2

Bankruptcy Code Chapter 14

A Proposal

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CONTENTS

INTRODUCTION

This chapter describes several proposed changes to the Bankruptcy Code that are designed for—and limited to—the reorganization or liquidation of the nation's largest financial institutions. The proposed changes create a new Chapter 14 of the Bankruptcy Code and incorporate features of liquidations under Chapter 7 as well as reorganizations under Chapter 11. In addition, the proposed Chapter 14 contains a number of substantive and procedural changes designed especially for the complexity, and potential systemic consequences, of the failure of these large financial institutions. We, the members of the Resolution Project group, believe it is possible through these changes to take advantage of a judicial proceeding—including explicit rules, designated in advance and honed through published judicial precedent, with appeals challenging the application of those rules, public proceedings, and transparency—in such a way as to minimize the felt necessity to use the alternative government agency resolution process recently enacted as a part of the Dodd-Frank Wall Street Reform and Consumer Protection Act. The new chapter could be adopted either in addition or as an alternative to the new resolution regime of Dodd-Frank.

The crucial feature of this new Chapter 14 is to ensure that the covered financial institutions, creditors dealing with them, and other market participants know in advance, in a clear and predictable way, how losses will be allocated if the institution fails. If the creditors of a failed financial institution are protected (bailed out), then the strongest and most rapidly responding constraint on risk taking by the financial institution's management is destroyed, and their losses are transferred to others.

In the following sections, we explain the features of this new Chapter 14 by **(a)** outlining existing bankruptcy provisions that we propose to amend or replace, **(b)** summarizing perceived weaknesses in those provisions that this proposal addresses, and **(c)** outlining the nature of the statutory provisions that are designed to address these weaknesses. These statutory changes can be encompassed within four basic categories: (1) the creation of a new Chapter 14, (2) the commencement of a Chapter 14 case, (3) the role of the primary regulator in Chapter 14 and special rules regarding debtor-in-possession financing for purposes of "prepayments" to certain creditors, and (4) the treatment of qualified financial contracts in Chapter 14. Following that, we provide in summary form a list of the changes we propose and the likely place in either the Bankruptcy Code or in Title 28 (the jurisdictional title) to make those changes.

I. CREATION OF A NEW CHAPTER 14

A. Define Financial Institution

1. Current Law

There is no special definition of a financial institution.

2. Concerns

Bankruptcy seems to be undervalued as a potential solution to the liquidation or reorganization of complex financial institutions, including in the 2010 congressional debate over financial reform, in part because of a view that the default of one or more of the nation's largest and most complex financial institutions is **(a)** outside the competence of the bankruptcy system, **(b)** unable to be resolved in a timely fashion in a judicial proceeding, and **(c)** likely to have systemic consequences that an adversarial system, which depends on parties-in-interest with standing before the court, is ill-equipped to respond to.

3. Proposal

In order to craft a bankruptcy process that is responsive to the special needs of the nation's largest financial institutions, it is necessary to create a special set of procedures and rules for them. This starts, most fundamentally, with a need to provide a definition in the Bankruptcy Code of which financial institutions would be covered by these special procedures and rules. Because many of the concerns focus on the nation's largest institutions, with no strong sense that existing procedures are insufficient for other financial institutions, the definition should not only define what a "financial institution" is but should also set a threshold for the size of the institution before invoking the special rules and procedures we propose. The definition we recommend would define a "financial institution" for bankruptcy (and hence Chapter 14) purposes as an institution "that is substantially engaged in providing financial services or financial products," and includes "any subsidiaries of any such institution."[1] To eliminate purely "local" financial institutions, the definition would include a minimum asset size of $100 billion for the combined enterprise—a figure that should have a mechanism for adjustment with changes in the financial system.[2]

1. The Bankruptcy Code would use the word "person," which is defined in § 101(41) as including an "individual, partnership, and corporation." For convenience, this chapter often uses the word "institution."

2. Unlike Title II of Dodd-Frank, where a "covered financial company" can be determined after the fact (the category includes both firms that derive 85 percent of their revenues from activities that are financial in nature as well as any financial company designated as systemically important through an elaborate executive branch determination regarding systemic consequences), we propose using a predetermined size threshold, so as to remove uncertainty in terms of whether a particular institution

B. Create Chapter 14

1. Current Law

No such chapter exists.

2. Concern

Because of the special procedural and substantive rules that are perceived to be needed to make bankruptcy a robust alternative to government agency resolution for the nation's largest financial institutions, there needs to be a mechanism within the Bankruptcy Code for **(a)** incorporating the vast majority of common Bankruptcy Code provisions in Chapters 1 (general provisions), 3 (case administration and administrative powers [such as the automatic stay; the use, sale, or lease of property; obtaining credit; and the treatment of executory contracts]), and 5 (determining assets and claims, priorities, and provisions such as setoffs, and the recovery of preferences and fraudulent conveyances), as well as the "outcome" Chapters 7 (liquidation) and 11 (reorganization), while **(b)** ensuring that those special procedural and substantive rules for covered financial institutions govern and amend or override certain common Bankruptcy Code provisions.

3. Proposal

In essence, our proposal provides a new bankruptcy process (including certain new substantive rules) for financial institutions for the liquidation or reorganization of these defined financial institutions. At the same time, the Bankruptcy Code's structure and rules for a liquidation proceeding, in Chapter 7, and for a reorganization

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(on either a voluntary or involuntary petition) is appropriate for our proposed Chapter 14.

proceeding, in Chapter 11, provide a solid starting place, with a wealth of important judicial gloss on statutory terminology that would be usefully applied in many situations involving a covered financial institution. To accomplish both goals simultaneously, we propose that the proceeding (or "case") when a covered financial institution invokes (or is placed in) bankruptcy follow the rules of the existing Bankruptcy Code, *except* where we propose to change those rules. Particularly because our proposal envisions a different judicial "path," as we describe later (involving district judges in lieu of bankruptcy judges), to use the existing Bankruptcy Code structure and attempt to amend various provisions in Chapters 7 and 11 to accommodate our proposal would be cumbersome. Thus, our proposal is to create a new Chapter 14 in the Bankruptcy Code and require covered financial institutions to *concurrently* file for Chapter 14 *and* Chapter 7 or Chapter 11 (that is, covered financial institutions cannot file for Chapter 7 or Chapter 11 without also filing for Chapter 14), and requiring the resulting liquidation (Chapter 7) or reorganization (Chapter 11) proceeding to be conducted according to the rules and under the special court supervision of Chapter 14.

