In Defense of the Bankruptcy Code’s Safe Harbors

By Mark D. Sherrill*

Since its enactment in 1978, the U.S. Bankruptcy Code has seen gradual but dramatic enlargement of rights for non-debtor counterparties to derivatives contracts. That enlargement of rights has generally tracked the rapid expansion of the use of derivatives in the United States. In light of the recent financial crisis, many have criticized the scope of the Bankruptcy Code’s safe-harbor provisions and called for them to be narrowed or eliminated. This article rejects several proposals to narrow the safe harbors and argues that the provisions reflect Congress’s effort to balance competing national policies. In contrast to many recent pieces, this article contends that the Bankruptcy Code’s safe harbors provide a net benefit to the United States and its financial stability.

I. INTRODUCTION

In recent years, it has become somewhat of a trend in academic journals to argue for a dramatic narrowing of the Safe Harbor Provisions in the Bankruptcy Code. Some critics go even further and advocate the outright repeal of the Safe

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2. As used herein, the Safe Harbor Provisions refer to 11 U.S.C. §§ 362(b)(6), 362(b)(7), 362(b)(17), 546, 556, 559, 560 & 561 (2012). The Safe Harbor Provisions are a set of statutes in the Bankruptcy Code that provide more beneficial treatment to counterparties of certain financial and commodity contracts, as compared to traditional creditor treatment under the Bankruptcy Code. If the counterparty and the relevant contract meet certain definitional requirements, there are three general areas of benefit from the Safe Harbor Provisions: (a) enforceability of contractual rights to terminate, liquidate, or accelerate the contract; (b) exceptions from the automatic stay with regard to rights of netting and setoff; and (c) exemption from the trustee’s powers to avoid certain types of transfers received from the debtor.

Both academics and legislators have proposed a wide variety of alternatives ranging from modest changes to repeal. Underlying those efforts is often an implication that the safe harbors represent some misbegotten benefit gifted from Congress to a powerful special-interest group.

This article provides a counterpoint. As discussed below, although derivatives markets may occasionally be the forum for abusive practices, they are likely a net positive to American society, including its consumers. The Safe Harbor Provisions guarantee the efficient operation of the derivatives markets for the benefit of their users and their beneficiaries, but they also do much more. At their core, they reflect a policy judgment on the part of Congress that favors a safeguard against systemic risk over the traditional bankruptcy policies of fostering debtor rehabilitation and maximizing creditor recovery. Some bankruptcy practitioners may be surprised by the subordination of those policies that are ordinarily granted the highest priority.

This article argues that the Safe Harbor Provisions represent a legitimate, rational exercise of Congress’s role in balancing competing bankruptcy and non-bankruptcy policies. Although there may be some tradeoffs involved, the overall risk to society is lessened by the inclusion of the Safe Harbor Provisions in the Bankruptcy Code. Part V of this article supports that conclusion by presenting seven principal counterarguments to criticisms of the Safe Harbor Provisions: (a) there is a material difference between derivatives and other contracts; (b) the rights of netting and immediate closeout are systemically important; (c) many criticisms of the Safe Harbor Provisions fail to take a sufficiently broad perspective in analyzing risk; (d) the Lehman Brothers bankruptcy case demonstrates rather than undercuts the utility of the safe harbors; (e) in practice, safe-harbor treatment of collateral is not materially different from traditional bankruptcy treatment of collateral; (f) the Safe Harbor Provisions have no adverse effect on market discipline; and (g) alternatives to the Safe Harbor Provisions have significant disadvantages.

A robust discussion that draws out both sides of the issue is timely. In June 2011, the American Bankruptcy Institute formed the Commission to Study the Reform of Chapter 11 (the Commission), seeking to study and propose necessary reforms to Chapter 11 of the Bankruptcy Code. The Commission formed thirteen advisory committees, including the Financial Contracts, Derivatives and Safe Harbors Committee. Each advisory committee issued a report to the Commission, which then evaluated the reports and synthesized them into final proposals. On December 8, 2014, the Commission issued its Final Report and Recommendations (the Report). The Report included proposed changes to the

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4. Lubben, Repeal, supra note 1, at 328–32.
6. Id. at 124.
7. Id.
Bankruptcy Code on a vast range of topics, most of them far afield from the Safe Harbor Provisions. Among the more relevant sections, however, were proposals to (a) dramatically limit the scope of the definition of “forward contract,” (b) narrow the scope of exemptions for market participants from trustees’ avoidance powers, and (c) abridge the rights of parties to repurchase agreements. Subject to the whims of the political process, Congress will likely consider the reform initiatives proposed in the Report.

Separate from the Commission’s efforts, Congress has recently taken an active interest in modifying the rights of nondefaulting parties under the Safe Harbor Provisions. First, Senator Elizabeth Warren introduced legislation in the last Congress that provided for the repeal of many of the Safe Harbor Provisions. Nine senators—six Democrats, two Independents, and one Republican—joined Senator Warren to cosponsor the bill. Representative John Tierney introduced a substantially identical bill in the House of Representatives, cosponsored by thirteen members of Congress. Although neither of those bills passed either house, they reflect the same vein of academic thinking advanced by the articles cited above.

Second, each house of Congress also introduced legislation that would modify the rights of nondefaulting parties to terminate their contracts after a bankruptcy filing by a large financial institution. Like the mechanism contained in the Orderly Liquidation Authority (OLA) of the Dodd-Frank legislation, those bills provided for a two-day stay of such termination rights, during which time the debtor would be permitted to seek to transfer its derivatives book to a bridge company. If the debtor successfully assigned the derivatives contracts, the non-defaulting party would be further enjoined from terminating after the assignment

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9. See id. at 94–110.
10. See S. 1282, 113th Cong. § 5 (2013) (proposing the repeal of 11 U.S.C. §§ 555, 559, 560, 561 & 562). The bill would have repealed nearly all of the provisions in the Safe Harbor Provisions that preserve termination and liquidation rights but would have left untouched section 556 of the Bankruptcy Code—the provision providing for safe-harbor rights under forward contracts. It is unclear why the bill would have spared the forward-contract provision; its omission from the bill may have been an oversight.
14. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, §§ 201–217, 124 Stat. 1376, 1442–520 (2010) [hereinafter Dodd-Frank Act]. The stay period under the OLA is one day, however. In addition, under the OLA treatment, a nondefaulting party is stayed against a solvent counterparty if that counterparty has credit support or other connections to a party subject to an OLA proceeding.
15. S. 1861, 113th Cong. § 4 (2013); H.R. 5421, 113th Cong. § 3 (2014). Likewise, the ISDA 2014 Resolution Stay Protocol (the “ISDA Protocol”) represents a contractual amendment to the ISDA Master Agreement (see infra notes 50–52 and accompanying text) under which adherents agree to a similar stay of termination rights against covered financial institutions. See ISDA 2014
of its contracts.16 Like the Warren and Tierney bills, neither piece of legislation became law, but there is some likelihood of similar efforts in the future.

In addition, lower courts throughout the country continue to issue rulings that often take a narrow view of the scope of the Safe Harbor Provisions.17 On appeal, such rulings have frequently been overturned, often with the appellate courts emphasizing the plain meaning of the statutory text.18 Although those appellate rulings provide beneficial support to the “plain meaning doctrine”19 within the context of the Safe Harbor Provisions, one presumes that some lower-court opinions that take more divergent views do not get appealed. Far too often, lower courts employ a preconception similar to that of the Grede district court, which summarized its conclusion in the following manner: “[R]egardless of whether the distribution . . . 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.”20

The lower-court opinions that limit the safe harbors are fundamentally different from the academic and legislative efforts mentioned above. The courts, in some cases, seem to misconstrue the statutes as currently written. In contrast, the academics and legislators presumably acknowledge the current state of the law and seek to modify it. Nevertheless, both reflect a tide flowing against the market participants who seek to enjoy robust rights under the Safe Harbor Provisions, now and in the future. The following is an endorsement of such rights.

II. DERIVATIVES MARKETS AND THEIR BENEFITS

This article will assume some familiarity with derivatives contracts generally, but nevertheless, a brief history of derivatives markets is in order. Although some forms of modern derivatives date back to farmers’ hedging activities in the mid-1800s,21 the more relevant part of their history occurs over the past fifty years.
During that span, markets have evolved from including only futures contracts and forward contracts to a broad “panorama” of agreements.  

**A. GROWTH AND DEVELOPMENT OF DERIVATIVES MARKETS**

A derivative is defined as a “financial instrument whose value depends on or is derived from the performance of a secondary source such as an underlying bond, currency, or commodity.” Derivatives are commonly used to hedge pre-existing risks, such as when a textile mill buys cotton futures to hedge against rising cotton prices, but they can also be used in profit-seeking, or speculation. In the context of the Bankruptcy Code, derivatives contracts are understood to include securities contracts, commodities contracts, forward contracts, repurchase agreements, swap agreements, and master netting agreements.

