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TRANSACTION SIMPLICITY

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David Skeel and Thomas Jackson come at the important question of derivatives in bankruptcy by wondering why the Bankruptcy Code was largely left out of the Dodd-Frank Act.[1] On one level, it is an odd question: Recent experience notwithstanding, the vast bulk of derivative users in bankruptcy are not financial institutions, and financial institutions are the focus of Dodd-Frank.[2]

Dodd-Frank itself draws a distinction between financial institutions and real economy companies with regard to derivatives: Financial institutions are subject to extra capital requirements, clearing, and exchange trading mandates with regard to derivatives, while "end-users" are largely exempt.[3] This separation reflects the reality that while financial institutions use derivatives for myriad purposes, end-users are almost exclusively hedgers, engaging in derivative trades as an ancillary part of their business.[4] And while their derivatives portfolios can undoubtedly be quite large in absolute terms, the

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1. David A. Skeel, Jr. & Thomas H. Jackson, Transaction Consistency and the New Finance in Bankruptcy, 112 Colum. L. Rev. 152, 153–54 (2012).

2. According to a query run in the UCLA-LoPucki Bankruptcy Research Database, of 941 large Chapter 11 cases in the dataset, 38 involved bank holding companies, 20 involved debtors that owned insurance companies, and six involved broker-dealer holding companies. While some of these bankruptcies involved companies like Lehman or Drexel Burnham Lambert, the vast bulk of these filings involved smaller banks and insurance companies. And in all cases these financial institutions make up just under 7% of all debtors in the database. See UCLA-LoPucki Bankruptcy Research Database, http://lopucki.law.ucla.edu/bankruptcy_research.asp (on file with the *Columbia Law Review*) (last visited May 8, 2012) (with all fields selected in the "First Step" and "Second Step" of the "Design a Study Page" select "Industry" as the variable in the "Third Step" and then select "Submit Query" to view relevant data).

3. 7 U.S.C. §§ 1a, 2, 6s (2006). This distinction is especially clear in § 2(h)(7). For a helpful discussion of central clearing of derivatives, see Anupam Chander & Randall Costa, Clearing Credit Default Swaps: A Case Study in Global Legal Convergence, 10 Chi. J. Int'l L. 639, 651–55 (2010).

4. See Sarah Pei Woo, Regulatory Bankruptcy: How Bank Regulation Causes Fire Sales, 99 Geo. L.J. 1615, 1623 (2011) (discussing financial institutions' increasing usage of "both long and short positions on the same entity"); see also Erik F. Gerding, Credit Derivatives, Leverage, and Financial Regulation's Missing Macroeconomic Dimension, 8 Berkeley Bus. L.J. 29, 37–38 (2011) (reviewing "hedging" derivatives).

amount of derivatives held by financial institutions is another matter altogether.[5] For example, the Office of the Comptroller of the Currency reported in June of this year that Goldman Sachs had the fifth largest derivatives portfolio in the United States, with a total notional amount of more than $50 trillion, and the two largest derivatives traders (JP Morgan Chase and Bank of America) held portfolios of more than $70 trillion each.[6]

Of course, understanding this distinction immediately calls into question the entire foundation for the Bankruptcy Code's special treatment of derivatives and repos. If a non-financial institution derivative or repo user files for bankruptcy and the filing perturbs the financial markets, it seems more likely that this disruption is the result of a failure of risk management at financial institutions than any systemic risk created by the bankruptcy. After all, a financial institution's exposure to an "end-user" is a one-way affair, and the actions of a single client should never threaten the viability of the bank. Nonetheless, systemic risk remains the primary justification for the inclusion of the "safe harbors" for financial contracts in the Bankruptcy Code.[7]

Skeel and Jackson thus correctly highlight what this Response argues is the real motivation for special treatment of derivatives and repos under the Bankruptcy Code: subsidy.[8] Taking these agreements out of the normal bankruptcy process means that counterparties need not incur the cost of the collective process used in this country to resolve financial distress.[9] While Chapter 11 is generally assumed to be socially efficient, exemption from Chapter 11 allows counterparties to make a socially inefficient but individualistically valuable decision.[10] In short, the special treatment of derivatives and repo agreements under the Bankruptcy Code is a subsidy to the financial industry, and it is time it is recognized as such.

Whether this subsidy is a good thing is unclear.[11] On the one hand,

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5. Laurin C. Ariail, The Impact of Dodd-Frank on End-Users Hedging Commercial Risk in Over-the-Counter Derivatives Markets, 15 N.C. Banking Inst. 175, 191 (2011) (noting, for example, that financial institutions constitute 91% of "$437.2 trillion market for interest rate derivatives").

