.S. 20, 26 (2003)).

113. *Id.* at 338.

114. *Id.* at 336–37 (citation omitted).

115. *Id.* at 336.

116. *Id.* at 338.

117. *Id.* at 339–47 (Koeltl, J. *dissenting*); Petition for Rehearing En Banc by Appellant Enron Creditors Recovery Corp., *Enron*, 651 F.3d 329 (2011) (No. 09-5122-bk(L)), 2011 WL 9153008.

118. For an overview of the Depository Trust Company's (DTC) programs for money-market instruments, including commercial paper, see BLUE SKY TASK FORCE, THE DEPOSITORY TRUST & CLEARING CORP., MONEY MARKET INSTRUMENTS (MMI) BLUE SKY TASK FORCE REPORT (2011), *available at* https://www.sifma.org/issues/item.aspx?id=24171.

behalf in the system.[119] Each issue of commercial paper in the system is evidenced by a "global" note and the actual purchasers of commercial paper do not receive "paper" at all. A typical retirement involved the following pattern. When a holder agreed to the retirement on the terms proposed by Enron, it would authorize its securities intermediary to have the paper credited to the DTC account of one of Enron's commercial-paper dealers (e.g., Goldman Sachs). DTC would then debit the dealer's account and credit the paper to a special account at DTC for its retirement. Enron provided funds to its paying agent and the funds were credited to the dealer's account. Through additional debits at DTC the former holder's intermediary would receive a credit of funds and then would, in turn, credit the former holder's account with the corresponding amount of funds.

The debits and credits that served to remove the paper from the holder's account and to place it in the account of one of Enron's dealers on the books of DTC would be indistinguishable from the book entries reflecting a sale by the original holder to the dealer.[120] But this reflects only that in the commercial-paper program (like all of DTC's systems and programs) debits and credits compose the principal means of recordkeeping. The system is agnostic as to *why* the debits and credits are entered. In the Enron transactions, the dealers generally did not act as principals (or purchasers).[121] They received the credits for the sole purpose of allowing DTC to debit their accounts so that the paper could be extinguished and discharged.[122] Stated otherwise, at the completion of the transaction the paper no longer existed. It is my view and understanding that, upon the completion of a securities transaction, the securities will exist and will not be extinguished and discharged. This conceptual point aside, the argument I present next is driven by the policy underlying the settlement-payment avoidance protection.

There appears to be no disagreement among the courts that the underlying policy supporting the settlement-payment avoidance protection is the reduction of systemic risk.[123] Consider in this context the numerous studies by various securities-industry organizations that have addressed the various risks-associated systems for

119. *See Enron*, 651 F.3d at 331 ("The broker-dealers then transferred the notes to the DTC account of Enron's issuing and paying agent, Chase IPA[.]").

120. *See id.* ("Immediately after the broker-dealer received payment, the commercial paper Enron redeemed was extinguished in the DTC system.").

121. *See id.* at 338. Enron's dealers generally took the position that they were not acting as principals but only as agents. Had a dealer actually bought a holder's commercial paper in its own capacity as principal—and thereby assumed the risk that Enron would fail to make the payment necessary to retire the paper—in my view, the payment to the original holder by the dealer clearly would have involved a settlement payment. If the defendants affected by the Second Circuit's decision in *Enron* had sold their commercial paper to a dealer acting as principal, then the Court would have reached the right result—no liability. But the Second Circuit never mentioned this issue.

122. *See id.* at 331 ("The broker-dealers then transferred the notes to the DTC account of Enron's issuing and paying agent, Chase IPA, and received payment from Enron through the DTC. Immediately after the broker-dealer received payment, the commercial paper Enron redeemed was extinguished in the DTC system.").