The essence of this change, then, would be to insert a new subsection into § 109,[3] which **(a)** limits Chapter 14 to financial institutions (as defined), **(b)** provides that a financial institution "may not be a debtor under Chapter 7 or Chapter 11 without first (or concurrently) commencing a case under Chapter 14," and **(c)** provides that all proceedings under this simultaneous Chapter 7 or Chapter 11 "shall be conducted pursuant to the provisions of Chapter 14."

3. All section numbers, unless explicitly indicated otherwise, refer to Title 11, U.S. Code.

C. Assign Chapter 14 Cases and Proceedings to Designated Article III District Judges

1. Current Law

a. Judges. Because bankruptcy judges are not "Article III" judges (primarily because they do not enjoy lifetime tenure, which is a constitutional requirement for Article III judges), the Supreme Court, in *Northern Pipeline Construction Co. v. Marathon Pipe Line Co.*, 458 U.S. 50 (1982), struck down certain features of the original jurisdictional grant in the Bankruptcy Code of 1978 to bankruptcy judges to hear and decide various cases and controversies that arise in connection with bankruptcy proceedings. In response to *Northern Pipeline*, Congress enacted the current jurisdictional structure in 28 U.S.C. § 157. It provides that bankruptcy cases are "filed" in the district court (comprised of Article III judges), but that a district court may provide (as all have) that "cases under title 11 [the Bankruptcy Code]" and "proceedings arising under title 11," "shall be referred to the bankruptcy judges for the district." Those judges may then hear "cases under title 11" and "core proceedings arising under title 11," with 28 U.S.C. § 157(b)(2) attempting to define "core proceedings" in a way that is consistent with what the Supreme Court, in *Northern Pipeline*, said that non–Article III judges could "hear and determine." Things that are not core proceedings but are otherwise related to a bankruptcy case can be heard by a bankruptcy judge, but that judge can only "submit proposed findings of fact and conclusions of law to the district court," and the district court must issue "any final order or judgment," 28 U.S.C. § 157(c)(1).

b. Venue. Bankruptcy cases can be commenced in the district court for the district that is the debtor's domicile: Its "principal place of business in the United States," where the "principal assets [of the debtor] in the United States are located," or in which an affiliate of the debtor has already filed, 28 U.S.C. § 1408, although cases can be transferred by a district court to another district "in the interest of justice or for the convenience of the parties," 28 U.S.C. § 1412.

2. Concerns

The current system ultimately depends on venue, and within venue, essentially random assignment of cases to bankruptcy judges for the district in which the bankruptcy case has been filed. While this is appropriate for the vast majority of business (and individual) bankruptcy cases that numerically dominate the system, it is unlikely that the nation's several hundred bankruptcy judges—all of whom can be presumed to have important knowledge of the Bankruptcy Code itself—will have the requisite financial expertise to deal, in real time, with the nation's largest financial institutions. To be sure, these institutions are clustered in a few venues, and one could envision (similar to our proposal) a designated panel of bankruptcy judges with requisite expertise, but there is a second concern as well that leads us to make a different proposal. In addition to the question of financial mastery necessary for complex financial institutions, the general bankruptcy procedure of automatically delegating bankruptcy cases from the district court to a bankruptcy court places the cases before non–Article III judges. While this is not troubling in the vast majority of bankruptcy cases, the essential need for complete independence from any perception of influence by the financial institution, the government, or a particularly significant creditor suggests that any bankruptcy system designed for the nation's largest financial institutions would want those institutions to have their cases and ancillary proceedings heard before an

Article III judge. In our system, there is no more "gold-plated" standard of independence from government.[4]

3. Proposal

Given the limited number of covered financial institutions, and the even more limited number that will be in bankruptcy at any given time, there is considerable merit to "funneling" such cases before a limited set of preselected Article III district judges. Our proposal is to funnel cases to the Second and DC Circuits, where a panel of district court judges has been predesignated to oversee Chapter 14 cases by the chief justice of the United States. These designated district judges would then have the same (and, to that extent, exclusive) jurisdiction over Chapter 14 cases that district judges currently have over other bankruptcy cases. These judges would be precluded from referring cases and proceedings to bankruptcy judges pursuant to 28 U.S.C. § 157(a), but they would have the power, by amendment to Title 28, to appoint a special master from a predesignated panel of special masters to hear the case and all proceedings under the case that could be heard by a bankruptcy judge. In addition, the district judge could similarly designate a bankruptcy judge, as well as experts, to provide necessary advice and input to the district judge or to the special master.

4. In *The Going-Concern Value of a Failed SIFI* (chapter 6 in this volume), Kenneth E. Scott and Thomas H. Jackson discuss more fully the advantages and limitations of Article III status through the lens of Chrysler's bankruptcy, which we believe was an abuse of the absolute priority rule of bankruptcy, in part through a "rigged" sale of most of Chrysler's assets under § 363, driven by the government. For present purposes, our point is that while no system can eliminate various government pressures on players and participants, an Article III judge is the least likely to "bend" the rules of the bankruptcy process to facilitate governmental favoritism or political forces.

II. COMMENCING A CHAPTER 14 CASE

A. Allow the Entire Covered Financial Institution (Including Subsidiaries) to Be Resolved in Bankruptcy

1. Current Law

While most entities with a place of business or property in the United States are eligible for bankruptcy, there are exclusions for:

- a domestic insurance company, § 109(b)(2), or a foreign insurance company engaged in business in the United States, § 109(b)(3)(A);
- a bank, savings bank, cooperative bank, savings and loan association, credit union, or similar entity "which is an insured bank as defined in section 3(h) of the Federal Deposit Insurance Act" (collectively, consider these "depository banks");
- a foreign bank, savings bank, cooperative bank, savings and loan association, credit union, or similar entity with a branch or agency (as defined in section 1(b) of the International Banking Act of 1978) in the United States.

In addition, there is an exclusion from eligibility for Chapter 11 (reorganization) but not for Chapter 7 for stockbroker and commodity brokers, § 109(d), as defined in §§ 101(6) and 101(53A). In essence, this forces stockbrokers and commodity brokers into special subchapters of Chapter 7. The important part of the stockbroker subchapter is that the Chapter 7 proceeding can be stayed, and then dismissed, upon the filing of "an application for a protective decree under the Securities Investor Protection Act of 1970." ("If SIPC [Securities Investor Protection Corporation] completes the liquidation of the debtor, then the court shall dismiss the case.") For commodity brokers, the Commodity Futures Trading Commission (CFTC) is given a right to be heard, § 762(b), and there are special rules for treating customer accounts "separately," §§ 763 and 766. (There is also a subchapter, commencing with § 781, for the liquidation of clearing banks, which makes the Federal Reserve Board (FRB)–designated conservator or receiver the trustee and provides for various methods for the "disposition" of the clearing bank.)