In the United States, futures contracts first developed in Chicago in 1865 as a method for agricultural players to guard against price risk. As early as 1873, the Chicago Board of Trade (CBOT) instituted rules regarding member solvency; and by 1883, the CBOT had created an early model of the clearinghouse. Futures contracts and the clearinghouse model were later validated in *Board of Trade of Chicago v. Christie Grain & Stock Co.*, which led to the CBOT’s creation of a more formal clearinghouse. Beginning in 1936, the federal government imposed various legislative and regulatory restrictions. Nevertheless, those restrictions did not prevent the development of the futures market as a significant risk-management tool throughout much of the twentieth century. In 1978, as the federal government began to curtail energy pricing programs, the New York Mercantile Exchange introduced the first futures contracts for energy products. Starting in the early 1980s, however, market participants began to develop an alternative in the form of swap agreements. Swap agreements are like futures.

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25. This article will refer to the foregoing list of derivatives contracts as “Safe Harbor Contracts.” Although there may be some academic discussion as to whether all derivatives contracts qualify as safe-harbor contracts and vice versa, this article generally treats the two as synonymous.
28. 198 U.S. 236 (1905).
29. Duff & Zaring, supra note 27, at 682.
32. Greenberger, supra note 26, at 131–32.
contracts because their value is tied to some external underlying asset, yet they are fundamentally different because they were historically traded over the counter (OTC), or off-exchange, with a direct counterparty rather than a clearinghouse. 33

Prior to the development of swap agreements, “financial institutions and commercial end-users were undoubtedly aware of the theoretical benefits associated with employing OTC derivatives, [but] legal uncertainty historically inhibited the growth of privately negotiated agreements.” 34 Prior to the 1980s, market participants accepted the rigidity of exchange rules as a necessary tradeoff for the certainty that their contracts would be legally enforceable. 35 As the legal uncertainty fell away, 36 some participants began to favor OTC trades because such trades left them “free to make their own assessments regarding which parties to trade with, what types of margin requirements to impose, and how to structure a particular transaction.” 37

Needless to say, the growth of the derivatives markets accelerated greatly after the 1980s as well. 38 No article on derivatives is complete without a note about the staggering size of those markets. The Bank for International Settlements (BIS) estimated the derivatives market, as of December 2013, to be $710 trillion in notional amounts. 39 In comparison, the aggregate notional amount was estimated at $2 trillion in 1990, 40 $88 trillion in 1999, 41 and $128 trillion in June 2002. 42 The growth in the OTC market, in particular, has been described as an “explosion.” 43 “By 2008, only sixteen percent of the notional amount of this market was trading on exchanges.” 44

The legal and regulatory treatment of OTC derivatives surely contributed to the rapid expansion of the market. In the years between the introduction of swap agreements and the passage of the Dodd-Frank Act, 45 the federal govern-

34. Id.
35. See id.
37. McBride, supra note 33, at 1086.
38. Both the derivatives markets and the Safe Harbor Provisions encompass many other types of contracts beyond futures and swaps. The narrative here focuses on those two because the emphasis is on the development of OTC markets, where swap agreements are emblematic.
39. Derivative Statistics, BIS Q. Rev. A141 & tbl. 19 (June 2015), http://www.bis.org/statistics/dt1920a.pdf. It is debatable just how informative the aggregate notional amount is, considering that the notional amount typically does not change hands in a swap. As an alternative indicator, also as of December 2013, the BIS estimated $18.8 trillion in gross market values of outstanding derivatives. See id. Some have also questioned how reliable any of these estimates can be. See, e.g., Hance, supra note 1, at 724.
40. Mooney, supra note 1, at 249.
41. Duff & Zaring, supra note 27, at 685.
42. Shmuel Vasser, Derivatives in Bankruptcy, 60 BUS. LAW. 1507, 1508 (2005).
43. McBride, supra note 33, at 1085.
44. Duff & Zaring, supra note 27, at 687.
45. Because the Dodd-Frank Act moved a significant majority of swaps from the OTC markets to exchanges, see Dodd-Frank Act §§ 711–774, 15 U.S.C. §§ 8301–8344 (2012), the passage of the Dodd-Frank Act is an appropriate bookend.
ment acted to aid the market on several occasions. For example, a 1989 policy statement from the Commodity Futures Trading Commission (CFTC) effectively exempted swap agreements from the scope of the Commodity Exchange Act (CEA).46 Similarly, in 1992, Congress passed the Futures Trading Practices Act, which amended the CEA to authorize and clarify such exemptions.47 Finally, Congress—at the recommendation of the President’s Working Group48—passed the Commodity Futures Modernization Act of 2000, which “removed many of the remaining barriers to the development and use of OTC derivatives.”49 The evolution of the Bankruptcy Code’s Safe Harbor Provisions, discussed below in Part III, must also be recognized as part of the government’s role in the development of the market.

Nevertheless, private forces certainly played a prominent role as well. The International Swaps and Derivatives Association (ISDA), a trade organization of OTC derivatives participants, developed a series of form contracts.50 The ISDA Master Agreement is eighteen pages long, providing standardized treatment of various terms of significance.51 The availability of such standardized forms—and the market’s recognition of the reliability that the forms provide—was a significant factor in the growth of the OTC markets: “By employing the derivatives documentation provided by the ISDA and other similar organizations, counterparties to OTC derivatives transactions are able to minimize the expense associated with participation in the OTC market and, concurrently, benefit from the wealth of legal precedent regarding how various courts and attorneys have interpreted the agreements.”52

Similarly, the ISDA contracted with numerous outside law firms to obtain legal opinions regarding enforceability of netting and collateral provisions in its form documentation, providing market participants with a greater degree of certainty concerning legal risks.53 The willingness of market participants to rely on those opinions provided another fundamental building block. ISDA also has a robust network of committees, to help keep pace with market demands. For example, the association’s documentation committee boasts “about 3000 people . . . [who] react[] quickly to modify documents—striking and

46. Policy Statement Concerning Swap Transactions, 54 Fed. Reg. 30694 (July 21, 1989); Greenberger, supra note 26, at 133; see also William D. Harrington, International Refining and Hedging of Mineral Products, 43 ROCKY MTN. MIN. L. INST. 11-1, 11-18 (1997) (stating that, “[u]ntil 1990, there was great uncertainty whether cash-settled forward contracts were illegal futures contracts”).
47. Greenberger, supra note 26, at 133–34.
48. The President’s Working Group consisted of representatives from the Department of the Treasury, the Board of Governors of the Federal Reserve System, the Securities and Exchange Commission, and the CFTC. Hance, supra note 1, at 750.
49. McBride, supra note 33, at 1088.
51. Greenberger, supra note 26, at 135.
52. McBride, supra note 33, at 1086.
53. Id.
B. BENEFITS OF THE DERIVATIVES MARKETS

The farmer who traveled to Chicago in 1865 did so because he faced risk regarding the future prices of corn, wheat, and other grains. To guard against that risk, he would enter into a contract to buy or sell a set quantity of the relevant commodity in the present, with delivery to occur at a future specified time. Such contracts allowed farmers or other “producers of raw materials to respect the delivery requirements of their clients while eliminating the price risk associated with sales that will take place in the future.”

Likewise, derivatives today allow companies and individuals to manage the risks that they face as they conduct their business. They are used broadly across the marketplace; in 2003, the ISDA reported that 92 percent of the world’s largest 500 companies used derivatives. Furthermore, the ISDA study concluded that 85 percent of those companies used derivatives “to manage interest rate risk; 78% use[d] them to manage currency risk; 23.5% use[d] them to manage commodity prices and 11% use[d] them to manage equity price risk.”

Futures contracts provide for an effective hedge against price risk when an exchange offers the appropriate contract. Exchanges cannot offer contracts on every imaginable product, however; among other problems, trading would be virtually nonexistent on some of the more arcane contracts. OTC contracts, on the other hand, can be closely tailored to the needs of each market participant. Similarly, the decentralized nature of the OTC markets allows for more individualized negotiation. OTC market participants “are free to make their own assessments regarding which parties to trade with, what types of margin requirements to impose, and how to structure a particular transaction.” For example, a trader with liquidity constraints may be able to negotiate an OTC swap with lesser margin requirements in exchange for less favorable pricing. Such an arrangement would be impossible in the futures markets, where margin requirements are standardized and governed by exchange rules.

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55. Greenberger, supra note 26, at 128.
56. See CLARK ET AL., supra note 22, at 31.
57. Id. at 33.
58. Vasser, supra note 42, at 1509.
59. Id.
60. See McBride, supra note 33, at 1085–86.
61. Id.
62. Id. at 1086.
63. This discussion is admittedly backward-looking. The forthcoming margin rules from the Federal Reserve and other regulators may alter the ability to negotiate the lower margin discussed herein. See, e.g., Margin and Capital Requirements for Covered Swap Entities, 79 Fed. Reg. 57348 (proposed Sept. 24, 2014) (to be codified at 12 C.F.R. pt. 45).
Derivatives may be useful in mitigating credit risk in other ways as well. For example, “credit derivatives . . . allow lenders to divide the overall lending risk into its two main components, interest rate risk and credit risk. Separating the components of the risk involved in a lending transaction makes it easier for the lender to protect itself against loss, and in turn will make the lender more likely to lend.”

The lender’s willingness to lend is emblematic of many of the benefits of derivatives in that they indirectly benefit the larger society. The greater willingness to lend leads to home ownership, small business success, and economic growth. Likewise, a manufacturer’s effective hedge of price risk leads to lower costs for the consumer.