6. These numbers are gross notional amounts. Office of the Comptroller of the Currency, OCC's Quarterly Report on Bank Trading and Derivatives Activities: Second Quarter 2011, at tbl.2 (2011), http://www.occ.treas.gov/topics/capital-markets/financial-markets/trading/derivatives/dq211.pdf (on file with the *Columbia Law Review*) (last visited May 8, 2012).

7. See Kenneth Ayotte & David A. Skeel, Jr., Bankruptcy or Bailouts?, 35 J. Corp. L. 469, 493–96 (2010) (discussing systemic concerns relating to financial contracts in bankruptcy); Bryan G. Faubus, Note, Narrowing the Bankruptcy Safe Harbor for Derivatives to Combat Systemic Risk, 59 Duke L.J. 801, 825 (2010) (explaining special treatment of derivatives in bankruptcy to reduce systemic risk).

8. Skeel & Jackson, supra note 1, at 155.

9. See Kenneth C. Kettering, Securitization and Its Discontents: The Dynamics of Financial Product Development, 29 Cardozo L. Rev. 1553, 1567–68 (2008) (making similar point with regard to asset securitization).

10. See In re Nat'l Gas Distributors, LLC, 556 F.3d 247, 259 (4th Cir. 2009) (allowing gas supply contract to be treated as safe harbored contract).

11. See Colleen M. Baker, Regulating the Invisible: The Case of Over-the-Counter Derivatives, 85 Notre Dame L. Rev. 1287, 1303–09 (2010) (reviewing benefits and costs of derivatives to financial markets).

evasion of the bankruptcy system has obvious costs for unsubsidized creditors and other stakeholders like employees. Namely, the bankruptcy process is less useful to these creditors, and they bear more of the bankruptcy system's cost if subsidized creditors are allowed to opt out. On the other hand, the loss of the subsidy would increase the costs of hedging, resulting in either increased cost or risk to corporations from unviable hedges,[12] which itself has a positive cost.[13] How these two costs balance out—and thus the net cost of the safe harbors—is uncertain and perhaps unknowable.[14]

Skeel and Jackson spend the bulk of their Essay arguing for the complete rethinking of derivatives and repos in bankruptcy, a project that they put under the general heading of "transactional consistency." In short, they argue that repos should be treated as sec ured financing, save for where the repo is based on cash-like collateral.[15] Swaps should be treated as regular contracts, insurance contracts, or financing, depending on their true purpose.[16]

I am largely sympathetic to the project, having argued myself that straight repeal of the "safe harbors" is often little more than an unrealistic thought exercise.[17] But I also worry that Skeel and Jackson's Essay relies too heavily on these new categories. To some degree they have replaced one set of exceptions with another. I thus use this short Response to outline these concerns and suggest a simpler solution to the issue.

I embrace the basic Skeel-Jackson premise that like agreements should be treated alike under the Bankruptcy Code. But I depart from them insofar as they engage in a re-sorting of agreements: Repos would be treated one way under their proposals, swaps another.[18] As the recent efforts to draft the content of the Volcker Rule show, translating financial transactions into legislative rules is no easy task.[19] Moreover, we should never doubt the creativity at work in financial institutions. Skeel and Jackson address swaps

12. This theory does assume that the derivatives market is price competitive and subsidies pass through financial institutions to end-users. There are reasons to doubt this proposition currently holds, although market features introduced by Dodd-Frank—like exchange trading—might make it so in the future. Cf. Aaron Unterman, Innovative Destruction—Structured Finance and Credit Market Reform in the Bubble Era, 5 Hastings Bus. L.J. 53, 94 (2009) (advocating heightened derivatives regulation to ensure "future economic stability").

13. See Peter H. Huang & Michael S. Knoll, Corporate Finance, Corporate Law and Finance Theory, 74 S. Cal. L. Rev. 175, 185–86 (2000) ("[H]edging can create value by reducing the costs of financial distress and bankruptcy."); see also David B. Spence, Can Law Manage Competitive Energy Markets?, 93 Cornell L. Rev. 765, 805 (2008) (noting "hedging devices, when used by retail sellers . . . can go a long way toward protecting retail customers from price volatility").

14. See Kristin N. Johnson, Things Fall Apart: Regulating the Credit Default Swap Commons, 82 U. Colo. L. Rev. 167, 199–214 (2011) (discussing benefits and dangers of credit derivatives).

15. Skeel & Jackson, supra note 1, at 179.

16. Id. at 180–81.

17. See generally Stephen J. Lubben, The Bankruptcy Code Without Safe Harbors, 84 Am. Bankr. L.J. 123 (2010) [hereinafter Lubben, Without Safe Harbors].