2. Concerns

Large financial institutions are oftentimes structurally complex and operate subsidiaries in a number of different areas, including those that are excluded from bankruptcy or are shunted to a special bankruptcy procedure. While the exclusion of depository banks has worked reasonably well for special reasons intimately related to the nature of the guaranteed deposit system, other exclusions, such as those for insurance companies, designed to leave their insolvency to state insurance agencies, never achieved that level of agreement or success and seem strangely disconnected with the broad scope of modern, large-scale insurance companies. Whatever their intent, these exclusions and special rules significantly complicate the resolution of a major financial institution, in which bankruptcy is only able to deal with pieces of the (often-integrated) whole and needs to coordinate, sometimes in awkward fashion, with nonbankruptcy resolution authorities that also have only a piece of the whole to work with.

3. Proposal

The Bankruptcy Code would be amended to:

- eliminate the exclusion in § 109(b)(2) and (b)(3)(A) for domestic and foreign insurance companies when Chapter 14 applies, but provide for treatment—to the extent consistent with the broader bankruptcy process for the covered financial institution—of insurance subsidiaries (and those they insure) with nonbankruptcy resolution processes;

- eliminate the exclusion of stockbrokers and commodity brokers from Chapter 11 when Chapter 14 applies by revising § 109(d). In doing this, the special subchapters for stockbrokers (§§ 741 et seq.) and commodity brokers (§§ 761 et seq.) in Chapter 7 would also be eliminated when Chapter 14 applies. The kinds of rules currently existing for the treatment of customer accounts in the commodity broker subchapter (particularly §§ 763 and 766) would be generalized and made applicable to bankruptcy proceedings (whether liquidations or reorganizations) of stockbrokers and commodity brokers, and the SIPC (for stockbrokers) or the CFTC (for commodity brokers) would be given a right to be a party to the proceeding.

The proposal does not change the current resolution practice of the Federal Deposit Insurance Corporation (FDIC) over depository banks.

B. Give the Primary Regulator the Power to File an Involuntary Petition

1. Current Law

There is no limitation on the commencement of a "voluntary" case—that is, a case begun by the filing of a petition by the debtor, § 301(a). "The commencement of a voluntary case under a chapter of this title constitutes an order of relief under such chapter," § 303(b).

Involuntary cases can be "commenced" by the filing by three or more creditors (some largely irrelevant exceptions exist), § 303(b).

2. Concern

Bankruptcy responds to the parties in a direct relationship with the debtor, such as creditors. Again, while this is appropriate for the vast majority of firms, financial or otherwise, there is a legitimate concern for the nation's largest financial institutions that "systemic" consequences going far beyond those direct relationships and affecting the functioning of the financial system need to be addressed as well.

3. Proposal

The existing provisions for the commencement of voluntary and involuntary cases would remain in place. There would be added to these provisions, by amending § 303(b) and (h), the ability of the primary regulator to commence an involuntary case against a financial institution for the same reasons as currently exist for three or more creditors.

C. Allow the Primary Regulator to File Based on "Balance Sheet" Insolvency

1. Current Law

If an involuntary case is contested, there is a "trial," and the court "shall order relief against the debtor" only if **(a)** "the debtor is generally not paying such debtor's debts as such debts become due" (unless the debts are subject to a bona fide dispute), § 303(h)(1), or **(b)** a custodian had been appointed or took possession within 120 days of the date of the filing of the petition, § 303(h)(2).

2. Concern

The Bankruptcy Code eliminated various forms of "balance sheet" insolvency as grounds for the commencement of an involuntary case, believing them (among other reasons) to be too subjective. While that concern has some validity, we believe that it is outweighed in cases of major financial institutions. In those cases, where there is a special concern of a financial "meltdown" leading to possible systemic consequences, limiting involuntary petitions to situations where the debtor is already failing to pay debts as they become due may be woefully late.

3. Proposal

Amend § 303(h) to provide that the primary regulator would be given the power to commence an involuntary case against a financial institution on the ground that either the financial institution's assets are less than its liabilities, at fair valuation, or the financial institution has an unreasonably small capital.[5] The financial institution could contest this (as it can any involuntary petition), although the likelihood is small that the filing would not, in essence, create a self-fulfilling prophesy.[6]

5. Since this is a change from the ordinary involuntary petition rules, added particularly because of a concern about systemic consequences, we have limited this expansion to the primary regulator, not to three or more creditors. If the "balance sheet" insolvency test for involuntary bankruptcy filings was to include unsecured creditors as petitioners, we would suggest a substantially higher aggregate threshold than the current $14,425 amount in Bankruptcy Code § 303(b).

6. Even without this power, it is probably the case that the primary regulator has many ways of "forcing" a weak financial institution to file a voluntary petition. Even so, it is important to make the regulator's power de jure as well as de facto, and this is the cleanest way to do that.

III. ROLE OF THE PRIMARY REGULATOR IN CHAPTER 14; DIP FUNDING

A. Regulator Standing

1. Current Law

There is no provision for such standing, apart from the situation of stockbrokers and commodity brokers in Chapter 7.

2. Concern

Under the current system, certain parts of a complex financial institution cannot be resolved in bankruptcy. The regulators, instead, are tasked with the responsibility of dealing with financial distress for those parts outside of the bankruptcy process. This approach is needlessly complex and fraught with territorial conflicts and disputes, as compared with a framework that encompasses the liquidation or reorganization of a covered financial institution "in total" in bankruptcy. But to gain those advantages, it is important not to lose the expertise and perspective of the primary regulators.

3. Proposal

The regulators of the business of a covered financial institution, or any subsidiary thereof, would have standing with respect to the financial institution or the particular subsidiary, to be heard as parties or to raise motions relevant to their regulation with the Chapter 14 court.

B. Motions for the Use, Sale, or Lease of Property

1. Current Law

Under § 363, motions to use, sell, or lease property of the estate (except in the ordinary course of business) are to be filed by the trustee (or, pursuant to § 1107, the debtor-in-possession).

2. Concern

Because of the importance of preventing systemic consequences, there may be situations in which the government is the only appropriate party to determine that the use, sale, or lease of property of the estate is important and proper; even so, the government's determination must be subject to court review to ensure that it is not likely to harm or favor certain creditors of the financial institution that is in bankruptcy.

3. Proposal

Section 363 should be amended to provide that the primary regulator has the power, in parallel with the trustee or debtor-in-possession, to file motions for the use, sale, or lease of property of the estate. As is currently the case, approval of such a motion would be subject to the safeguards provided in § 363.