Although counterparty credit risk is the most obvious risk addressed by derivatives, they also provide for hedging against other, more obscure types of risk. For example, an “amusement park owner might enter into a temperature derivatives contract to hedge against summer heat waves (or hurricanes or earthquakes or blizzards) that predictably lower attendance at, and revenue generated by, his amusement park.” Again, guarding against event risk will presumably inure to the consumers’ benefit in the form of lower ticket prices. Other issues that traders must address, often through derivatives contracts, include price risk, market risk, foreign-exchange risk, volumetric risk, geopolitical risk, liquidity risk, technology risk, fuel risk, taxes, regulatory risk, operational risk, speed issues, and news risk. Quite simply, prudent business practices demand that any entity safeguard against those issues—whether through risk-management programs, traditional insurance policies, or hedging with derivatives contracts.

III. THE SAFE HARBOR PROVISIONS

When the Bankruptcy Code was enacted in 1978, it contained very little that could be considered similar to the present Safe Harbor Provisions. In this original Code, the only provision related to derivatives was “an exemption from the automatic stay for non-debtor brokers and forward merchants with respect to transactions involving margin payments or deposits received from a debtor under a commodities contract or a forward contract.”

Congress made its first serious foray into bankruptcy and derivatives in 1982 with amendments protecting forward contracts, commodity contracts, and

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security contracts.\textsuperscript{69} Congress added protections for repurchase contracts in 1984,\textsuperscript{70} for swap agreements in 1990,\textsuperscript{71} and for master netting agreements in 2005.\textsuperscript{72}

Viewed broadly, there are three primary components to the Safe Harbor Provisions. First, notwithstanding the general prohibition on \textit{ipso facto} clauses,\textsuperscript{73} market participants are guaranteed the ability to exercise contractual rights to terminate, liquidate, or accelerate their Safe Harbor Contracts as triggered by a bankruptcy filing.\textsuperscript{74} Second, the Safe Harbor Provisions allow contractual setoff or netting rights without the application of the automatic stay.\textsuperscript{75} Third, certain types of prepetition transfers are exempted from the avoidance powers granted to trustees and debtors in possession.\textsuperscript{76}

With each of the aforementioned amendments to the Bankruptcy Code, Congress emphasized the desire to minimize systemic risk.\textsuperscript{77} As the financial markets evolved and new products were developed, some worried that the existing protections were outdated. “The markets became increasingly concerned that the inconsistent and outdated Safe Harbor Provisions would not protect newer innovative contracts and counterparties’ ability to close out transactions and to net obligations in the event of a failure of a large financial market participant.”\textsuperscript{78} Therefore, the legislative history repeatedly refers to efforts to forestall “the potentially massive losses and chain reaction of insolvencies that could occur”\textsuperscript{79} and to “reduce systemic risk in the financial marketplace.”\textsuperscript{80}

\textbf{A. OVERLAY OF MARKET EVOLUTION AND SAFE HARBOR AMENDMENTS}

It is instructive to note and synthesize the timing of the various developments outlined above. At the time of the enactment of the Bankruptcy Code in 1978, the derivatives market was relatively sparse. Although there were some forms of option trading and repurchase agreements, none resembled the robust markets

\begin{itemize}
\item \textsuperscript{73} See 11 U.S.C. § 365(e) (2012).
\item \textsuperscript{74} See id. §§ 555, 556, 559, 560, 561.
\item \textsuperscript{75} See id. §§ 362(b)(6), (b)(7), (b)(17), 560, 561.
\item \textsuperscript{76} See id. § 546(e), (f), (g), (h), (j).
\item \textsuperscript{77} See Eleanor Heard Gilbane, Testing the Bankruptcy Code Safe Harbors in the Current Financial Crisis, 18 AM. BANKR. INST. L. REV. 241, 242–44 (2010).
\item \textsuperscript{78} Id. at 244.
\end{itemize}
seen today. For hedging purposes, the futures contract and, to a lesser extent, the forward contract were the primary derivatives contracts at that time. It stands to reason that those two types of derivatives were the only types granted any protection in the original Bankruptcy Code.

In 1982, Congress added special provisions for forward contracts, commodity (i.e., futures) contracts, and security contracts. In doing so, it noted: “Certain protections are necessary to prevent the insolvency of one commodity or security firm from spreading to other firms and possibly threatening the collapse of the affected market.” At that juncture, the scope of the Safe Harbor Provisions reflected the still-modest scope of the derivatives market generally, and yet the addition of security contracts also marked the beginning of the expansion of the types of contracts protected.

Around the same time, market participants began to develop swap agreements and the OTC market. Additionally, just two years later, Congress revisited the Bankruptcy Code to alter[] Sections 546(e) and 555 to broaden their applicability . . . [and to] introduce[] Section 559.” Those provisions broadened the scope of rights provided to traders of securities contracts and repurchase agreements. In 1985, the ISDA was founded to advance the stated goal of making “OTC derivatives markets safe and efficient.”

By 1990, the swaps market was almost ten years old and began crossing over from financial to commodity hedging. Market participants expressed concerns that “the potential exposure for all swap counterparties [would be] materially increased, and this could undermine the basic foundation of the swap market.” Congress responded by expanding the Safe Harbor Provisions to include swap agreements. In doing so, Congress attempted to “ensure that the swap and forward contract financial markets are not destabilized by uncertainties regarding the treatment of their financial instruments under the Bankruptcy Code.”

Even in the relatively mature futures markets, this was a period of great expansion. For example, the New York Mercantile Exchange did not offer a natural gas

82. See supra note 68 and accompanying text.
83. See supra note 69.
85. See supra notes 32–37 and accompanying text.
86. Mooney, supra note 1, at 248 (footnotes omitted); see also supra note 70.
91. See supra note 71.
futures contract until 1990. In 2001, it offered its first exchange of futures for swaps, or EFS.

In 1998, Long-Term Capital Management (LTCM) collapsed, with fears of a ripple effect allayed by a $3.6 billion payment provided by private banks but arranged by the Federal Reserve Bank of New York. At that time, the President’s Working Group had already introduced its proposed legislation to update the Bankruptcy Code, but the LTCM insolvency “further ignited fears of a domino effect and systemic collapse if the Bankruptcy Code and the Safe Harbor Provisions were not amended.” Those legislative proposals eventually evolved into the 2005 amendments, which sought “to clarify that the safe harbor treatment would apply to the expanded derivative markets as they had evolved.”

Among the new provisions in the 2005 amendments was section 561, which specifically applies to master netting agreements and governs cross-contract and cross-product netting rights. Master netting agreements were developed in the mid-1990s and by 2002, they were heavily used in the dealer community. Because of the rapid evolution of the master netting agreement in the market, the draft legislation proposed by the President’s Working Group in 1998 included the master netting agreement provisions among its netting rights.

Finally, Congress amended the Safe Harbor Provisions again in the Financial Netting Improvements Act of 2006 (the FNIA). Although the FNIA was less extensive than the 2005 amendments, it, too, broadened the scope of the rights of the nondefaulting counterparty. For example, the FNIA resulted in more expansive definitions for the terms “swap agreement,” “securities contract,” and “forward contract.”

B. ADDITIONAL OVERLAY: THE CONCEPT OF SYSTEMIC RISK

Systemic risk has been defined as “the risk that (i) an economic shock such as market or institutional failure triggers (through a panic or otherwise) either (X) the failure of a chain of markets or institutions or (Y) a chain of significant losses to financial institutions, (ii) resulting in increases in the cost of capital or decreases in its availability, often evidenced by substantial financial market volatil-

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93. Id.
94. See Vasser, supra note 42, at 1508.
96. See supra note 72.
97. Gilbane, supra note 77, at 248.
100. See Mark A. Guinn & William L. Harvey, Taking OTC Derivative Contracts as Collateral, 57 BUS. LAW. 1127, 1148 (2002).
101. See Gilbane, supra note 77, at 247.
ity.”104 History includes many instances in which one might identify systemic risk. For example, scholars frequently point to the Great Depression as an example of a time when systemic risk was present.105 The fundamental difference between systemic risk then and systemic risk today “is the extent of interconnectivity between institutions both in the United States and abroad. Even today, financial institutions are increasingly interconnected, and greater interconnectivity creates more opportunities for financial contagion transmission.”106

Nevertheless, systemic risk as a theory is relatively young.107 A search by the Federal Reserve Bank of Atlanta revealed that the “first appearance of the term systemic risk in the title of a paper in professional economics and finance literature was in 1994.”108 One might surmise that academics and policymakers discussed systemic risk and perhaps included the term in the text of their literature for a handful of years before it first appeared in a title. Dating the first use of the term in a title to 1994, however, does give some sense of the relative immaturity of the concept.