18. E.g., Skeel & Jackson, supra note 1, at 199 (summarizing their proposal).

19. See Peter Schroeder, SEC Head Indicates Slow Going on Volcker Rule, The Hill (March 6, 2012, 1:33 PM), http://thehill.com/blogs/on-the-money/banking-financial-institutions/214395-sec-head-indicates-slow-going-on-volcker-rule (on file with the *Columbia Law Review*) (discussing agencies' inability to meet Volcker Rule implementation deadline).

throughout their Essay, but what of the various combinations of forwards, options, linear certificates, structured notes, correlation products, and other instruments that can achieve the same ends?

And their basic project is still largely based on two financial institutions as counterparties, which may reflect the bulk of the derivatives and repo markets, but plays a relatively small part in Chapter 11, and is apt to get even smaller with the creation of the new Orderly Liquidation Authority (OLA).[20]

I therefore conclude by arguing that two simple changes would better address the pressing problems of the special treatment of derivatives in bankruptcy. First, opening the door to judicial recharacterization of putative derivatives and repos that are really just disguised versions of other transactions would solve much of the problem associated with the overbroad safe harbors. A supply contract that is rewritten as a swap should be treated as a supply contract, and the bankruptcy court should have the power to do just that. This is a simpler version of transactional consistency.

Second, the Bankruptcy Code should be harmonized with Dodd-Frank. This revision is the simpler, immediate solution to Skeel and Jackson's concerns about financial institutions in bankruptcy, and if we are to take the financial regulators at their word, we must anticipate that a few financial institutions will be resolved under Chapter 11. If Chapter 11 is the complement to the OLA, there should be consistency between the two proceedings.

These are not perfect solutions but rather first steps. They are, however, steps that should be easily achievable.

I. THE PROBLEM OF DERIVATIVES IN BANKRUPTCY

Derivatives and bankruptcy interact in strange ways, creating strange laws.[21] But one of the most fundamental problems is that discussions of "derivatives" in this context sweep up the rather distinct issue of repurchase agreements, which are treated the same as traditional derivatives under the Bankruptcy Code but are otherwise quite distinct.[22]

Derivatives are, at heart, contracts.[23] Repos, however, are financing.[24]

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20. See Adam J. Levitin, In Defense of Bailouts, 99 Geo. L.J. 435, 487–89 (2011) (reviewing Dodd-Frank Act's Orderly Liquidation Authority).

21. Given the space constraints of this short Response, I assume the reader is familiar with the treatment of derivatives and repos under the Bankruptcy Code, particularly post-2005. If not, good reading on the topic includes Stephen J. Lubben, Repeal the Safe Harbors, 18 Am. Bankr. Inst. L. Rev. 319 (2010); Frank Partnoy & David A. Skeel, Jr., The Promise and Perils of Credit Derivatives, 75 U. Cin. L. Rev. 1019 (2007); Mark J. Roe, The Derivatives Market's Payment Priorities as Financial Crisis Accelerator, 63 Stan. L. Rev. 539 (2011); Michael Simkovic, Secret Liens and the Financial Crisis of 2008, 83 Am. Bankr. L.J. 253 (2009). For something even more concise, see Mike Konzcal, An Interview About the End User Exemption with Stephen Lubben, Rortybomb (May 6, 2010), http://rortybomb.wordpress.com/2010/05/06/an-interview-about-the-end-user-exemption-with-stephen-lubben/ (on file with the *Columbia Law Review*).

22. See Eleanor Heard Gilbane, Testing the Bankruptcy Code Safe Harbors in the Current Financial Crisis, 18 Am. Bankr. Inst. L. Rev. 241, 267–70 (2010) (discussing repurchase agreements and Bankruptcy Code).

23. Stephen J. Lubben, Derivatives and Bankruptcy: The Flawed Case for Special

Contracts are subject to the debtor's special power to assume (perform) or reject (breach).[25] Financing, on the other hand, is considered to be among the special class of agreements, like personal service contracts, that are exempt from this normal rule.[26]

By the time of bankruptcy, financing has typically transformed itself into debt. The corporate debtor that enters Chapter 11 with untapped sources of liquidity is a rare bird indeed.

Skeel and Jackson spend a good bit of time grappling with these issues, before ultimately coming to some sensible conclusions regarding swaps.[27] But there are some bigger issues that loom here and some non-problems that also cloud the Skeel-Jackson analysis.

The basic issue is that contracts of all sorts are subject to default. If an entire class of contracts is subject to rumors or fears of default, that type of contract is subject to a run.[28] Once a class of contract or debt instrument becomes subject to a run, it ceases to have value in the market, and is then termed "illiquid." Often this is a temporary condition, but it can also be self-reinforcing.