C. Debtor-in-Possession (DIP) Financing

1. Current Law

If the business is continuing in operation (which is the ordinary course in Chapter 11, but is also plausibly involved in a Chapter 7 for at least a while), the debtor-in-possession, § 1107(a), or a trustee appointed in lieu of a debtor-in-possession, § 1108, is authorized to obtain unsecured credit and incur unsecured debt, in the ordinary course of business (and without court approval), with such credit/debt having "administrative expense" priority, § 364(a). (Administrative expense priorities are the expenses of running the bankruptcy proceeding, which [simplifying somewhat] essentially rank *before* prebankruptcy unsecured claims but *after* prebankruptcy secured claims in priority, §§ 507(a)(2), 725, and 726.) Under § 364(b), administrative expense priority can also be given to other funding that does not qualify as being in the "ordinary course of business," but now only upon court approval, after notice and a hearing. If administrative expense priority is insufficient to obtain credit, the court becomes involved and priority can be increased, subject to increasingly rigorous requirements. It may be authorized, after notice and a hearing: **(a)** with priority over other administrative expenses, or with a security interest on property that is not already subject to a security interest, or with a junior security interest on property that is already subject to a security interest, § 364(c); or **(b)** with a senior or equal security interest on property already subject to a security interest, however, the court must now find not only that the financing is not otherwise available but also that the existing secured creditors receive "adequate protection" under § 361 of their security interest, § 364(d). (The latter is very difficult to establish, because it basically requires a showing that no one is willing to lend without priority over (or parity with) an existing secured credit *and* the debtor can demonstrate that the existing secured creditor is no worse off than it was before.)

2. Concerns

There may be situations where liquidity or other systemic concerns suggest that the appropriate action—without involving a government bailout of any sort—would be for certain liquidity-sensitive creditors to be "advanced" a portion of their likely bankruptcy distribution, which would be accomplished through DIP financing. It is unlikely that § 364, which focuses on funding ongoing operations, not prepayments to existing creditors, currently would allow such as result. Because of the necessity of an estimation of final distribution, this possibility needs to be carefully circumscribed, however.

Because of the importance of the principle, it is perhaps worth outlining the concern with a numerical example. Assume the debtor has assets of $100 million and unsecured claims of $300 million. Without any prepayments, the expected distribution at the end of the bankruptcy proceeding would be 33 cents on the dollar to the unsecured creditors. If, however, there is a determination that the "liquidity-sensitive (LS) creditors" with unsecured claims of $100 million should receive advanced payments, and those advanced payments come from funding under § 364, the problem of "aggressive" prepayment manifests itself in this way. Assume that the debtor (or the government) persuades the court that a "conservative" payout to the LS creditors would be $50 million (or 50 cents on the dollar), and the government will provide that funding pursuant to § 364. The following changes occur: **(a)** the LS creditors receive $50 million (instead of $33 ⅓ million), and **(b)** the government has an administrative expense (or higher-priority) claim for $50 million, § 364(b). Because of these two changes, the debtor still has assets of $100 million (the government's money came and went, leaving the assets as before), but now has an administrative expense claim (held by the government) of $50 million and $200 million of remaining unsecured claims (i.e., claims that did not receive an advance payment). Following ordinary bankruptcy distribution rules, the government would get the first $50 million of the debtor's assets, leaving $50 million for the remaining $200 million of unsecured creditors. In short, because of the "aggressive" prepayment, the LS creditors receive a distribution of 50 cents on the dollar rather than 33 cents on the dollar, and the remaining unsecured creditors receive a distribution of 25 cents on the dollar, rather than 33 cents on the dollar. The LS creditors are better off and the remaining creditors are worse off. The government is, financially, indifferent, but it has—through this—accomplished a partial bailout of the LS creditors. The innocent parties (beyond the taxpayers) in this are the remaining unsecured creditors, whose share of the bankruptcy estate went from 33 cents on the dollar to 25 cents on the dollar. To undo this, it is necessary either to "claw back" the difference between 33 and 50 cents on the dollar from the LS creditors or to require the government's $50 million claim to be subordinated to the remaining unsecured creditors to the tune of $16⅔ million (one-third of the total)—so the government would receive $33⅓ million, and there would be $66⅔ million left for distribution to the remaining $200 million of unsecured creditors. (While this has focused on the government as funder, because the innocent "victims" are the remaining unsecured creditors, a similar concern would arise even if the $50 million funding to the LS creditors came from a private source.)

3. Proposal

The proposal would add a provision making it clear that DIP financing is available in Chapter 14 pursuant to § 364(b) (nonordinary-course financing, as well as § 364(c) and (d))—all of which require court approval after notice and a hearing—for financing that will permit partial or complete payouts to some or all creditors where liquidity of those creditors is a concern, and the payments are intended as "advances" for the likely payouts such creditors would receive in a liquidation or a reorganization at the end of the bankruptcy process. To prevent unfair treatment of creditors entitled to particular distributions under the Bankruptcy Code, approval of any such request would be subject to several burden of proof requirements. First, the movant would be required to show the necessity (for liquidity or other systemic reasons) of the payout (including its amount) to particular creditors.[7] Second, the movant would be

7. Any creditors receiving such advanced payout, at least in the case of a reorganization, would necessarily constitute a separate "class" under § 1122(a) for purposes of voting on the plan.

required to show that such payout is less than a conservative estimate of the amount those creditors would receive in bankruptcy without such prepayment. Third (and logically following from the second), the movant would be required to show that any such prepayment was not likely to favor particular creditors or classes of creditors, or otherwise undermine the operation of the absolute priority rule embodied in §§ 725 and 726, and the plan confirmation requirements of § 1129. If the government is the entity providing the funding, it will additionally be required to show that no private funding on reasonably comparable terms is available. Those provisions on burden of proof should be written into the statute, in an analogous fashion to the burden of proof on issues of adequate protection of secured creditors in § 364(d)(2).

In addition, it shall be a provision of any such funding that, should the payout exceed the amount that the creditors would have received in the bankruptcy proceeding in the absence of such funding, the entity providing the funding, in clear and explicit fashion, agrees to subordinate its § 364 funding claim to the claims of the remaining creditors to the extent of that excess.

D. Filing Plans of Reorganization

1. Current Law

In Chapter 11, the debtor may file a plan at any time, including at the time of its voluntary petition (a "prepack"), § 1121(a). Any other party in interest (including a creditor or a creditor's committee), can usually file a plan (there are a couple of largely unimportant exceptions) only if the debtor has not filed a plan within the first 120 days, § 1121(c)(2), unless, upon request and after notice and hearing, the court reduces (or increases) that period (which is known as the debtor's "exclusivity" period).

2. Concerns

Given the concerns with systemic consequences, as well as speed, a presumptive 120-day exclusivity period for plan formulation and filing given to the debtor-in-possession (i.e., existing management, usually selected by the former shareholders, who are now presumably "out of the money") is cumbersome and potentially destructive of significant value that depends on rapid resolution.