In the context of this article, there are two items to note concerning the development of systemic risk as a concept. First, the concern regarding systemic risk grew within the same timeframe outlined above—as the derivatives markets grew rapidly. That stands to reason because derivatives increase the degree of interconnectivity, a key ingredient to systemic risk.109 Second, it should not be considered meaningful if early pieces of legislative history fail to use the specific term “systemic risk” while generally articulating the same concern. It appears likely that the term may not have been coined yet at the time of the early amendments to the Safe Harbor Provisions.110

IV. CRITICISMS AGAINST THE SAFE HARBOR PROVISIONS

There have been several criticisms levied against the Safe Harbor Provisions in recent years.111 The intention of this article is not to defend against all such criticism or to suggest that the Safe Harbor Provisions must remain exactly as they are.112 Rather, this article seeks to present a handful of arguments in favor of

106. Id. (footnotes omitted).
108. Id.
109. See supra note 105 and accompanying text.
111. See supra note 1 (collecting sources).
112. For example, Judge Sontchi levied criticisms against the scope of the Safe Harbor Provisions for repurchase agreements. See Hon. Christopher S. Sontchi, Mortgages Should Be Removed from Repo Agreement Safe Harbors, AM. BANKR. INST. J., June 2014, at 10. This article takes no position on those issues, for at least two reasons. First, the author claims less familiarity with repo markets than with other derivatives markets. Second, “Momma didn’t raise no fool.”
maintaining the statutory scheme in a form relatively similar to its current form. Although there may be useful improvements to be made at the margin, the derivatives markets and the Safe Harbor Provisions work together to provide useful protections for virtually everyone who comes in contact with the financial and commodity markets, directly or indirectly.

Professors Edwards and Morrison were among the first to argue that the modern scope of the Safe Harbor Provisions is incongruent with the prevailing rationale of reducing systemic risk. They pointed to the collapse of LTCM as evidence that the Safe Harbor Provisions do not counteract systemic risk. Because the Bankruptcy Code allows nondebtor counterparties to terminate their derivatives contracts upon a bankruptcy filing, Edwards and Morrison noted that bankruptcy provided little protection to LTCM, which dealt heavily in derivatives. Therefore, they argued, “exempting derivatives counterparties from the automatic stay may make matters worse by increasing systemic risk.”

As additional support for their conclusions, Edwards and Morrison pointed to the bankruptcy case of Enron Corp. and its affiliates (collectively, Enron). They noted that “Enron’s bankruptcy did not destabilize either energy derivatives markets or financial markets generally” and that the ISDA argued that this was a vindication of the Safe Harbor Provisions. Edwards and Morrison, however, pointed to Enron’s annual reports to demonstrate that its derivatives book was one of its few profitable business units. They argued, therefore, that the potential systemic risk was muted not by the Safe Harbor Provisions but by the fact that more derivatives trades would have been in-the-money to Enron.

Jonathon Keath Hance, too, pointed to the “LTCM disaster” in his critique of the Safe Harbor Provisions. Like Edwards and Morrison, he argued that “the Bankruptcy Code is incapable of greatly reducing systemic risk and may actually aggravate it.” In addition, Hance emphasized that the Safe Harbor Provisions allowed “nondebtor counterparties to terminate derivatives agreements held by the debtor and reclaim any underlying collateral. No other creditor enjoys such luxury. For all other credit relationships, the automatic stay protects the debtors’ limited assets until they can be distributed in an economically efficient fashion.”

113. See Edwards & Morrison, supra note 68, at 94. Although it is outside the scope of this article, it is worth noting that Edwards and Morrison ultimately concluded that the Safe Harbor Provisions are justifiable on other grounds. Id. at 121–22.
114. Id. at 102–04.
115. Id. at 99 (noting LTCM’s “operations in derivatives markets were broad and complex”); see also 11 U.S.C. § 362(b) (2012) (setting forth exceptions for certain derivatives to the automatic stay).
117. Id. at 103–06.
118. Id. at 104.
119. Id. at 104–05.
120. Id. at 105.
121. Hance, supra note 1, at 750.
122. Id. at 717.
123. Id. at 737 (footnote omitted).
Professor Lubben has authored a series of articles advocating for the abolition or narrowing of the Safe Harbor Provisions. Consider the provocatively titled Repeal the Safe Harbors, in which he argued that the Safe Harbor Provisions “give the derivatives industry a kind of ‘free pass.’ They get treated as though they established an escrow or securitization, without actually doing it.” Lubben pointed to the 2008 insolvency of American International Group, Inc. (AIG), which presents a similar set of facts to those of LTCM. Whereas most companies in such a downward spiral would have filed for bankruptcy to halt collection actions, “AIG had no such option, especially after 2005. Because the contracts at issue were swap agreements, and subject to the ‘safe harbor’ exceptions in the Bankruptcy Code, the counterparties could have continued to take collateral and previously posted collateral was irretrievable.” He continued:

Before the current crisis, it was often argued that the safe harbors were required to protect the financial system from the threat posed by the Bankruptcy Code. Since those putative benefits do not seem to have materialized, and the financial system has not been harmed by its involvement in Lehman’s domestic bankruptcy case, it is time to reexamine the need for the safe harbors.

In Derivatives and Bankruptcy: The Flawed Case for Special Treatment, Lubben argued that the case for special treatment of derivatives contracts in bankruptcy was “inherently weak.” He pointed to recent literature that had asserted the Safe Harbor Provisions were justified as a countermeasure to a Chapter 11 debtor’s ability to “cherry-pick” executory contracts. Lubben rejected that contention, arguing instead that “the ability to assume and reject contracts under the Bankruptcy Code is not particularly special, and simply reflects the general option to breach and pay damages that exists under non-bankruptcy contract law.”

In his next article, Lubben returns to his critique of the “cherry-picking” argument. He goes on to note the typical argument in favor of the Safe Harbor Provisions based on systemic risk—“the belief that an inability to close out a derivative

124. See Lubben, Repeal, supra note 1; Lubben, Code Without Harbors, supra note 1; Lubben, Flawed Case, supra note 1.
125. Lubben, Repeal, supra note 1, at 334.
126. See id. at 320; see also Henkel, supra note 1, at 97 (arguing that the “obvious conclusion is that the safe harbors did not prevent, but rather created, systemic risk by encouraging, if not incentivizing, a run on AIG’s derivative positions”). The entity triggering AIG’s financial distress was actually its subsidiary, AIG Financial Products Corp. (AIG-FP). See Elizabeth F. Brown, The New Laws and Regulations for Financial Conglomerates: Will They Better Manage the Risks than the Previous Ones?, 60 Am. U. L. Rev. 1339, 1370–74 (2011). Lubben treats the two as one—see Lubben, Repeal, supra note 1, passim (referring generally to AIG throughout)—but the distinction may not be meaningful, as the liabilities of AIG-FP almost certainly rendered AIG insolvent as well. See Brown, supra, at 1374.
127. Lubben, Repeal, supra note 1, at 320 (footnotes omitted).
128. Id. at 321 (footnote omitted).
129. Lubben, Flawed Case, supra note 1, at 62.
130. Id. at 61–62 (citing Alan Schwartz, A Normative Theory of Business Bankruptcy, 91 Va. L. Rev. 1199 (2005)).
131. Id. at 78.
132. Lubben, Code Without Harbors, supra note 1, at 130.
position because of the automatic stay would cause a daisy chain of failure amongst financial institutions.” Lubben rejected that notion, however:

The problem with this argument is that it fails to consider the risks created by the rush to close out positions and demand collateral from distressed firms. Not only does this contribute to the failure of an already weakened financial firm, by fostering a run on the firm, but it also has consequent impact on markets generally, as parties rush to sell trades with the debtor and buy corresponding positions with new counterparties. It is not clear that this latter disruption, created by the safe harbor exceptions to the automatic stay and the debtor’s avoidance powers, is not systematically more important than the risk that is put forth in support of the safe harbors . . .

Following Lubben’s lead, Vail Cloar argued that the Safe Harbor Provisions “are best understood as a subsidy to the financial industry, which, far removed from removing systemic risk, necessitate government intervention and ‘too big to fail’ measures.” Like Lubben, he takes aim at the “cherry-picking” argument in favor of safe harbors: “[I]f outrage over ‘cherry picking’ was the cause of the safe harbor provisions, one would expect to see an overhaul of the ability to accept and reject executory contracts (and leases) across the board, not just in the realm of derivative contracts.” Also like Lubben, Cloar criticizes the proposition that “the inability to close out a derivative position . . . would cause a daisy chain of failure amongst the major derivatives players.”

Cloar points to the Lehman Brothers bankruptcy case to support his thesis. He notes that, in the days preceding the Lehman bankruptcy filing, J. P. Morgan “seized $17 billion worth of Lehman’s securities and cash that it held, and demanded another $5 billion.” Whereas Cloar asserts that such actions would ordinarily lead to an action to avoid that transfer, he criticizes the Safe Harbor Provisions for exempting J.P. Morgan from any such avoidance action. “Thus, the rest of Lehman’s non-derivative creditors lost more than their fair share, while their derivative and repo creditors received more than their fair share.”