123. *See*, *e.g.*, *id.* at 334 (quoting *Kaiser Steel Corp. v. Charles Schwab & Co., Inc.*, 913 F.2d 846, 849 (10th Cir. 1990) (quoting H.R. REP. NO. 97-420, at 2 (1982), *reprinted in* 1982 U.S.C.C.A.N. 583, 583)) (stating Congress enacted § 546(e)'s safe harbor in 1982 as a means of "minimiz[ing] the displacement caused in the commodities and securities markets in the event of a major bankruptcy affecting those industries"). If a firm is required to repay amounts received in settled securities transactions, it could have insufficient capital or liquidity to meet its current securities trading obligations, placing other market participants and the securities markets themselves at risk.

clearance and settlement. Intermediated holding systems, and systems for clearance and settlement of securities transactions in particular, necessarily implicate various risks for market participants. For example, principal risk in the settlement of securities transactions is the risk that payment might be made and the delivery of the security would not be forthcoming or that delivery might be made and payment would not be forthcoming.[124] Moreover, even if a seller of securities does not deliver because payment is not forthcoming, the absence of the expected funds may expose the seller to liquidity risk.[125] The seller may be forced to borrow funds or sell assets in order to meet its own payment obligations. When a seller is not paid, it is also exposed to replacement-cost risk. This risk is that the market value of the securities involved is less than the contract price.[126] A buyer is similarly exposed to replacement-cost risk if the market price of the securities that are not delivered to the buyer is higher than the contract price.[127] Moreover, these risks in clearance and settlement systems also can lead to systemic risk—the risk that an institution's inability to meet its obligations in timely fashion will cause other institutions to be unable to meet their obligations when due.[128] The insolvency-related risks addressed in the various reports on clearance and settlement generally relate to the insolvency of a system participant, an investor's intermediary, or a bank through which payments are transmitted.[129]

Note the absence in the foregoing discussion of another risk that all investors in a security always assume and accept—the risk that the *issuer* of the security will become subject to an insolvency proceeding. This risk is part and parcel of the investment decision that must contemplate the possibility that equity securities will become worthless and that debt securities will not be paid. This issuer risk includes the attendant risk that pre-insolvency proceeding payments might be clawed back into the insolvency estate under an avoidance power available under the applicable law.

Given this distinction between issuer risk and the various other risks inherent in intermediated holding systems, and clearance and settlement systems (including

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124. *See*, *e.g.*, International Federation of Stock Exchanges, 'Clearing and Settlement Best Practices' [hereinafter, IFSE, Best Practices] at 11 (1996); Bank for International Settlements, Committee on Payment and Settlement Systems of the Central Banks of the Group of Ten countries, 'Delivery Versus Payment in Securities Settlement Systems' [hereinafter, BIS, DVP] at 3, 13, A2-2, A2-6 (1992).

125. *See*, *e.g.*, IFSE, Best Practices, *supra* note 124, at 12; BIS, DVP, *supra* note 124, at 3-4, 13-14, A2-4.

126. *See*, *e.g.*, IFSE, Best Practices, *supra* note 124, at 12; BIS, DVP, *supra* note 124, at 13, A2-6.

127. *Id.* A participant in a system also may face counterparty risks in respect of its customers. For example, a seller of a security through a stockbroker may fail to deliver the security to the stockbroker in a manner that will enable the stockbroker to settle the sale transaction by making a delivery. Or, a buyer of a security may fail to pay its stockbroker. However, in these situations the risks can be controlled by the intermediary, which could refuse to execute a trade before delivery or payment.

128. *See*, *e.g.*, IFSE, Best Practices, *supra* note 124, at 12; BIS, DVP, *supra* note 124, at 14, A2-7.

129. *See*, *e.g.*, COMM. ON PAYMENT AND SETTLEMENT SYS., BANK FOR INT'L SETTLEMENTS, RECOMMENDATIONS FOR SECURITIES SETTLEMENT SYSTEMS 7, 39 (2001) (discussing investor risks concerning creditors of a custodian, the risk of failure of a securities settlement system participant, and the risk of a securities system participant default resulting from insolvency); BIS, DVP at 14, 18 (discussing the risk of settlement bank failure and the risk of a securities settlement system participant default in repayment of credit extended within the system).