3. Proposal

In addition to the debtor, in the case of a Chapter 14 proceeding, allow the primary regulator or a creditors' committee to file a plan of reorganization at any time after the order for relief (which occurs upon filing in a voluntary case, § 301(b), and after a court order in the case of a contested involuntary petition, § 303(h)). This would be accomplished either through an amendment to § 1121 ("Who may file a plan") or through a provision in Chapter 14 that provided "notwithstanding § 1121(c)," the entities listed previously could file a plan of reorganization at any time after the order for relief.

IV. QUALIFIED FINANCIAL CONTRACTS IN CHAPTER 14

Introduction

The current—like our proposed—treatment of various forms of qualified financial contracts (QFCs) is complex and easily misunderstood. In essence, our proposal has three major parts, two of which focus on the automatic stay and one that focuses on the trustee's avoiding powers (preference law, in particular).[8] The first part, which concerns repos, proposes modest changes in current bankruptcy law, mostly to clarify that, for purposes of Chapter 14 (and hence for covered financial institutions), the automatic stay does not apply to repos (which will be treated as a form of secured loans that are automatically "breached" by the debtor upon the commencement of a bankruptcy case) in terms of netting, setoff, or collateral sales by the counterparty of cashlike collateral that is in its possession. The second part, which concerns derivatives, proposes short-term, more-significant changes in current bankruptcy law. For three days, the counterparty will be subject to bankruptcy's automatic stay and therefore stayed from exercising any right under an ipso facto clause (unless the debtor first explicitly rejects the derivative contract) to enable the debtor to exercise its choice between assumption and rejection of this form of executory contract. After three days, and unless the debtor has previously assumed the derivative, the counterparty will be free to exercise any rights it may have under ipso facto clauses (or otherwise) to terminate the derivative and, upon termination (either by action of the counterparty or by rejection by the debtor), the counterparty will have the netting, setoff, and collateral sale rights of a repo counterparty in bankruptcy. The third part, which concerns both repos and derivatives, applies trustee's avoiding powers, including preference law, to

8. While our focus is on QFCs in Chapter 14, we believe that these changes are not tied in any specific way to financial institutions covered by Chapter 14. Thus, in our view, it would be desirable to incorporate these proposals so as to be applicable to any bankruptcy proceeding, whether or not dealing with a covered financial institution in Chapter 14. For a fuller analysis of these issues, *see* both Darrell Duffie and David Skeel's contribution to this volume (chapter 5), as well as David Skeel & Thomas Jackson, *Transaction Consistency and the New Finance in Bankruptcy*, 112 Colum. L. Rev. 152 (2012).

such transactions, but also provides a "two-point net improvement test" safe harbor for certain payments and collateral transfers that otherwise would be subject to preference attack. These three parts are only briefly summarized here; a more detailed consideration of each—such as provisions dealing with the sale of other types of collateral or the enforceability of master agreements—is developed later in this chapter.

A. Repos and the Automatic Stay

1. Background

Before looking at current law, or at the proposal, it is useful to have some background information about the treatment of loans in bankruptcy, and the likely treatment of repos under normal bankruptcy rules (rather than the special rules that have been added governing their treatment).

Loans—situations where a creditor has loaned money to a debtor and awaits a repayment—are considered "claims" in bankruptcy of the debtor. The essence of a "claim" is that it is a liability from the perspective of the debtor. Since the debtor has already received the funds and the only obligation remaining is the debtor's repayment, it is a classic liability. The filing of a bankruptcy petition effectively "breaches" (or, to use language we will see later more precisely fits the terminology of the Bankruptcy Code, "rejects") this repayment obligation. This occurs automatically. The creditor does not need to take any action and the debtor is not permitted to "assume" the obligation. The claim is "accelerated" and valued as of the date of the filing of the petition; interest accruing after that date is disallowed unless the debtor has a security interest and is "oversecured." Thus, if the debtor borrowed $10,000 from the creditor on February 1 with repayment on June 1 and files for bankruptcy on April 1, the claim would be for $10,000 plus accrued but unpaid interest to that date.

The creditor is stopped by the essential nature of bankruptcy as a collective proceeding from taking any steps to collect this claim. The "automatic stay" of § 362 prohibits "any act to collect, assess, or recover a claim against the debtor that arose before the commencement of the case under this title," § 362(a)(6). This includes any setoff of a prepetition claim against a prepetition obligation that the debtor may owe the creditor, § 362(a)(8). (The *right* of setoff is recognized by bankruptcy law, § 553, but *exercising* it is prohibited by the automatic stay without first seeking court permission.)

If the loan is secured by collateral, the automatic stay extends to any effort to seize, use, or sell that collateral, § 362(a)(3), (4), (5); this would include collateral in the possession of the creditor. (Indeed, pursuant to § 542(a), the secured party may need to turn over the collateral to the debtor if it is the type of property that the debtor may "use, sell, or lease" under § 363.) The debtor is relieved of any obligation to post additional collateral. If there is a danger that the existing collateral will decline in value during the bankruptcy proceeding (traditionally because the debtor is using the collateral, but it would extend to market fluctuations as well), the secured creditor may ask the court for "adequate protection" of its security interest under § 361. Under a Supreme Court interpretation of the Bankruptcy Code, the secured party is not compensated for the delay itself—for the "time value" of money—unless the secured party's collateral is worth more than the amount of the loan outstanding.

In short, in the case of a secured loan, upon the filing of a petition in bankruptcy: **(a)** the loan is "breached" and valued as of that date; **(b)** the collateral is similarly valued as of that date and further decreases in its value are protected, upon request, by "adequate protection"; **(c)** the debtor is relieved of any obligation to post additional collateral; and **(d)** the secured creditor cannot take steps to collect the debt, including by self-help (setoff or selling collateral in its possession), without first getting bankruptcy court permission.

Most repos, despite their form (a sale and repurchase), are in fact considered by practitioners to be secured loans, and it is very probable that virtually all repos would be recharacterized to *be* secured loans by Article 9 of the Uniform Commercial Code. (Article 9 applies to "a transaction, *regardless of its form*, that creates a security interest in personal property," § 9–109(a)(1).)[9] Thus, their *probable* treatment in bankruptcy, apart from "special" rules, would likely be identical to what has been described earlier in terms of secured loans.

With this as background, we can turn to the current and proposed treatment of repos vis-à-vis the automatic stay in bankruptcy.