Finally, Professor Mooney provides a more nuanced criticism. He favors maintaining the status quo with regard to termination rights and the exceptions to the automatic stay, but only under repurchase agreements. For all other Safe Harbor Contracts, he advocates a more moderate approach in which a short stay of one to three days would be imposed against nondefaulting counter-

133. Id.
134. Id. at 130–31 (footnotes omitted).
136. Id. at 1672.
137. Id.
139. Cloar, supra note 1, at 1680.
140. Id.
141. Id. (citing 11 U.S.C. § 547(b)(1)–(4)).
142. Id.
143. Mooney, supra note 1, at 245–47.
144. Id. at 255.
parties.\textsuperscript{145} During that time, the debtor would have the right to assume and assign its derivatives contracts; if the contracts had not been assumed by the end of the stay, then the nondefaulting party would retain its rights to terminate, liquidate, and accelerate.\textsuperscript{146} Mooney also supports modifications to section 546(e) to narrow the class of parties protected from avoidance actions: “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.”\textsuperscript{147}

V. RESPONSES AND COUNTER-CRITICISMS

The following responses are not intended to address the foregoing criticisms on a point-by-point basis. Rather than mimicking a reply brief, this part of the article provides a high-level analysis of the pertinent policies. At a time when the Commission’s Report may influence policymakers with regard to the shape of the Safe Harbor Provisions, it is more important than ever to recognize the following broad principles.

A. THERE IS A MATERIAL DIFFERENCE BETWEEN DERIVATIVES AND OTHER CONTRACTS

Fundamentally, derivatives contracts are different from other types of contracts. Although there are many justifications for the different treatment they receive in bankruptcy, those fundamental differences are a significant part of the reason.

By definition, derivatives are valued by reference to some external factor, which differs from most forms of contracts.\textsuperscript{148} Derivatives’ “inherent characteristics are very different; the value of a derivative is dynamic as it responds to an underlying commodity, interest rate, credit rating, index, etc.).”\textsuperscript{149} The derivative nature of the contract is one key difference, but it is exacerbated by the inherent volatility in the underlying asset or index.\textsuperscript{150}

Suppose a purchaser of goods enters bankruptcy protection but waits one year before rejecting its supply contract.\textsuperscript{151} The damages of the supplier are relatively

\begin{footnotesize}
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\item \textsuperscript{145} Id. at 255–57.
\item \textsuperscript{146} Id. This is not intended to suggest that the short stay advocated by Professor Mooney is a novel concept. It is a common concept in other insolvency statutes and, in recent years, a frequent proposal for amendments to the Bankruptcy Code. See, e.g., 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) (mentioning that Skeel favors a short stay for all derivatives). The novel aspect, to this author’s knowledge, is the suggestion of a bifurcated treatment between repo agreements and other Safe Harbor Contracts.
\item \textsuperscript{147} Mooney, supra note 1, at 262.
\item \textsuperscript{148} See BLACK’S LAW DICTIONARY 509 (9th ed. 2009).
\item \textsuperscript{149} ANTONIO CORBIA, NETTING AND OFFSETTING: REPORTING DERIVATIVES UNDER U.S. GAAP AND UNDER IFRS 14 (2012).
\item \textsuperscript{150} See, e.g., Vasser, supra note 42, at 1510 (stating “market fluctuations . . . create an inordinate risk” (quoting 128 CONG. REC. S15981 (daily ed. July 13, 1982) (statement of Sen. Dole))).
\item \textsuperscript{151} See generally 11 U.S.C. § 365(a) (2012) (providing that the trustee, subject to the court’s approval, may reject any executory contract).
\end{itemize}
\end{footnotesize}
clear: the bankruptcy court would look to state law, which generally determines that the nonbreaching party is entitled to “damages sufficient to place the nonbreaching party in as good a position as the party would have been had the contract been performed.” For the hypothetical supplier of goods, the damages would generally be the contract price, less any amounts already paid and any mitigating factors.

If the supplier of goods had been the bankrupt party, then the purchaser’s damages would be calculated under the same general principles. The purchaser’s expectation interest, however, would be subject to any movements in the market price of the goods. In the event that the cost of goods increased between the time that the parties entered into their contract and the time of valuation, the purchaser would include the cost increase in its claim because that component would be necessary “to place the nonbreaching party in as good a position as the party would have been had the contract been performed.”

A derivatives contract is more like the latter scenario because of market fluctuation. However, the external factors that serve as underlying derivatives contracts—commodity prices, interest rates, foreign exchange rates—are far more likely to move on a day-to-day, or even hour-to-hour, basis. Moreover, the notional amount used in many derivatives contracts serves to amplify even small price differentials in the underlying index or asset. As a result, absent the ability to terminate, the nondefaulting party may face tremendous volatility between the petition date and the time that the debtor decides whether to assume or reject the contract. Particularly when the contract exists for hedging purposes, the effect—on the nondefaulting party, but potentially on the broader market as well—can be dramatic.

Another unique aspect of derivatives contracts is also worth mentioning. Several articles have attempted to rebut the proposition that the Safe Harbor Provisions “prohibit unfair ‘cherry picking’ of contracts by debtors.” Lubben, for one, contends:

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152. Giant Eagle, Inc. v. Phar-Mor, Inc., 528 F.3d 455, 459 (6th Cir. 2008).
155. See 11 U.S.C. § 365(g) (2012) (treating the rejection of an executory contract as a breach); cf. id. § 562(a) (calculating damages as of the earlier of the date of rejection or the date of any liquidation, termination, or acceleration).
158. The meaning of the term “notional amount” is apparently subject to some disagreement. Kelly S. Kibbie, Dancing with the Derivatives Devil: Mutual Funds’ Dangerous Liaison with Complex Investment Contracts and the Forgotten Lessons of 1940, 9 HASTINGS BUS. L.J. 195, 225 (2013). At least in some contexts, however, the notional amount serves as a multiplier applied against the underlying asset price. See id.
159. Lubben, Code Without Harbors, supra note 1, at 129 (citing In re Enron Corp., 349 B.R. 96, 106 (Bankr. S.D.N.Y. 2006)); see also Cloar, supra note 1, at 1672 (suggesting that cherry-picking concern is one of “two main justifications for safe harbor provisions”).
Of course, this ability to decide whether to treat a contract as an asset or a debt is key to the operation of § 365, and applies to all sorts of contracts. It thus imposes no special burden on derivative contracts . . . . [T]he safe harbors simply give the non-debtor party an option to terminate upon a bankruptcy—which amounts to cherry picking from the other side of the deal.160

The structure of the ISDA Master Agreement is noted above,161 but it is worth considering in the present context. The parties to a swap agreement will typically execute a master agreement, which is not negotiated, and a schedule that includes the negotiated terms about the parties’ relationship.162 The transactions themselves are usually documented in separate trade confirmations.163 Although the master agreement, the schedule, and the confirmations are deemed to be a single contract, it is not uncommon for hundreds or thousands of transactions and confirmations to exist underneath a single master agreement.164 Many other forms of derivatives contracts employ a similar structure.

With the structure of derivatives contracts as backdrop, the concern with cherry-picking appears sensible. A fundamental principle of bankruptcy law provides relevant background for the cherry-picking issue: the law generally “does not allow a debtor to ‘cherry pick’ which portions of contracts to assume or reject, but rather the debtor must assume [or] reject the contract in its entirety.”165 If a given master agreement serves as the governing document for over one thousand different transactions—some economically favorable for the debtor in bankruptcy, some for its counterparty—then the nondebtor counterparty would have reasonable concerns about cherry-picking. If the debtor were able to reject all of its unfavorable trades and assume all of its favorable trades, the losses for the counterparty would be significantly worse. Instead, assuming that the contractual documentation provides for those transactions to be part of one unified agreement, bankruptcy law generally prohibits the debtor from cherry-picking and from denying the nondebtor counterparty the benefit of its bargain with regard to the unified contract.166 It requires the contract to be assumed or rejected in toto, just as the counterparty would generally be forced to terminate the entire contract.167 Viewed in the proper context, the concern with cherry-picking is simply a demand to be treated in a manner consistent

160. Lubben, Code Without Harbors, supra note 1, at 130 (footnotes omitted).
161. See supra notes 50–52 and accompanying text.
163. Partnoy, supra note 162, at 431.
167. See, e.g., ISDA Master Agreement § 6(a) (1992) (providing nondefaulting party may designate a day “as an Early Termination Date in respect of all outstanding Transactions” (emphasis added)).
with years of bankruptcy jurisprudence, which prohibits the piecemeal assumption or rejection of an executory contract.

B. THE RIGHTS OF NETTING AND IMMEDIATE CLOSEOUT ARE SYSTEMICALLY IMPORTANT

There is some irony in the efforts to narrow the Safe Harbor Provisions with regard to netting rights. During the same timeframe that legal academics have increasingly argued for less enforceability of netting agreements, economists and regulators have consistently agreed on the global benefits of netting. For example, a recent report by UNIDROIT\(^\text{169}\) (the UNIDROIT Report) noted, “Regulatory authorities (most recently the Cross-border Bank Resolution Group of the Basel Committee on Banking Supervision) encourage the use of such netting agreements because of their beneficial effects on the stability of the financial system.”\(^\text{170}\)

The BIS identified at least five advantages from valid, enforceable closeout netting. First, it reduces the exposure and counterparty risk. Second, it enhances risk management. Third, it improves market liquidity. Fourth, netting rights lead to a decrease in contagion. Fifth, they result in lower capital requirements and lower cost of capital.\(^\text{175}\) The UNIDROIT Report gives more color to each of those assertions. For one, it notes:

Gross exposures between different market participants . . . can be enormous. Close-out netting is an instrument that allows the institutions’ risk situation to be assessed on the basis of net exposure. Therefore, close-out netting has an application in risk management and in the calculation of capital requirements, since the net exposure in the event of default of the counterparty is often only a small fraction of the gross exposure.\(^\text{176}\)

\(^{168}\) See, e.g., House Subcommittee Discusses Financial Institution Resolution Through the Code, Am. BANKR. INST. J., Jan. 2014, at 10 (describing testimony of Prof. Mark Roe to include recommendation to “limit the scope of the Code’s netting provisions”).