systemic risk), *and* further given that the underlying purpose of the settlement-payment avoidance protection is to reduce such risks in the settlement process, *Enron* was incorrectly decided. It should have been resolved based on the following general rule: A "settlement payment" does not include a payment made by an issuer of a security, made in that capacity and acting as such, to or for the benefit of a beneficial holder of that security, received in that capacity and acting as such. The settlement-payment avoidance protection should not apply to rescue a beneficial investor that has been paid by its issuer from the issuer risk that it necessarily assumed. The payments made by Enron as issuer of commercial paper to retire its debt held by beneficial holders through intermediaries (the *only possible* means of holding commercial paper issued in DTC's program) meets this test. This is so regardless of how the payments and retirements are structured—redemptions, repurchases, or otherwise. A corporation's payment to redeem its own shares of stock from the beneficial holders of the stock also would meet the test under circumstances in which the corporation's payment would be avoidable as a fraudulent transfer (as is the case under some leveraged buyout structures).[130]

As already mentioned, a payment by an issuer to a beneficial holder through the DTC commercial-paper program is largely indistinguishable from a purchase-and-sale transaction.[131] Upsetting various intermediate payment steps might indeed impose risks from which system participants should be protected. But it is not necessary to gratuitously rescue a beneficial holder from issuer risk to provide such protection. Returning to the Enron retirement transactions, assume that Enron paid funds to DTC for certain contemplated retirements. DTC next debited the account of Goldman (Enron's dealer acting in connection with the retirements) for the relevant commercial paper and credited Goldman's cash account in the agreed amount of the retirement payment. Goldman's cash account was then debited in the relevant amount, and the relevant beneficial holder's intermediary (for convenience and simplicity, assume that the intermediary also was a DTC participant) was credited with funds in a like amount. Finally, the beneficial holder's intermediary credited the holder's account in the amount of the retirement payment. It is this final step—the ultimate credit to the beneficial holder's account—that should be denied treatment as a settlement payment. It does not follow, of course, that the payment to DTC and the resulting credits to Goldman and the beneficial holder's intermediary should be vulnerable to avoidance. These payments should be classified as settlement payments[132] or should be immune from avoidance because the recipients were merely conduits in the process of paying the beneficial holder.[133]

130. For a recent article examining the settlement-payment avoidance protection under Section 546(e) in the context of purchases of stock in the leveraged buyout context, see Parikh, *supra* note 104, at 305.

131. One distinguishing factor within DTC, however, is the credit of commercial paper to be retired to a special account.

132. They might be considered preliminary settlement payments or interim settlement payments, for example.

133. *See*, *e.g.*, *In re* Parcel Consultants, Inc., 287 B.R. 41, 46 (Bankr. N.J. 2002) ("Property that is subject to avoidance may be recovered from an initial transferee. Although the bankruptcy code does not define initial transferee, courts addressing the issue have determined that where a party is a 'mere conduit' of funds, recovery from that party cannot be had."). Moreover, these payments might not be avoidable even without such avoidance protections. For example, they might not be avoidable as preferences because they were not on account of an antecedent debt. 11 U.S.C. § 547(b)(2) (2012). Alternatively, they could have been made for new value in a contemporaneous exchange. *Id.* § 547 (c)(1)(A).

The policy-driven analysis that I advocate here—that settlement-payment avoidance protection does not embrace protection against issuer risk—depends in part on legislative history regarding concerns about systemic risk in settlement systems. Some courts would eschew reliance on legislative history in the absence of an ambiguity, relying instead of the "plain meaning" of a statute.[134] But the term "settlement payment," even as supplemented by the circular examples included in the definition of the term, has no plain meaning. It is inherently ambiguous.[135] This reliance on policy and legislative history need only serve to explicate the meaning of the term "in the context of the securities industry," as expressed by the *Enron* court.[136]

C. *The Second Clause of Subsection (e): Avoidance Protection for Transfers in Connection with Securities Contracts.*

In rejecting Enron's argument that a settlement payment must involve a purchase and sale and not merely the retirement of debt, the *Enron* majority also rejected the suggestion by Enron and the dissent that a determination that the payments were settlement payments could mean that the repayment of ordinary loans could be sheltered as settlement payments.[137] The majority concluded that interpreting the term "in the context of the securities industry will exclude from the safe harbor payments made on ordinary loans."[138] But, to apply the majority's own analysis on both Enron's and the dissent's more restrictive views on the proper interpretation, there is nothing in the definition of the term that would support the majority's conclusion that it excludes payments on ordinary loans. The term "security" is defined in the Bankruptcy Code quite broadly to include, inter alia, a "note."[139] Although the definition excludes "debt or evidence of indebtedness for goods sold and delivered or services rendered[,]" so long as a note evidences a loan of funds it would be a security.[140] In sum, the majority's apparent conclusion that