Based on these simple truths and a semi-plausible argument that derivatives are especially likely to be subjected to runs and illiquidity, the derivatives industry persuaded Congress to enact a series of "safe harbors" for derivatives.[29] In particular, financial institutions have large gross exposures to derivatives and wanted assurances that their net exposures are what really matter.[30]

Actually, the argument began with the Federal Reserve and the concern over the failure of a few repo dealers shortly after the enactment of the current Bankruptcy Code in 1978.[31] The swaps dealers, and their allies in Treasury

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Treatment, 12 U. Pa. J. Bus. L. 61, 68–73 (2009) (supporting this principle).

24. Granite Partners L.P. v. Bear, Stearns & Co., 17 F. Supp. 2d 275, 301–02 (S.D.N.Y. 1998) (reviewing repo treatment).

25. 11 U.S.C. § 365 (2006).

26. Id. § 365(c).

27. See Skeel & Jackson, supra note 1, at 185. However, their conclusion that an International Swaps and Derivatives Association (ISDA) master agreement and all subsidiary documents must constitute a single agreement, even in the absence of the safe harbors, is not nearly as clear as they make it out to be. See Rhett G. Campbell, Energy Future and Forward Contracts, Safe Harbors and the Bankruptcy Code, 78 Am. Bankr. L.J. 1, 44 (2004) (raising possibility of debtor assuming favorable trades but rejecting others).

28. See Charles K. Whitehead, Reframing Financial Regulation, 90 B.U. L. Rev. 1, 22–23 (2010) (describing collapse of Bear Stearns to illustrate this principal).

29. See Thomas J. Giblin, Financial Markets in Bankruptcy Court: How Much Uncertainty Remains After BAPCPA?, 2009 Colum. Bus. L. Rev. 284, 288–90 (reviewing these regulatory changes); Shmuel Vasser, Derivatives in Bankruptcy, 60 Bus. Law. 1507, 1509–11 (2005) (discussing public policy underlying "safe harbors" for derivatives).

30. See David Mengle, ISDA Research Notes: The Importance of Close-Out Netting (2010), available at http://www.isda.org/researchnotes/pdf/Netting-ISDAResearchNotes-1-2010.pdf (on file with the *Columbia Law Review*) (noting financial institutions' large gross derivatives exposure and attempts to reduce credit risk from this exposure).

31. Bevill, Bresler & Schulman Asset Management Corp. v. Spencer S & L Ass'n (In re Bevill, Bresler & Schulman Asset Mgt. Corp.), 878 F.2d 742, 745–50 (3d Cir. 1989) (reviewing

and the Federal Deposit Insurance Corporation (FDIC), simply used the preexisting repo safe harbors to gain special treatment for derivatives, too.[32] Thus, repo and derivatives became linked together in the world of bankruptcy.

The end result is that both repos and derivatives are exempt from the normal rules of bankruptcy: There is no automatic stay, there are no avoidance actions, and the debtor does not get to decide whether to assume or reject contracts that are still executory upon bankruptcy.[33] After 2005 the definitions of the relevant repos and derivatives were expanded, resolving every possible doubt in the prior definitions in an industry favorable way, so that now anything that even "sort of" looks like a covered transaction can arguably be included within the safe harbors.[34]

Although I might put the emphasis in different spots—and I doubt that the safe harbors really had much role to play in Lehman's infamous "repo 105"—Skeel and Jackson correctly identify many of the pernicious effects of safe harbors.[35]

Because of the subsidy given to repo and derivatives, the debtor's cost of capital will be lower if it can finance itself with either of these two classes of instruments.[36] The safe harbors thus encourage overuse, especially since most of the bad effects of overuse are likely to occur far in the future, in a state of failure that managers will understandably discount. This overuse becomes extreme in cases where "normal" contracts become recast as either type of financial contract.

And while Dodd-Frank has created a new bankruptcy system for financial institutions, it did not replace the Bankruptcy Code in all instances.[37] Indeed, the FDIC indicates that Chapter 11 remains the primary framework for

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this history).

32. Timothy P.W. Sullivan, Comment, Swapped Disincentives: Will Clearinghouses Mitigate the Unintended Effects of the Bankruptcy Code's Swap Exemptions?, 80 Fordham L. Rev. 1491, 1510–12 (2011) (recapping this progression).

33. For example, with regard to swaps, see 11 U.S.C. § 362(b)(17) (2006) (providing exemption from automatic stay); 11 U.S.C. § 546(g) (providing exemption from certain avoiding powers); and 11 U.S.C. § 560 (preserving rights of termination including under an ipso facto clause, close-out netting and swap enforcement).