2. Current Law

Under § 559, a repo counterparty can terminate a repo notwithstanding a "condition" of the sort that is invalidated by § 365(e)(1). Unlike ordinary contract creditors, who cannot enforce so-called ipso facto clauses that allow termination at the event of the commencement of a bankruptcy case or the debtor's insolvency, repo counterparties are permitted to invoke these provisions, § 559. Under § 362(b)(7), a repo counterparty also can offset or net out obligations (including transfer obligations) under one or more repo agreements, including a master agreement, notwithstanding the automatic stay. (Although this language, added in 2006, is not crystal clear, it is apparent from prior language and intent that this includes the repo counterparty's ability to sell the "collateral" (the property that is the subject of the repo) that is in its—or its agent's—possession.)

9. Emphasis added.

3. Concerns

Current law suggests "special" treatment vis-à-vis the automatic stay for repos when, in fact, ordinary bankruptcy principles would lead to much the same result. At the same time, because of the complete exemption of current law, there is no attention paid to types of collateral. And, even with the special repo rules in bankruptcy, the right of a repo counterparty to marketable securities that are in the possession of the debtor, even upon motion, is unclear.

4. Proposal

Very little would change because of two overarching principles. First, as a matter of nonbankruptcy law, repos are forms of secured loans (see earlier discussion). Second, because the property that is the subject of repos is usually marketable securities or other cash-like instruments, there is no "firm-specific" value to the assets and there is little subjectivity regarding their market value. Putting together these two principles, the following emerges: First, repos are automatically breached upon the filing of a bankruptcy petition. Second, because all repos are breached, no such provision in a master agreement that cross-links repos is necessary to ensure that the breach of one is considered a ground to terminate all (since all have been terminated automatically upon the filing of a bankruptcy petition). Third, because of the highly marketable attributes of the property that is oftentimes the subject of repos—the "secured property" in the recharacterization of repos as secured loans—there is little reason to prohibit the sale of such property, if it is in the possession of the counterparty, by the automatic stay. Since all the repos are breached by the filing of the bankruptcy petition, the setting off or netting out across repos invades no bankruptcy norm and should also be allowed—although master agreements that allow netting of repos against derivatives or other qualified financial contracts would be limited to netting across repos. These results are all consistent with the current Bankruptcy Code "special rules" involving repos, and thus—despite their linguistic awkwardness—no change in either § 559 or § 362(b)(7) is necessary. The changes we propose are threefold:

First, our proposal would ensure that the right of collateral sales of repos by counterparties—without court permission and where the debtor is in bankruptcy—is limited to cashlike or otherwise highly marketable securities. (Arguments that the debtor "needs" access to the cashlike assets [by definition, in possession or control of the counterparty] conflates DIP financing, discussed earlier, with firm-specific collateral, which cashlike collateral is not. Requiring the counterparty to be a DIP financer, with "adequate protection" of its secured interest given in return, is both coercive and defaults to the highest level of DIP financing priority because of the requirement of providing the counterparty with adequate protection. The issue of DIP financing, which our Chapter 14 proposal addresses, should not be conflated with the idea that a secured creditor holding cash-like collateral should be able to sell it because it is neither **(a)** firm-specific nor **(b)** subject to valuation manipulations.) Precisely because of the lack of firm-specific value and the ease of valuation, our proposal is limited to cashlike or otherwise highly marketable securities. If a repo involved (for example) a drill press, that repo's counterparty would not be automatically exempted from the automatic stay (on selling the collateral).

Second, our proposal would give the repo counterparty the right to sell other, non–firm-specific collateral in its possession upon motion to the court and the court's determination of the collateral's reasonable value.

Third, for situations where the collateral is in the hands of the debtor, not the repo counterparty, we propose to amend § 362, for

Chapter 14 purposes, to give a right of relief upon petition by a counterparty seeking to sell collateral backing the repos in the possession of the debtor to the extent that collateral consists of highly marketable securities or other cashlike collateral (which can be easily valued and does not have firm-specific value) as well as other non–firm-specific collateral upon the court's determination of the collateral's reasonable value.

B. Derivatives/Swaps and the Automatic Stay

1. Background

Before turning to current law or our proposals, it is useful, as for repos, to discuss the background treatment of "executory contracts" in bankruptcy, and what the likely treatment of derivatives/swaps in bankruptcy would be vis-à-vis the automatic stay under normal bankruptcy rules.

Derivatives/swaps, analytically, come in two different (but closely related) forms. In one form, they set (or guarantee) a price on a certain date. As such, they are (as a matter of form) analogous to a contract entered into on February 1, for the debtor to buy widgets on June 1 for $1,000. A simple future or forward contract—such as a contract to buy oil at a specified price on June 1, takes this form. The second is a protection (such as against default or a price change) over time. An interest rate or currency swap is a familiar example, as are credit default swaps. As such, these contracts are analogous (as a matter of form) to a fire insurance policy on a building. As a matter of bankruptcy law, the widget contract is considered an "executory contract" under § 365, since it consists of materially unperformed obligations on both sides (the buyer needs to pay and the seller needs to deliver). The same would be true of an insurance contract where the debtor had not already paid for the insurance. The fundamental notion of an executory contract is that the debtor has a right to either "assume" (i.e., determine that the contract is a net asset) or "reject" (i.e., determine that the contract is a net liability). Upon assumption, the contract is treated as if it was one entered into by the debtor in bankruptcy, and thus the debtor is expected to perform, with any damages resulting from a failure to perform treated as an administrative expense claim rather than a prepetition claim. Upon assumption, the debtor must comply with the terms of the contract, including the posting of additional collateral (although the debtor may "assign" the contract to another party upon the provision of adequate assurance of performance by the assignee, notwithstanding contractual provisions prohibiting such assignment, § 365(f)). However, if the debtor decides that the contract is a net liability, the debtor may "reject" the contract, in which case, any resulting damage claim is treated as a prepetition claim whose value is determined as of the filing of bankruptcy, just as in the case of ordinary loans (or repos). This right of the debtor to choose between assumption and rejection cannot be circumvented by a term in the contract that permits the nondebtor party to terminate because of bankruptcy or the financial condition of the debtor. As discussed under repos, clauses that permit this are called "ipso facto" clauses in bankruptcy and are normally unenforceable; see § 365(e)(1). The effect of a termination by the nondebtor party pursuant to an ipso facto clause would be to remove the choice of the debtor to "assume" the contract—that is, determine (from the perspective of the bankruptcy estate) that the contract was a net asset. That is prohibited by bankruptcy, as is any setoff right or collateral disposition, because of the operation of the automatic stay, as discussed under repos.