134. *See*, *e.g.*, United States v. Ron Pair Enter., Inc., 489 U.S. 235, 242 (1989) (citations omitted) (quoting Griffin v. Oceanic Contractors, Inc., 458 U.S. 564, 571 (1982)) ("The plain meaning of legislation should be conclusive, except in the 'rare cases [in which] the literal application of a statute will produce a result demonstrably at odds with the intentions of its drafters.' In such cases, the intention of the drafters, rather than the strict language, controls.").

135. For a contrary view, see Parikh, *supra* note 104, at 341–47 (arguing that courts should construe the term "settlement payment" according to its plain meaning and that confusion over the term stems from an erroneous analysis of § 546(e)'s legislative history).

136. Enron Creditors Recovery Corp. v. Alfa, S.A.B. de C.V., 651 F.3d 329, 337 (2d Cir. 2011). Interestingly, under the *Enron* court's interpretation of the definition, under which the limitation in the final clause ("commonly used in the securities trade") modifies only its immediate antecedent ("other similar payment"). *Id.* at 336. There is nothing that ties the rest of the definition to the securities industry (other than its location in Chapter 7, Subchapter III, on stockbroker liquidation). Yet courts have not interpreted the term to include, for example, payments made in connection with the *settlement* of a real-estate sale transaction, the *settlement* of a lawsuit or other claim, a property division *settlement* in a divorce case, or the settlement of a decedent's estate.

137. *Id.* at 336–38.

138. *Id.* at 337.

139. 11 U.S.C. § 101(49)(A)(i) (2012).

140. *Id.* § 101(49)(B)(vii).

under its holding prepayment of an ordinary loan evidenced by a note would not be a settlement payment is highly suspect.

By the time the *Enron* case was decided, it is quite plausible that its holding was without any meaningful precedential effect, except as to the parties before it. *Enron* was decided based on the version of Section 546(e) that was in effect in 2001, when the commercial-paper retirements occurred.[141] As already explained, the protection provided in Section 546(e) was expanded in 2006, affording an even greater opportunity to shelter payments of ordinary loans.[142] After that amendment, it now protects from avoidance any transfer by, to, or for the benefit of, inter alia, a "financial institution . . . in connection with a securities contract."[143] As defined in Bankruptcy Code Section 741(7)(A), a securities contract includes "a contract for the purchase, sale, or loan of a security[.]"[144]

The Second Circuit recently interpreted and applied the second clause of Section 546(e) in *In re Quebecor World (USA) Inc.*[145] The Chapter 11 debtor (Debtor) and Quebecor World Capital Corporation (QWCC) were subsidiaries of Quebecor World, Inc. (QWI).[146] QWCC issued private placement notes that were purchased by investors under note purchase agreements (NPAs).[147] The Debtor and QWI guaranteed the notes.[148] In the face of a potential financial covenant breach that would have cross-defaulted QWI's revolving credit facility, it became necessary to prepay the notes issued under the NPAs.[149] QWCC, the issuer, first proposed to redeem the notes, but it was necessary to restructure the transaction in order to avoid adverse tax consequences.[150] Under the new structure, the Debtor purchased the notes from the noteholders by making a payment in the appropriate amount, as provided by the NPAs, to the trustee for the noteholders, a financial institution.[151] Subsequently, QWCC redeemed the notes from the Debtor in exchange for forgiveness of Debtor's debt to QWCC.[152]

Both the bankruptcy court and the district court held that the Debtor's payment to the trustee was a settlement payment that was protected by Section 546(e).[153] Both

141. *See Enron*, 651 F.3d at 343 n.4 (mentioning that the 2006 amendment to 546(e), if used, would not have changed the Second Circuit's ruling and thus the court relied on the pre-2006 version).