34. See John J. Chung, From Feudal Land Contracts to Financial Derivatives: The Treatment of Status Through Specific Relief, 29 Rev. Banking & Fin. L. 107, 130–38 (2009) (reviewing expansion of derivatives exemption in Bankruptcy Code to "reduce or even eliminate virtually all exposure losses"); Stephen J. Lubben, Systemic Risk & Chapter 11, 82 Temp. L. Rev. 433, 443–44 (2009) (crediting broad definition of "swap" with expansion of derivatives "safe harbors").

35. For a brief review of Lehman's "repo 105" see Michael J. de la Merced & Julia Werdigier, The Origins of Lehman's 'Repo 105,' N.Y. Times DealBook (March 12, 2010, 7:02 AM), http://dealbook.nytimes.com/2010/03/12/the-british-origins-of-lehmans-accounting-gimmick/ (on file with the *Columbia Law Review*).

36. I am implicitly assuming that Modigliani & Miller overstated their case, and that the debtor can avoid paying more to subordinated creditors. See John D. Ayer, The Role of Finance Theory in Shaping Bankruptcy Policy, 3 Am. Bankr. Inst. L. Rev. 53, 59–60 (1995) (reviewing Modigliani & Miller's premise and "ideal" assumptions).

37. Hollace T. Cohen, Orderly Liquidation Authority: A New Insolvency Regime to Address Systemic Risk, 45 U. Rich. L. Rev. 1143, 1151 (2011).

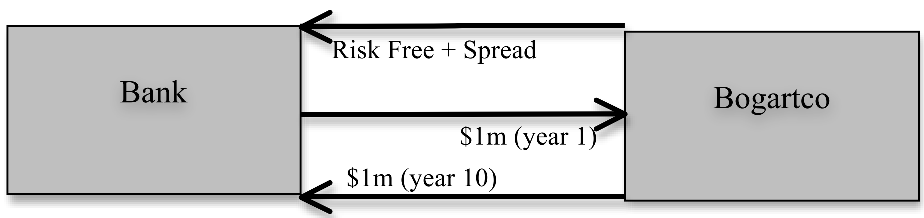
resolving financial distress in these institutions.[38] In this light, we then need to worry about the ways in which the safe harbors create runs in repos and derivatives markets, given the extensive involvement of most financial institutions.

It is these two problems that are the most pressing issues with regard to financial contracts in bankruptcy. These problems, and my proposed solutions, animate the remainder of this short Response.

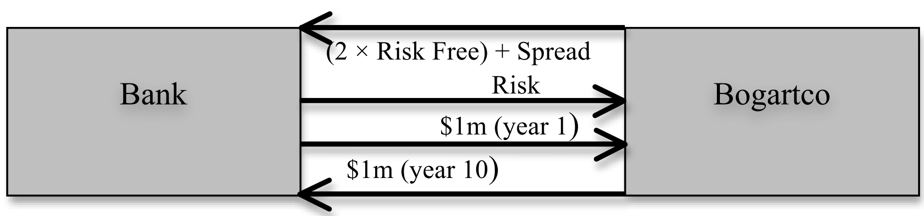
II. THE PROBLEM OF PRETEND DERIVATIVES

Whatever position one might have regarding the special treatment of financial contracts under the current Bankruptcy Code, it seems unquestionably problematic that the definition of a thing like "swap" was left so open-ended that it could potentially cover relatively mundane contracts.

Consider, for example, a hypothetical debtor: Bogartco, a leading manufacturer of trenchcoats and fedoras. Bogartco enters a transaction with a bank whereby the bank gives Bogartco $1 million and Bogartco promises to repay that sum in ten years. In the interim, Bogartco promises to make periodic interest payments to the bank. To secure its performance, Bogartco agrees to provide the bank with a lien on its property, plant, and equipment (PP&E). The cash flows would look like this:



This is rather clearly a secured loan. But what if the original deal was modified as follows:



38. See Does the Dodd-Frank Act End Too Big to Fail?: Hearing Before the Subcomm. on Fin. Insts. and Consumer Credit of the H. Comm. on Fin. Servs., 112th Cong. (2011) (statement of Michael H. Krimminger, Gen. Counsel, Federal Deposit Insurance Corporation), available at http://www.fdic.gov/news/news/speeches/chairman/spjun1411.html (on file with the *Columbia Law Review*) (describing mechanisms for resolving financial institutions through bankruptcy and the OLA).

And replace the security interest with "margin," represented by the grant of an interest in Bogartco's PP&E.