\(^{171}\) Klaus Lober, CPSS Secretariat, Bank for Int’l Settlements, Close-Out Netting: Impact on Risk Management and Systemic Risk 2 (Nov. 16–17, 2013). The term “exposure,” in industry parlance, refers to the amount that a party stands to lose from a given contract or a given counterparty. In the context of derivatives contracts, exposure may refer to not only out-of-the-money positions but also in-the-money positions that become uncollectible due to a counterparty insolvency.

\(^{172}\) id.

\(^{173}\) id.

\(^{174}\) id.

\(^{175}\) id.

\(^{176}\) Paech, supra note 170, at 16.
The effect on capital requirements is an important, but underappreciated, aspect of netting agreements. Regulators around the world have increased the capital requirements on banks, but the banks are permitted to calculate those requirements based on their net exposure, subject to additional conditions.\footnote{177} Under the Basel II Accord, banks may use their net exposure only if they have a netting agreement in place and “a well-founded legal basis for concluding that the netting agreement is enforceable in each relevant jurisdiction regardless of whether the counterparty is insolvent or solvent.”\footnote{178}

Finally, more broadly, the UNIDROIT Report underscores the systemic importance of the use of master netting agreements. It states:

The use of close-out netting can prevent this risk of contagion from becoming systemic. . . . This beneficial effect is grounded in the idea that close-out netting shields systematically important market participants from the consequences of their counterparty’s insolvency. . . . This is why the [Cross-border Bank Resolution Group of the Basel Committee on Banking Supervision] . . . mentions enforceable netting agreements in a list of mechanisms capable of mitigating systemic risk \textit{in the first place}, along with collateralisation, segregation of client assets and standardisation and regulation of derivatives over-the-counter transactions.\footnote{179}

C. \textbf{MANY CRITICISMS OF THE SAFE HARBOR PROVISIONS FAIL TO TAKE A SUFFICIENTLY BROAD PERSPECTIVE IN ANALYZING RISK}

An overarching theme of many of the criticisms of the safe harbors is that they harm the debtor and, in turn, the bankruptcy estate.\footnote{180} That is the wrong focus, however, in light of Congress’s identification of systemic risk as the primary purpose of the Safe Harbor Provisions.

As detailed above, Congress has repeatedly emphasized that its reason for enacting various amendments to the Safe Harbor Provisions was its concern with systemic risk.\footnote{181} By definition, systemic risk refers to the dangers posed to the entire financial system because of the failure of one or more firms.\footnote{182} If that is the concern, then commentators must broaden their perspective in analyzing the costs and benefits of the Safe Harbor Provisions.

In other words, it is quite possible for the Safe Harbor Provisions to be detrimental to the debtor and the bankruptcy estate while still protecting against systemic risk and serving the purpose intended by Congress. Bankruptcy profes-

\begin{footnotesize}
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\item \footnote{177} Id. at 18.
\item \footnote{178} Id.
\item \footnote{179} Id. at 18–19.
\item \footnote{180} See, e.g., Lubben, \textit{Repeal}, supra note 1, at 320–21.
\item \footnote{181} See supra notes 77–80 and accompanying text.
\end{itemize}
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sionals and academics who specialize in bankruptcy may be accustomed to a scope of analysis that goes no wider than the interests of the bankruptcy estate. Indeed, the interests of the bankruptcy estate and facilitating a debtor’s rehabilitation are traditionally among the highest priorities of the Bankruptcy Code.183 Nevertheless, critics must recognize that Congress’s role is to weigh bankruptcy policy against any relevant nonbankruptcy policies. The Bankruptcy Code includes numerous instances in which Congress determined that the best interest of the bankruptcy estate must be subordinated to a compelling non-bankruptcy policy.184 So, too, with the Safe Harbor Provisions: if systemic risk is a legitimate concern—and the repeated references in the legislative history suggest that Congress believes it is—then it is only logical to treat any safeguards against systemic risk as a higher policy priority than the interests of the bankruptcy estate.

D. THE LEHMAN BROTHERS CASE DEMONSTRATES—RATHER THAN UNDERCUTS—THE UTILITY OF THE SAFE HARBORS

As noted above, Lubben and Cloar point to the Lehman Brothers bankruptcy as evidence that the Safe Harbor Provisions are unnecessary or harmful.185 On the contrary, however, the Lehman case is a perfect example of the utility—and even the necessity—of the Safe Harbor Provisions.186

As many will remember, Lehman Brothers Holdings Inc. filed its bankruptcy petition on September 15, 2008.187 Although the Lehman bankruptcy may represent the nadir of the financial crisis, it is important to note the full context. In March of the same year, Bear Stearns “nearly collapsed before JPMorgan Chase bought it at a fire-sale price.”188 After several months of relative calm, the federal government seized control of Fannie Mae and Freddie Mac on September 7, placing the two companies in federal conservatorships.189 As Lehman filed its bankruptcy petition, Merrill Lynch & Company (Merrill) averted the same fate by finalizing a merger with Bank of America.190 On September 25, the Federal Depository

184. See, e.g., 11 U.S.C. § 362(d)(3) (2012) (providing relief from the automatic stay against “single asset real estate” when the creditor is secured by an interest in such real estate); id. § 365(n) (providing relief to licensors of intellectual property); id. § 1110 (providing relief to a secured party with an interest in an aircraft or aircraft equipment).
185. See supra notes 138–42 and accompanying text; see also Lubben, Repeal, supra note 1, at 320–21.
186. It is difficult to make any similar argument with regard to the insolvencies of LTCM or AIG. The only counterpart to the criticisms concerning those firms is that amendments to the Bankruptcy Code would be a very indirect means of addressing the problems. In other words, it is true that the Bankruptcy Code did not offer a good solution in the face of the crises involving LTCM and AIG, but it would likely be more efficient to prevent the crises in the first place rather than changing an insolvency statute to accommodate them after the fact.
190. Rich Schapiro, Street Fears Lehman Tsunami, N.Y. DAILY NEWS, Sept. 15, 2008, at 5 (“If Lehman fails, the next bank . . . would be Merrill” (quoting an analyst)).
Insurance Corporation took control of Washington Mutual, and its parent corporation then filed a voluntary bankruptcy petition on September 26.\footnote{191}

Even more relevant is the saga of AIG. On September 15—the same date of Lehman’s bankruptcy petition and Merrill’s merger with Bank of America—credit rating agencies downgraded AIG’s rating, sending its share prices down nearly 61 percent.\footnote{192} The next day, the federal government rescued AIG with an $85 billion loan.\footnote{193}

Although AIG primarily was a traditional insurance company, in the years leading up to the financial crisis, AIG-FP became a major player in the credit default swaps (CDS) market.\footnote{194} Similar to its insurance roots, AIG-FP generally acted as credit insurer for fixed payments.\footnote{195} Before defaults were commonplace—particularly in the markets for collateralized debt obligations, including residential and commercial mortgage-backed securities—AIG-FP used the profits from the CDSs “to fund a $600 million bonus pool for the officers in charge . . . .”\footnote{196} After those markets turned in 2007 and 2008, the CDS liability led AIG to lose $99 billion in 2008 and $61.7 billion in the first quarter of 2009 alone.\footnote{197}

Among AIG-FP’s counterparties, “Goldman Sachs prodigiously purchased CDSs on its portfolios of mortgage-backed securities and other real estate-related assets.”\footnote{198} Although Goldman Sachs may have been the largest counterparty for AIG-FP,\footnote{199} the more salient point is the degree to which a number of major market participants were vulnerable to the failure of AIG-FP: “[A]n exploration of AIG’s demise and its relationships with firms like Goldman offers important insights into the mystifying, virally connected—and astonishingly fragile—financial world.”\footnote{200}

Against that backdrop, consider the perspective of a major Lehman counterparty immediately after its bankruptcy filing. Something akin to a fog of war must have complicated operations; Bear Stearns and Merrill had essentially disappeared, and Fannie and Freddie had essentially been nationalized. With the AIG insolvency looming and rumors circulating about the next firms to fail, systemic risk surely appeared very real. The Safe Harbor Provisions allowed that hypothetical counterparty to terminate its derivatives contracts with Lehman.\footnote{201} If the counterparty was out of the money, it still owed the same amount to

\footnotesize{193. Id.}
\footnotesize{195. Id. at 713.}
\footnotesize{196. Id.}
\footnotesize{197. Id. at 712–14.}
\footnotesize{201. See, e.g., 11 U.S.C. § 560 (2012) (“Contractual right to liquidate, terminate, or accelerate a swap agreement”).}
Lehman. If it was in the money, then it could apply any collateral held, but otherwise was left to file a claim in the bankruptcy. More important, to the extent that its Lehman contracts were for hedging purposes, the counterparty could then return to the marketplace to enter into a new hedge with a more reliable party.