142. *See*, *e.g.*, H. R. REP. NO. 109-648, *supra* note 54, at 8; 2006 U.S.C.C.A.N. 1593

> ([The 2006 amendment] amends Section[] 546(e) . . . of the Bankruptcy Code, which protect[s] margin payments and settlement payments, to also protect transfers made by or to a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, securities clearing agency, or repo participant, in connection with a securities contract, commodity contract, forward contract, or repurchase agreement.).

143. *Id*.

144. 11 U.S.C. § 741(7)(A)(i) (2012).

145. *In re* Quebecor World (USA), Inc v. American United Life Ins. Co., 719 F.3d 94, 97–100 (2d Cir. 2013).

146. *Id.* at 96.

147. *Id.*

148. *Id.*

148. *Id.*

149. *Id.*

150. *In re Quebecor World*, 719 F.3d at 97.

151. *Id.*

152. *Id.*

153. *Id.*

also held the payment to be protected under the second clause of Subsection (e), although with somewhat differing reasoning.[154] The Second Circuit, for its part, held that the payments were protected under the second clause because they were a "transfer made by or to (or for the benefit of) a . . . financial institution . . . in connection with a securities contract."[155] For this reason the Second Circuit did not reach the settlement payments issue.[156] The NPAs "were clearly 'securities contracts' because they provided for both the original purchase and the 'repurchase' of the Notes."[157] Following *Enron*, the court held that payment to the financial institution trustee qualified the payment for Section 546(e) protection even though the trustee was "merely a conduit" and did "not have a beneficial interest in the transfer."[158]

Had the Second Circuit reached the settlement payment issue, no doubt it would have followed *Enron* and concluded that the payment was a settlement payment. Note that in *Quebecor* the Debtor's payment was in fact made in connection with the purchase and sale of a security and completed a securities transaction.[159] Unlike in *Enron*, the Debtor was not the issuer of the securities but was purchasing securities issued by a third party, albeit an affiliate of the Debtor.[160]

Given the breadth of the second clause of Section 546(e) and the definition of "securities contract," is there work left for the settlement payment clause? Stated otherwise, can there be a settlement payment to a stockbroker, financial institution, financial participant, or securities clearing agency that is not also a transfer to such an entity in connection with a securities contract (or commodity contract or forward contract)? I seriously doubt it. On the other hand, it is clear that there are transfers that qualify for protection under that second clause that are not settlement payments. For example, the second clause is not limited to payments but applies to any transfer, including security interests in collateral.

It would be easy enough for a bank or other financial institution to structure a routine extension of credit as a note-purchase agreement (the traditional structure of insurance company "private placement" transactions) instead of the more traditional structure as a loan evidenced by a note. Moreover, the terms of the note-purchase agreement could permit prepayment, purchase, repurchase, or redemption of the note. Certainly such payments would be made in connection with a contract for the purchase or sale of a security, as in *Quebecor*.[161] Consequently, the payments would

154. *Id.*

155. *Id.* at 98 (quoting 11 U.S.C. § 546(e) (2012)).

156. *In re Quebecor World*, 719 F.3d at 98.

157. *Id.* at 98–99 (citing 11 U.S.C. § 741(7)).

158. *Id*. at 99 (citing Enron Creditors Recovery Corp. v. Alfa, S.A.B. de C.V, 651 F.3d 329, 338–39 (2d Cir. 2011)).

159. *Id*. at 96.

160. *Id.* at 99. Because the Debtor was a guarantor of the notes, however, on the reasoning and analysis presented above in Part II.B, I would deny settlement-payment treatment. The risk of non-payment by an affiliate guarantor of the issuer's debt securities, like issuer risk, does not fit the paradigm of the risks that should be protected by Section 546(e) as settlement payments. *But see Enron*, 651 F.3d at 335 (rejecting Enron's argument that without financial intermediary taking title there was no "implicat[ion of] the risks that prompted Congress to enact the safe harbor").