Note that the economics of the transaction have not changed—the additional risk-free rate payments cancel each other out. Nonetheless, there is an argument that the second transaction is a swap[39]—especially if memorialized under the ISDA form documents used to document derivatives trades.[40]

If the payments were made in different currencies, the transaction would easily fit within the safe harbors, as currency swaps are some of the few transactions that involve the exchange of principal.[41] Bogartco could then be obligated by the bank to hedge the currency risk in the transaction with another safe-harbored instrument.

A similar, if somewhat less problematic, situation exists with regard to the definition of "repurchase agreement" under the Bankruptcy Code.[42] The safe harbor encompasses essentially any loan collateralized by certificates of deposit, bankers' acceptances, U.S. or other Organization for Economic Co-operation and Development government securities, mortgage loans or interests in the same, including mortgage-backed securities, with less than a one-year term. In an extreme case, the debtor could grant a security interest in a large portion of its cash—in the form of a certificate of deposit—which essentially exposes the lender to no risk so long as it is fully collateralized, yet the loan will still be exempt from the automatic stay.[43]

These provisions thus exclude legitimate financial contracts—things we would think really are swaps, forwards, and repos—from the scope of the Bankruptcy Code. But they also exclude pretend financial contracts from the Code, to such a degree that there might not be much left of the debtor to reorganize once enough contracts get rewritten to take advantage of the expansion of the safe harbors in 2005.[44]

While Skeel and Jackson might argue for a reconsideration of the special treatment of derivatives generally, and I have undeniably done the same in the past, it seems time to admit that such a broad approach leads to a dead end. Namely, derivatives have become integrated into the American economy, so that even a mid-cap manufacturing company will have a portfolio of interest rate and currency swaps to hedge its loans and foreign operations. Removing the bankruptcy subsidy to these contracts will result in higher prices for the

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39. See 11 U.S.C. § 101(53B)(A)(ii) (2006).

40. See In re Enron Corp., 328 B.R. 58, 70 (Bankr. S.D.N.Y. 2005) ("[E]quity swaps and credit derivatives should include what the swap market understands to be a swap agreement.").

41. See Jennifer A. Frederick, Note, Not Just for Widows & Orphans Anymore: The Inadequacy of the Current Suitability Rules for the Derivatives Market, 64 Fordham L. Rev. 97, 99 n.8 (1995) (explaining currency swaps).

42. 11 U.S.C. § 101(47).

43. Id. § 362(b)(7).

44. The definitions were also expanded in 2006, but for ease I collapse the two changes to the Code and refer to the "2005 changes" throughout. For a discussion of the 2006 alterations, see Seth Grosshandler & Kate A. Sawyer, The Financial Netting Improvements Act of 2006 Clarifies the Bankruptcy Protections and Promotes Netting for Qualifying Derivative Transactions, 124 Banking L.J. 523, 525 (2007).

hedge.

Maybe the higher prices are outweighed by the net social benefits of not subsidizing derivatives. However, maybe they are not; this is an essentially unanswerable empirical question.

But it seems unquestionable that efforts to sneak "regular" contracts into the financial contracts provisions of the Bankruptcy Code are pernicious, and could eventually destroy the benefits of Chapter 11. As such, I argue in the Conclusion for an increase in bankruptcy court power to police the line between true financial contracts and pretend financial contracts.

But I will first explain the other issue in need of immediate attention: the impossibility of financial institutions in a bankruptcy case under the Bankruptcy Code.

III. DODD-FRANK'S PARTIAL SOLUTION TO ORDERLY LIQUIDATION

Dodd-Frank's Title II creates a new Orderly Liquidation Authority that potentially replaces Chapter 11 as the resolution tool for bank holding companies and their non-regulated subsidiaries.[45] The OLA could only potentially displace Chapter 11 because Chapter 11 remains in place unless financial regulators decide to invoke the OLA,[46] through an intricate process that culminates with the D.C. District Court having twenty-four hours to say "no" under very controlled circumstances.[47]

In essence, the OLA expands the FDIC's bank receivership powers to cover a greater part of the financial institution.[48] This provision allows the FDIC to conduct a purchase and assumption transaction with regard to non-depository bank parts of the institution or transfer the institution to a newly created "bridge bank."[49] The latter option allows the FDIC to split the good assets from the bad, in a process that is very much like that used in "363 sales" under Chapter 11, widely publicized by the automotive Chapter 11 cases.[50]

Importantly, the FDIC is granted a one-day stay on counterparties' ability to terminate their derivative contracts.[51] This stay obviously facilitates the sale

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45. 12 U.S.C. §§ 5381–5394 (2006). See also Stephen J. Lubben, Resolution, Orderly and Otherwise: B of A in OLA, U. Cin. L. Rev. (forthcoming 2012) (on file with the *Columbia Law Review*) (exploring implications of invoking the OLA in hypothetical resolution of Bank of America).