In short, in the case of executory contracts, in bankruptcy **(a)** the debtor has a right to decide whether to "assume" or to "reject" the contract; **(b)** this right cannot be eliminated by any right of the other party to terminate based on an ipso facto clause; **(c)** the automatic stay applies during this interregnum to prohibit the other party from setting off, selling collateral, or otherwise attempting to collect on the underlying obligation; **(d)** if the debtor "rejects," then analytically the contract is treated in the same manner as a loan or repo, discussed previously; **(e)** if the debtor "assumes," then the contract is treated as one "created by" the debtor in bankruptcy, and thus one for which it needs to perform (including additional collateral postings); any breach of that obligation would be equivalent to a breach of a postpetition "administrative expense priority" contract; and **(f)** the debtor may, following assumption, "assign" the contract.

There is little doubt that, apart from the special provisions governing derivatives/swaps, they would be considered to be executory contracts, treated as are other executory contracts as described previously. With this as background, we can turn to the current and proposed treatment of swaps and derivatives vis-à-vis the automatic stay in bankruptcy.

2. Current Law

Here, unlike the case with respect to repos, the special rules for derivatives/swaps do, in fact, significantly change the rights of a derivative/swap counterparty in bankruptcy vis-à-vis the rights of an ordinary secured creditor. Section 560 calls off the application of § 365(e)(1)—and thus permits the counterparty to terminate based on an ipso facto clause. The effect of a termination by the counterparty pursuant to an ipso facto clause is to remove the choice of the debtor to "assume" the contract. And, upon termination, a parallel exception built into § 362(b)(17) allows the counterparty "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." This permits "self-help" by the counterparty, including selling any collateral that might be in its possession. [If the collateral is not in its possession, there is no comparable exception to the automatic stay that would allow the counterparty to pursue collateral in the possession of the debtor without first gaining court permission, so that is not an issue.] Because of the master agreement provisions, any rejection or termination of any one derivative/swap with a counterparty is grounds for the counterparty's termination of all the derivatives within the same master agreement, thus precluding the debtor "cherry-picking" which derivatives/swaps with a counterparty to assume (because a net asset) or reject (because a net liability). A provision determining that "breach of one is a ground for the termination of all" is enforceable.

The provisions do seem to require the counterparty, in order to terminate, to take some concrete step toward that (such as notifying the debtor that it is terminating the contract). In the interim, the debtor remains free to assume or reject under § 365. (Indeed, *Metavante* suggests that unless the counterparty terminates a derivative/swap in a rather quick time frame, it loses the right to avoid assumption under § 365 by the debtor.)[10]

3. Concerns

By removing derivatives completely from the automatic stay, a debtor may be precluded from assuming valuable derivatives (subject to a master agreement that may, functionally, require an "all-or-nothing" determination). Both the FDIC resolution model for depository banks and the recently enacted government agency

10. *In re Lehman Brothers Holdings Inc.*, Case 08-13555 (Bankruptcy SDNY Sept. 15, 2009), more commonly known as the *Metavante* case.

resolution procedures for financial institutions under the Dodd-Frank Act provide a one-day window in which the debtor (or the government agency) may decide to assume and assign derivatives that place bankruptcy in a significant disadvantage (from the perspective of the financial institution) as an alternative.

4. Proposal

Although the debtor should be on a tight time leash with respect to the decision whether to assume or reject, the fundamental nature of derivatives/swaps as forms of executory contracts suggests that the debtor should have the right to determine whether to assume or to reject them. This means that during this period, the counterparty should be subject to the automatic stay, as well as precluded from terminating any derivative/swap because of an ipso facto clause. At the same time, whether as a matter of a "vested" provision of a master agreement (that cannot be undone by the debtor rejecting the master agreement itself) or the consequences of a right of setoff that is not excluded from the stay, the counterparty should retain the right to terminate any or all derivatives/swaps with the debtor should the debtor decide to reject, under § 365, *any* derivative/swap with the counterparty. Because of that, the debtor cannot "cherry-pick"—picking the derivatives/swaps with a particular counterparty that it views as net assets, and assuming them, while rejecting all derivatives/swaps that it views as net liabilities. The interplay of the right of the debtor to assume or reject and the counterparty to treat the rejection of one as the rejection of all leads to a global decision of the debtor (vis-à-vis any single counterparty) to assume or reject all derivatives/swaps with that counterparty. In addition, should the debtor assume derivatives/swaps, the ordinary rules of § 365 should allow the debtor to assign those derivatives/

swaps as well, upon the provision of adequate assurance of performance by the assignee. (This is essential to allowing bankruptcy to have going-concern values of large financial institutions and mirrors, in that respect, the "bridge" institution ability of FDIC resolution and Title II of Dodd-Frank.)

With prebankruptcy planning and wind-down plans, and with recognition of the right (currently one that can be circumvented by a counterparty by the special QFC bankruptcy rules) of the debtor to decide whether to assume or reject, the automatic stay, as well as the normal rules prohibiting termination based on ipso facto clauses, should apply for a period of three days from the time of the filing of the bankruptcy petition. After that, the debtor's right to assume the derivatives/swaps can be terminated by the counterparty (pursuant to the agreement's termination provisions; until termination by the counterparty has occurred, the debtor continues to have the right to assume). Upon termination, the counterparty enjoys all the rights described previously under repos vis-à-vis setoff and collateral sales: for example, the right of collateral sales (without going to court) in the case of marketable securities and other cashlike collateral in the counterparty's possession, with both recognized market values and no firm-specific value; the right of collateral sales, upon motion, for other collateral without firm-specific value and upon court determination of the fair value of the collateral; and the right, upon motion, to access collateral of the categories just identified, still in the possession of the debtor.

There are concerns that no such short stay, such as our proposal of three days, could possibly allow a debtor to "net out" the value of potentially thousands of related swaps. Whether or not true under the existing procedures—and we note that an even more aggressive abbreviated timetable exists for depository banks under the FDIC resolution procedure and in Title II of Dodd-Frank—it is also the case that recent requirements, including Dodd-Frank's insistence on "living wills" as well as its push to have swaps traded on exchanges, will go far to make "net out" valuations much more instantaneous, and thus potentially consistent in terms of quick valuation and evaluation with the brief stay we favor.

Operationally, this would be accomplished through the following changes, applicable to Chapter 14, of current bankruptcy provisions. The single most important "fix" would be to condition the application of § 560 on the expiration of three days from the filing of a petition in bankruptcy by a financial institution.[11] Prior to the termination of that period, the derivative/swap counterparty (like a party to any other comparable executory contract) would not have the right to terminate the contract without going to court first. And the debtor would have, as it does with other comparable executory contracts, the right to decide to assume (and, if appropriate, assign) or reject the derivative contract (although a master agreement or the setoff right might make that exercise an "all-or-nothing" affair).