In the absence of the Safe Harbor Provisions, the automatic stay would have prevented the termination of the derivatives contracts.202 The unique nature of derivatives contracts—as discussed above, their value is derived from some external factor—results in ongoing volatility in their value.203 At a time when Lehman and other failures caused significant shocks to multiple markets,204 applying the automatic stay to Lehman’s derivatives counterparties would have increased the risk that those counterparties would suffer unsustainable losses. With major firms already very vulnerable and the financial system “astonishingly fragile,”205 applying the automatic stay to derivatives counterparties would have been far too costly. It is plausible that an application of the automatic stay to Lehman counterparties would have led to some form of domino effect, exacerbating the crisis. As asserted above, a careful balancing of policy objectives leads to the conclusion that it is better to risk some losses by Lehman and its creditors than to risk a greater collapse of the financial system.206

E. IN PRACTICE, SAFE HARBOR TREATMENT OF COLLATERAL IS NOT MATERIALLY DIFFERENT

Critics of the Safe Harbor Provisions often decry the “vast erosion of the automatic stay.”207 One particular complaint is the ability of nondefaulting parties to seize collateral.208 That criticism is true only to a limited extent, however, and the treatment afforded by the Safe Harbor Provisions offers outcomes not dramatically different from those that would transpire in a nonderivatives context.

Section 362(b) contains a number of exceptions to the automatic stay.209 Among the exceptions are several Safe Harbor Provisions aimed at limiting the scope of the automatic stay with regard to derivatives contracts. For example, section 362(b)(17) provides that the stay will not apply to:

the exercise by a swap participant or financial participant of any contractual right (as defined in section 560) under any security agreement or arrangement or other credit

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202. See id. § 362(a).
203. See supra notes 148–50 and accompanying text.
205. Morgenson, supra note 200, at 10.
206. See also Kimberly Summe, Misconceptions About Lehman Brothers’ Bankruptcy and the Role Derivatives Played, 64 STAN. L. REV. ONLINE 16, 18 (2011) (rebutting misconception that, in Lehman’s bankruptcy, “massive destruction of value could have been averted if an automatic stay had been in place for derivatives contracts”).
207. Hance, supra note 1, at 753.
208. See, e.g., Lubben, Repeal, supra note 1, at 320 (asserting AIG had no viable bankruptcy option because “counterparties could have continued to take collateral and previously posted collateral was irretrievable”).
enhancement forming a part of or related to any swap agreement, or of any contractual right (as defined in section 560) to offset or net out any termination value, payment amount, or other transfer obligation arising under or in connection with 1 or more such agreements.210

At first glance, section 362(b)(17) appears to confer broad rights to the nondefaulting party to a swap agreement. In reality, the provision certainly confers some benefit—but perhaps less than appears on the surface.

First, the statute refers to section 560 for a definition of “contractual right.”211 Unfortunately, section 560 does not define the term; it describes “contractual right” and specifies some of what must be included in its scope.212 As a result, there is some ambiguity about what the term should mean in the context of section 362(b)(17). At least conceivably, the reference to section 560 may limit the scope of the automatic stay exception to closeout situations, allowing the nondefaulting party to apply collateral after it has terminated its contract, but not while the contract remains in force.213 If that is the case, section 362(b)(17) would certainly convey some benefits to the counterparty, but not the broad ability to seize collateral that is sometimes suggested.

Second, it is worth considering how events would transpire in a typical scenario. Suppose a debtor enters bankruptcy protection, and, exercising its rights under the Safe Harbor Provisions, its swap counterparty terminates an existing swap agreement.214 It is common, but not universal, for one or both parties to hold collateral, usually in the form of cash or U.S. Treasury bills.215 After the counterparty terminates its swap agreement, section 362(b)(17) provides the exception to the automatic stay, and, similarly, section 560 guarantees the counterparty’s ability to exercise contractual rights to liquidate the contract.216 Accordingly, the counterparty generally can apply the value of the collateral it holds against any amount owed by the debtor. To the extent it was undercollateralized, it is left with an unsecured claim. If the counterparty was oversecured, it must return the excess collateral to the debtor.

210. Id. § 362(b)(17).
211. Id.
212. Id. § 560 (“[T]he term ‘contractual right’ includes a right set forth in a rule or bylaw of a derivatives clearing organization (as defined in the Commodity Exchange Act), a multilateral clearing organization (as defined in the Federal Deposit Insurance Corporation Improvement Act of 1991), a national securities exchange, a national securities association, a securities clearing agency, a contract market designated under the Commodity Exchange Act, a derivatives transaction execution facility registered under the Commodity Exchange Act, or a board of trade (as defined in the Commodity Exchange Act) or in a resolution of the governing board thereof and a right, whether or not evidenced in writing, arising under common law, under law merchant, or by reason of normal business practice”).
213. But see H.R. Rep. No. 109-31, at 132 (2005), reprinted in 2005 U.S.C.C.A.N. 88, 192 (stating that that legislation “amends section 362(b) of the Bankruptcy Code to protect enforcement, free from the automatic stay, of setoff or netting provisions in swap agreements and in master netting agreements and security agreements or arrangements related to one or more swap agreements or master netting agreements. . . . Because the relevant definitions include related security agreements, the references to ‘setoff’ in these provisions . . . are intended to refer also to rights to foreclose on . . . collateral . . . ”).
215. See ISDA Credit Support Annex ¶ 13(b) (1994).
Consider a similar set of facts, but without a derivatives contract. The automatic stay generally would apply to prevent the termination of the contract or the application of the collateral.\(^{217}\) Nevertheless, the counterparty likely would continue to hold the collateral because of the ongoing nature of the contract. Even if the contract were not ongoing—by virtue of rejection, or the counterparty’s termination after receiving relief from the automatic stay, or even after expiring by its terms—the result would likely be the same. The counterparty could not technically apply the collateral or exercise setoff rights without court approval,\(^{218}\) but as a practical matter, it would be unlikely to return the collateral in its entirety without first reaching some form of agreement or accommodation with the debtor.\(^{219}\)

Thus, the derivatives counterparty surely fares better because of the Safe Harbor Provisions, due to its ability to terminate the contract and apply the collateral promptly. From the debtor’s perspective, though, the difference between the derivatives and nonderivatives scenarios is limited. In either case, the debtor is unlikely to see a prompt return of the collateral it has posted. The impact on the debtor, therefore, arises more from its agreement to enter into a secured transaction of any kind—particularly one in which the type of collateral is held by its counterparty—and less from the Safe Harbor Provisions.\(^{220}\)

**F. THE SAFE HARBOR PROVISIONS HAVE NO ADVERSE EFFECT ON MARKET DISCIPLINE**

Some commentators have suggested that the benefits provided in the Safe Harbor Provisions serve to “remove discipline from the derivatives markets by removing the consequences of contracting with an unstable party.”\(^{221}\) Upon closer analysis, however, that appears unlikely. On the contrary, participants in the derivatives markets tend to be very concerned with counterparty credit risk, which is both inherent in many forms of derivatives contracts and one of the reasons for entering into hedging contracts generally.\(^{222}\)

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\(^{217}\) Id. § 362(a)(3), (4), (5).

\(^{218}\) Id. §§ 362(a), 541(a), 553(a).

\(^{219}\) In such a situation, the nondebtor counterparty would follow the tongue-in-cheek version of the Golden Rule: he who holds the gold makes the rules. In other words, the counterparty would continue holding the collateral to increase its negotiating leverage.

\(^{220}\) As discussed above, Cloar points to J. P. Morgan’s alleged seizure of $17 billion worth of Lehman’s collateral and concludes, “[T]he rest of Lehman’s non-derivative creditors lost more than their fair share, while their derivative and repo creditors received more than their fair share.” Cloar, supra note 1, at 1680. In that example, however, J.P. Morgan is necessarily a secured party. It appears to have seized collateral, pursuant to its contractual rights and the Safe Harbor Provisions, but it does not follow that J.P. Morgan received more than its fair share. Even if it had not applied that collateral, secured claims recovered 100 percent under Lehman’s plan of liquidation. See Debtors’ Disclosure Statement for Second Amended Joint Chapter 11 Plan of Lehman Brothers Holdings Inc. and Its Affiliated Debtors Pursuant to Section 1125 of the Bankruptcy Code at 6–14, In re Lehman Bros. Holdings Inc., No. 08-13555 (Bankr. S.D.N.Y. June 29, 2011).

\(^{221}\) Cloar, supra note 1, at 1676.

As with the collateral discussion above, the treatment of derivatives-based creditors is less different from that of typical creditors than the critics suggest. A creditor under a derivatives contract is well-situated to the extent that it holds adequate collateral. If it holds no collateral or insufficient collateral, then it faces the same delayed, pro-rata distribution as other types of creditors. Therefore, there is a clear incentive for market participants to negotiate prudent contractual terms that allow for robust collateral and then to monitor the market fluctuations carefully to ensure that collateral holdings match market positions. If a market participant does so, then he or she will often be relatively well protected from the bankruptcy process—but only because he or she has exercised, not neglected, necessary market discipline.