46. 12 U.S.C. § 5382(c)(1) ("[T]he provisions of the Bankruptcy Code . . . shall apply to financial companies."); see id. § 5383(b)(2) (allowing D.C. District Court review of a financial company's failure which may have "serious adverse effects on financial stability in the United States" for purposes of commencing orderly liquidation under 12 U.S.C. § 5382(a)(1)(A)).

47. Id. §§ 5382, 5383.

48. Id. § 5384(b).

49. Id. § 5390.

50. For a discussion of this process, see generally Stephen J. Lubben, No Big Deal: The GM and Chrysler Cases in Context, 83 Am. Bankr. L.J. 531 (2009). See also Stephanie Ben-Ishai & Stephen J. Lubben, Sales or Plans: A Comparative Account of the "New" Corporate Reorganization, 56 McGill L.J. 591 (2011) (comparing "quick sales" under American reorganization regime to similar proceedings under Canadian law).

51. 12 U.S.C. § 5390(c)(10)(B)(i).

of the debtor financial institution in a way that is lacking under the Bankruptcy Code, where there are no restraints on counterparties' ability to terminate derivatives contracts.[52] Similarly, under Dodd-Frank, the FDIC has the ability to nullify ipso facto clauses in financial contracts between subsidiaries and counterparties that are triggered solely because of the parent company's OLA filing.[53]

In short, under the OLA, the debtor's derivatives book can remain intact; under Chapter 11 it will be pulled to pieces. Nonetheless, the FDIC and Treasury have asserted that bankruptcy remains the preferred solution for financial distress in financial institutions.[54] The OLA is only to be used when the debtor's distress threatens to cause systemic problems.

The reason for the disparity is puzzling, especially if one focuses on situations where there has been no performance default on the debtor's financial contracts. Why should a systemic crisis in particular provide an occasion for the preservation of going concern value, whereas such value is destroyed in all other situations?

Moreover, the potential disruption in the derivatives markets caused by the Chapter 11 case of a financial institution could itself necessitate invoking the OLA. If the regulatory community is serious about making Chapter 11 the primary tool for resolving financial distress in this area, that would itself seem another reason to achieve some degree of parity with regard to financial contracts.

For the "end-users" of financial contracts, the unequal treatment of financial contracts is all the starker since by and large these debtors will never be eligible to reorganize under the OLA.[55] The airline that has hedged its fuel needs might rightly wonder why it must lose its hedges upon bankruptcy, whereas its counterparty, a major financial institution, can demand the airline's continued performance after the FDIC takes over the bank as receiver. This disparity exposes the one-way direction of the safe harbors, especially after the advent of Dodd-Frank.[56]

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52. 11 U.S.C. §§ 546(g), 548(d)(2)(D), 561(a) (2006) (explaining termination of derivatives contract is exempt from classification as constructive fraudulent transfer or preference).

53. 12 U.S.C. § 5390(c)(16). On March 20, 2012, FDIC issued its Notice of Proposed Rulemaking setting forth the proposed rule to implement this section. Enforcement of Subsidiary and Affiliate Contracts by the FDIC as Receiver of a Covered Financial Company, 77 Fed. Reg. 18,127 (proposed Mar. 20, 2012).

54. See Dep't. of the Treasury, Financial Regulatory Reform–A New Foundation 8 (2009) (describing bankruptcy as suitable option for distressed financial firms in situations not impacting "greater financial stability").

55. I use the term "reorganize" intentionally, despite the OLA's claimed model of "liquidation only." A recapitalized financial institution has been reorganized, whatever the language of the statute.

56. See Stephen J. Lubben, Financial Institutions in Bankruptcy, 34 Seattle U. L. Rev. 1259, 1261 (2011) (arguing "there are significant gaps in the federal system for resolving financial distress in a financial firm even after passage of the Dodd-Frank bill").

CONCLUSION: SIMPLE SOLUTIONS

In an ideal world, the treatment of derivatives under the Bankruptcy Code, the Securities Investor Protection Act, the OLA, and other insolvency statutes would be entirely reconsidered, and these various insolvency systems would be further integrated.[57] The legitimate concerns that support the safe harbors in all of these statutes could be addressed in a far more narrowly tailored way.[58] But given the larger, difficult empirical questions identified at the outset of this Response, this discussion is not apt to be easy or quick.