161. Because the Debtor's payment was for the acquisition of the notes of an affiliate of Debtor, the Second Circuit held that Debtor had purchased the notes. *In re Quebecor World*, 719 F.3d at 100. The

not be subject to avoidance (even if not treated as settlement payments). The same would apply to a transfer of collateral, as the protection extends not only to payments but to all forms of transfer. Based on this analysis, it seems that the carve-outs for settlement payments (and probably margin payments as well, in the securities context) have been rendered superfluous. More significantly, the second clause beckons the structuring of ordinary loans as NPAs in order to inoculate payments and other transfers from avoidance. The second clause reflects the triumph of form over substance.[162]

Notwithstanding the Second Circuit's expansive view of settlement payments and its literal application of the broad shelter offered by the second clause, other courts might balk at attempts to shelter ordinary loans through the application of Section 546(e). Consider, for example, the approach taken by the court in *Grede v. FCStone, LLC*, which refused to apply Section 546(e) literally.[163] In *Grede*, the debtor primarily operated as an investment advisor, although it also was a futures commission merchant (which allowed it to advise commodity futures customers).[164] Shortly before the debtor's bankruptcy filing it sold certain securities, received the proceeds of the sale, and distributed the proceeds to some (but not all) of its customers on a non-pro-rata basis.[165] The debtor's liquidating trust brought a preference action against a customer to which proceeds were distributed.[166] The defendant contended that the payment made to it was not avoidable because it was "both a settlement payment made to a commodity broker as well as a transfer made in connection with a securities contract [.]"[167] As the court explained:

> I decline to address these specific arguments because, *regardless of whether the distribution of the . . . proceeds fits under a literal interpretation of § 546(e)*, I find it inconceivable that Congress intended the safe harbor provisions to apply to the circumstances of this case. There are two main bases for my finding. First, applying the safe harbor to shield [the] distributions . . . would create the very type of systemic market risks that Congress sought to prevent with its passage. Second, failing to apply the safe harbor in this case will not result in the unwinding of completed securities and commodities transactions that Congress sought to protect.

court did not reach the question whether the payment would have been protected if Debtor had "redeemed" its own securities. *Id.* But the distinction should make no difference. Either way, the payment would have been made "in connection with a securities contract" (i.e., the NPAs).

162. Only tradition, habit, and custom can account for the structuring of credit transactions as NPAs (featuring investors that purchase the notes), typically issued to institutional investors, and the structuring of bank and credit company extensions of credit as loans evidenced by notes. There is no distinction between the two debtor-creditor relationships under private law. But if lawyers for banks and credit companies have not already advised clients of the potential advantages of the note-purchase structure, it is unlikely that they will give that advice in the future. How would one answer a client who asks why the advice was not given in 2006?

163. Grede v. FCStone, LLC, 485 B.R. 854 (N.D. Ill. 2013).

164. *Id.* at 861.

165. *Id.* at 866–67.

166. *Id.* at 884.

167. *Id.*

> Thus, applying the safe harbor here would produce a result "demonstrably at odds with the intentions of its drafters."[168]

The *Grede* court's appealing policy analysis notwithstanding, given the holdings in *Enron* and *Quebecor*, it seems unlikely to have much influence in the Second Circuit.

CONCLUSION

In this Article I have joined the chorus of those who have called for a rollback on the safe harbors. But I am quite skeptical that Congress will see fit to do so. And I am sympathetic to the idea that change should be approached cautiously with an awareness of possible unintended consequences, such as rapid market contraction.

Perhaps some of the concerns aroused by the safe harbors could be addressed by more direct means that would not require further Congressional action. One such approach is prudential regulation and supervision that is in place, underway, or otherwise authorized. Both in anticipation of rulemakings under Dodd-Frank and as a result of some final rules, and also taking into account losses incurred and observed during the financial and credit crises, the QFC markets have changed. Most QFCs are secured now, and counterparty monitoring and limits are stricter, notwithstanding that the safe harbors remain unchanged. A regulatory approach to concerns about short-term repo financing also is plausible. Dodd-Frank did little to address repos. But the Financial Stability Oversight Council is authorized by Dodd-Frank to recommend new or heightened standards and safeguards for activities that increase risks of, inter alia, significant liquidity problems. Moreover, the Federal Reserve is required to establish prudential standards for large financial institutions, including liquidity requirements. Short-term repo financing as was practiced by Bear Stearns and Lehman could be addressed directly even without tinkering with (or repealing) the safe harbors.

168. *Id*. at 885 (emphasis added) (citation omitted) (quoting United States v. Ron Pair Enters., Inc., 489 U.S. 235, 242 (1989)).