Indeed, derivatives contracts often include various provisions that specifically address counterparty credit risk and that are uncommon in other types of contracts. For example, the deterioration of a counterparty’s credit rating may trigger either increased collateral requirements or even the termination of the contract. Because sudden market volatility can lead to significant losses and unsecured claims, parties to derivatives contracts should be particularly attuned to “the consequences of contracting with an unstable party.” That volatility, however, generally leads to an increased focus on counterparty credit risk, which, in turn, increases the overall market discipline.

G. Alternatives to the Safe Harbor Provisions Have Significant Disadvantages

In the absence of the Safe Harbor Provisions, the debtor would need to transfer its derivatives portfolio quickly. Most alternative proposals recognize that reality and envision a truncated automatic stay during which the debtor seeks to assign its derivatives contract, such as the proposal from Mooney. Similarly, Lubben states:

It would both reduce systemic risk and enhance the return to the debtor’s creditors to dispose of a financial firm’s derivative portfolio as a whole, perhaps as part of a quick § 363 sale of the debtor’s entire business, rather than see it dismembered in a panic in the sales before and immediately after a Chapter 11 filing.

The Mooney suggestion is similar to the approach employed by the Federal Deposit Insurance Corporation (the FDIC), the OLA of the Dodd-Frank Act, and the approach included in the 2014 Proposed Legislation. One relevant

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223. See Cloar, supra note 1, at 1676 (providing the critics’ view: “Unlike a general unsecured creditor, a derivative creditor knows that it will somehow be paid, or else can at least minimize exposure to the debtor, and therefore has little interest in the stability of the debtor”).


225. Cloar, supra note 1, at 1676.

226. See Mooney, supra note 1, at 255–57.

227. Lubben, Code Without Harbors, supra note 1, at 133.

inquiry is whether, in the absence of a functioning assignee, a bridge company could receive the derivatives portfolio, as permitted in the OLA and essentially required in the 2014 Proposed Legislation. If an insolvency regime allows for the bridge company, then presumably the contracts will almost always get assigned, preserving value for the estate. On the other hand, however, the counterparty may be frustrated by having its contracts assigned and by learning that its contractual anti-assignability provisions are unenforceable. That degree of frustration would likely be even higher when the assignee is a bridge company, which would necessarily be unrated by the credit ratings agencies and would present other credit risk issues for the counterparty.

Without the bridge company, there is less of a burden on the counterparty. There may be times of financial distress when competing firms are unwilling to take on the derivatives portfolio, however, leading to mass terminations after the expiration of the stay. By way of parallel, Lehman Brothers received court authority to transfer its in-the-money derivatives contracts that had not been terminated, but it was generally unsuccessful in finding willing assignees.

Likewise, the idea of a “quick sale” under section 363 is problematic. The Lehman Brothers case seemed to establish the vanguard in terms of the quickest possible bankruptcy sale, when the court approved the sale of substantially all of the debtors’ business (though not the derivatives portfolio) on the fifth day of the case. Because a shorter sale process results in fewer and less informed bidders, one may assume that a bankruptcy court would generally refuse to approve a sale on such an abbreviated time frame, absent exigent circumstances. Indeed, the extreme truncation of the sale process in Lehman Brothers led to considerable confusion and litigation in subsequent years because of the degree of ambiguity in the sale documents.

230. See 11 U.S.C. § 365(f)(1) (2012) (“[N]otwithstanding a provision . . . that prohibits, restricts, or conditions the assignment of such contract or lease, the trustee may assign such contract or lease under . . . this [] section”). Additional sources of frustration may include lack of input with regard to the identity of the assignee, which could trigger follow-on counterparty credit risk or portfolio risk.
231. See Debtors’ Motion Pursuant to Section 105(a) of the Bankruptcy Code and General Order M-143 for Authorization to Implement Alternative Dispute Resolution Procedures for Affirmative Claims of Debtors Under Derivative Contracts at 3, In re Lehman Bros. Holdings Inc., No. 08-13555 (Bankr. S.D.N.Y. July 20, 2009) (requesting relief regarding debtor’s claims for monetary recovery arising from terminated and open prepetition derivative contracts).
The intention here is not to argue against the approval of the Lehman Brothers sale, which, despite the subsequent confusion and litigation, may well have benefited the bankruptcy estate and the broader financial system. Nevertheless, it is difficult to imagine any significant asset sale occurring on a shorter time frame and, therefore, five days likely represents the “quickest sale” practicable. Five days, however, clearly entails considerable sacrifices from what a court and bankruptcy estate would ordinarily require in terms of notice, marketing, and opportunity to object. More important, in the context of a large debtor, five days would likely be too long of a period to enjoin counterparties from terminating during a period of market distress, without driving systemic risk to an unacceptable level. The Mooney proposal is, for a two-day stay, three days shorter than what Lehman Brothers suggests is the quickest sale possible. Ultimately, it may be impossible to reconcile the need for a procedurally adequate sales process with the legitimate needs of counterparties to close out and rehedge their positions.

There is one last notable concern with the stay of termination rights in the OLA, the ISDA Protocol, the 2014 Proposed Legislation, and Mooney’s proposal. Under the present Bankruptcy Code, a rational actor trading under a derivatives contract will generally wait until immediately after the bankruptcy filing before exercising termination rights. That approach allows for a quick exit and the opportunity to rehedge if necessary, but does not cause the more stable party to expend unnecessary time or expense if the counterparty manages to avert bankruptcy (subject to further credit risk analysis). If the applicable insolvency regime stays termination rights, however, then the rational actor will not wait for bankruptcy. Instead, it will likely seek a basis for termination prior to the bankruptcy, to avoid the exposure during the period of the temporary stay and the risks attendant with nonconsensual assignment of the contract. Played out across a number of rational actors/nondefaulting parties, the net effect is to accelerate the “run on the bank” scenario. The party in financial distress will almost never avert bankruptcy, and unsecured creditors will fare even worse.

H. SYNTHESIS

Ultimately, the most important question is whether the financial system features more risk with or without the Safe Harbor Provisions. To some extent, the answer cannot be known with certainty; the last time that the Bankruptcy Code had no Safe Harbor Provisions, the derivatives markets were in their infancy. Therefore, it is impossible to make any empirical determinations concerning the amount of risk in the financial system if the Safe Harbor Provisions were repealed from the Bankruptcy Code.
Notwithstanding the counterfactual nature of the contention, many academics have argued strongly that the Safe Harbor Provisions increase risk. For the reasons discussed above, many of those arguments are flawed. As a result, one might view the question through the following lens: we assume that Congress considered various competing policy interests in passing the Safe Harbor Provisions and that the bills that it ultimately passed reflect its measured consideration of those interests. Nothing contained in the academic critiques discussed herein is sufficiently compelling to overcome that assumption.

One can build a bit more from that fundamental starting point, however. As noted above, legislative history supporting the Safe Harbor Provisions frequently refers to the desire to avoid a “chain reaction” of cascading defaults. In smaller or midmarket bankruptcy cases, perhaps that concern is muted. In the largest bankruptcies, however, there is genuine risk of one defaulting party triggering solvency or liquidity issues for its nondefaulting counterparties if they are unable to exercise contractual remedies promptly.

As discussed in Part V.D above, the Lehman Brothers insolvency provided the most telling example seen to date. With Lehman Brothers freshly in bankruptcy and AIG-FP and other dealers teetering on the precipice of insolvency, the Safe Harbor Provisions almost certainly played a major role in mitigating systemic risk by allowing Lehman’s counterparties to exercise certain contractual rights. The exercise of those rights, without the injunction of the automatic stay, allowed the counterparties to access cash that would otherwise have been frozen. Other major banks may have been the short-term beneficiaries of the Safe Harbor Provisions, but their ability to use that cash—in part to post margin and make payments under other derivatives contracts—provided an even greater benefit to the markets and the financial system as a whole.

VI. CONCLUSION

On the surface, the Safe Harbor Provisions may appear to be nothing more than a giveaway to a powerful lobbying group. There is significant overlap between the universe of traders in the derivatives markets and the country’s largest banks, which undeniably boast a very influential lobby to represent their interests. Nevertheless, the story behind the Bankruptcy Code’s Safe Harbor Provisions is far more nuanced than it would appear at first glance.

For one, despite the heavy involvement of the banks on the dealer side, virtually every large company in the country also uses derivatives contracts for some purpose. In many instances, the ultimate result of those company’s derivatives contracts is a net positive for consumers, such as lower prices from manufacturers. Therefore, the beneficiaries of the Safe Harbor Provisions are a far larger and more diverse group—arguably extending to a vast majority of Americans—than the “giveaway” narrative would suggest.

239. See supra note 79 and accompanying text.
More important than reinforcing the day-to-day benefits of derivatives trading, however, is that the safe harbors serve a larger policy. In enacting the Safe Harbor Provisions, Congress repeatedly articulated its emphasis on combatting systemic risk. That concern may seem distant in many bankruptcy cases, but it is virtually impossible to forecast when systemic risk will appear. When it does—often suddenly, inspiring legitimate fear in the markets—derivatives traders need the ability to be nimble. In those rare instances, the entire financial system benefits from the Safe Harbor Provisions, even if they result in some harm to the bankruptcy estate. Any such harm to the estate and its creditors reflects the policy judgment of Congress that some harm spread across a medium-sized creditor body is preferable to a much greater aggregate harm spread across the entire financial system.