But in the interim, the key problems identified herein could be addressed. First, the problem of pretend financial contracts could be addressed by a little faith in judicial discretion—admittedly something Congress showed little regard for in 2005.[59]

Nonetheless, in virtually every other context the bankruptcy judge is empowered to recast a transaction to reflect its true nature.[60] This principle has a long history.[61]

If the bankruptcy court had such a power with regard to putative financial contracts, it would give the court the ability to police the boundaries between the legitimate goals of the safe harbors and their potential, particularly post-2005, to swallow the whole of the Bankruptcy Code.[62] In essence, this power would amount to an anti-evasion rule, such as are common in many other corporate statutes[63]—including recently enacted provisions of Dodd-Frank.[64]

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57. See Brett McDonnell, Don't Panic! Defending Cowardly Interventions During and After a Financial Crisis, 116 Penn St. L. Rev. 1, 68–69 (2011) (discussing regulatory agency reorganization).

58. See generally Lubben, Without Safe Harbors, supra note 17.

59. Lauren E. Tribble, Note, Judicial Discretion and the Bankruptcy Abuse Prevention Act, 57 Duke L.J. 789, 804 (2007) (criticizing replacement of "judicial discretion with a rigid and formulaic rule" under Bankruptcy Abuse Prevention Act).

60. See, e.g., In re SubMicron Sys. Corp., 432 F.3d 448, 459 (3d Cir. 2006) (applying "clearly erroneous" standard to review district court's recharacterization of instruments as debt); Roth Steel Tube Co. v. C.I.R., 800 F.2d 625, 629–32 (6th Cir. 1986) (applying multi-factor test to determine whether advances were capital contributions or loans); In re BH S & B Holdings LLC, 420 B.R. 112, 157 (Bankr. S.D.N.Y. 2009), aff'd as modified, 807 F. Supp. 2d 199 (S.D.N.Y. 2011) (discussing multi-factor recharacterization analysis); In re Commercial Loan Corp., 316 B.R. 690, 700–02 (Bankr. N.D. Ill. 2004) (same); see also Robert D. Aicher & William J. Fellerhoff, Characterization of a Transfer of Receivables as a Sale or a Secured Loan Upon Bankruptcy of the Transferor, 65 Am. Bankr. L.J. 181, 182–84 (1991) (noting various legal contexts in which recharacterization issues can arise); Simkovic, supra note 21, at 281 (explaining that "the Bankruptcy Abuse Prevention and Consumer Protection Act . . . effectively rendered derivatives immune from recharacterization based on economic substance").

61. See Home Bond Co. v. McChesney, 239 U.S. 568, 575–76 (1916) (characterizing contracts as "mere shams . . . to cover loans of money at usurious rates of interest"); James M. Wilton & Stephen Moeller-Sally, Debt Recharacterization under State Law, 62 Bus. Law. 1257, 1268 (2007) (discussing early twentieth-century state court cases on debt recharacterization).

62. Cf. Shu-Yi Oei, Context Matters: The Recharacterization of Leases in Bankruptcy and Tax Law, 82 Am. Bankr. L.J. 635, 655 (2008) (discussing application of "economic substance" doctrine by bankruptcy courts).

63. E.g., Securities Exchange Act of 1934, Pub. L. 73-291, § 30(b), 48 Stat. 881 (codified as amended at 15 U.S.C. § 78a et seq. (2006)).

64. E.g., 12 U.S.C. §§ 1851(e), 5323(c) (2006).

In this case, the court's ability to recharacterize would work as a prohibition on evasion of the Bankruptcy Code.

The great bugaboo of a rogue bankruptcy judge would undoubtedly be raised against such a move. But financial contracts are most apt to be an issue in large Chapter 11 cases, the kind that are most likely to be filed in front of experienced bankruptcy judges.[65] It seems farfetched to assume these judges would not "get it."

Similarly, regardless of the type of debtor, it seems that if financial institutions are allowed twenty-four hours to save their financial contracts, real economy companies should also have this option. Moreover, if financial institutions are to ever use Chapter 11 as their resolution tool, such a change is quite obviously necessary.

Thus, the Bankruptcy Code should be amended to allow debtors one day to assume or reject their swaps and other derivatives before counterparties can terminate those contracts. If the debtor assumes a swap, only performance-related defaults would justify termination going forward.

These two practical changes would go a long way toward addressing the very serious issue of derivatives in bankruptcy.

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65. Troy A. McKenzie, Judicial Independence, Autonomy, and the Bankruptcy Courts, 62 Stan. L. Rev. 747, 777–82 (2010) (describing consistent handling of major bankruptcy cases by sophisticated bankruptcy judges in preferred jurisdictions).