This change (i.e., the limitation that would be written into § 560) would mean that the counterparty could *not* offset, net out, or sell collateral unless and until **(a)** the debtor decides to reject the contract and it is (by that action) terminated, or **(b)** the three-day time period for the debtor to decide whether to assume or reject expires. Upon termination (either by the counterparty, upon the expiration of the three-day time period, or by the debtor when it

11. Although not the current focus (which is on derivatives/swaps), §§ 555 and 556, which deal with securities contracts and forward contracts in an analogous manner to § 560, should likewise be conditioned on the expiration of three days from the filing of a petition in bankruptcy by a financial institution.

rejects the contract), the existing § 362(b)(17) rights (which are opaquely worded and should be clarified) would remain—that is, a right to set off one contract against another without first going to court and, ancillary to that, sell collateral in the possession of the counterparty without first going to court. With the understanding, that should be made the basis of statutory distinction, that most of that collateral will be financial instruments—or cashlike collateral (with recognized market values)—the ability of a counterparty to "self-help" by selling collateral (in its possession) or netting out need not be a major disruption to the ongoing operations of the debtor and would not need to be repealed.

The right of a counterparty, under a master agreement, to "cross-link" derivatives/swaps so that the rejection of one by the debtor would permit the counterparty to treat all of the derivatives/swaps as terminated (thus precluding the debtor's assumption of any of them) would remain in force.[12] Section 362 should also be amended, for Chapter 14 purposes, to give a right of relief upon petition by a counterparty seeking to sell collateral backing the derivatives/swaps **(a)** in the possession of the counterparty that, while not highly marketable, has no firm-specific value upon the determination of its fair market value; **(b)** in the possession of the debtor to the extent that collateral consists of highly marketable securities or other cashlike collateral (which can be easily valued and does not have firm-specific value); and **(c)** in the possession of the debtor to the

12. This right, however, would be limited to cross-linking derivatives/swaps pursuant to a master agreement. The master agreement would not be enforceable to the extent it attempted to cross-link repos and derivatives/swaps. Since repos are automatically "terminated" upon the filing of a bankruptcy petition, cross-linking across these categories would allow a counterparty with one (small) repo to avoid the debtor's ability to assume all derivatives/swaps under § 365. The master agreement provisions in the Bankruptcy Code should be amended to make this clear.

extent that the collateral consists of other non–firm-specific collateral, upon the determination of its fair market value.

C. Repos, Derivatives/Swaps, and Trustee's Avoiding Powers

1. Background

Bankruptcy has several devices, usually lumped together under the rubric of "trustee's avoiding powers" to protect dismemberment of the estate, either through actions of the debtor or through actions of creditors to seek to protect themselves, after making a loan or entering into a contract, from the consequences of an imminent bankruptcy proceeding. The most important of these "reach back" avoiding powers are **(a)** fraudulent transfers, §548, and **(b)** preferences, §547.

Under § 548, the fraudulent transfer provision,[13] the trustee (or debtor-in-possession) may avoid two types of transfers as fraudulent: The first, in § 548(a)(1)(A), are transfers made within two years of bankruptcy "with actual intent to hinder, delay, or defraud any entity"—this is known as the actual fraud provision. The second, in § 548(a)(1)(B), known as the constructive fraud provision, reaches prebankruptcy transfers within two years of bankruptcy where the debtor "received less than a reasonably equivalent value" at a time when the debtor was insolvent, had unreasonably small capital, or believed that it would incur debts beyond its ability to pay.

Under § 547, the preference section, the trustee may avoid a transfer "on account of an antecedent debt," made within 90 days

13. The trustee also has access to state fraudulent transfer provisions pursuant to his § 544 "lien creditor" powers, which oftentimes have a longer reach-back period than the two-year period provided by § 548.

of bankruptcy and while the debtor was insolvent,[14] that enables a creditor to receive more than it would have received, in bankruptcy, had the transfer not been made. Thus, transfers are not just payments but would include things such as the posting of additional collateral on an existing contract ("on account of an antecedent debt"). There is an exception for transfers that are both intended and are in fact, "a contemporaneous exchange for new value given to the debtor," although it is essential to note that "new value" is defined as excluding "an obligation substituted for an existing obligation," § 547(a)(2). There is also, for security interests in inventory or receivables, what is known as a "two-point net improvement" test, which looks at whether "the aggregate of all such transfers caused a reduction," on the commencement of bankruptcy, of the creditor's claim 90 days before bankruptcy (or the date on which new value was first given), § 547(c)(5). (Thus, the fact that the inventory went down in value and then went back up in value would be ignored, unless the inventory value on the date of bankruptcy was greater than the inventory value 90 days before bankruptcy.)

2. Current Law

Under § 546(e), (f), (g), and (j), the trustee's avoiding powers (with the exception of the actual fraud provision of § 548) are not enforceable against the holder of qualified financial contracts. This started with what is now § 546(e), exempting the transfers of margin and settlement payments by or to brokers (an exemption that makes some sense since these payments usually do not have the

14. "Insolvent" is defined in § 101(32) as having debts greater than assets, at fair valuation. The period is extended from 90 days to one year if the transfer is made to or benefits an "insider" of the debtor.

hallmarks of "opt out" activity on the eve of bankruptcy). From this narrow beginning, the Bankruptcy Code has been amended to provide similar protection for *all* qualified financial contracts, including repos, § 546(f), and derivatives/swaps, § 546(g).

3. Concerns

QFC counterparties tend to be among the most sophisticated creditors of a financial institution. Providing a safe harbor from preference law (and other avoiding powers of the trustee), when "regular" creditors are subject to such powers, seems perverse in that it protects the parties most likely to "see" bankruptcy coming and take steps to protect themselves or, alternatively, take steps that lead to a bankruptcy case being commenced in a more timely fashion. While there are special features of various QFCs that do not fit comfortably into existing preference law, a blanket exemption seems overbroad.

4. Proposal

With respect to repos and derivatives/swaps, and subject to an amendment to § 547(c)(5) regarding an extension of a "two-point net improvement" safe harbor that is discussed subsequently, remove the current exemption from trustee's avoiding powers by amending § 546(f) and (g) (as well as § 546(j) , which repeats the protection for transfers made pursuant to a master netting agreement) to provide that these provisions do not apply in a Chapter 14 proceeding.

It is important to understand what this does and what it does not do (here, focusing on the preference provisions of § 547). Because of the nature of preference law—did a creditor improve his position at the expense of other creditors via a transfer within the preference period?—"improvements in position" by a creditor that are due to market increases in value of collateral are *not* subject to preference attack. Say a security, posted as collateral, is worth $70,000 on 90 days before bankruptcy and is worth $90,000 at the time of bankruptcy. The $20,000 "improvement in position" is not a voidable preference because it involves no "transfer of property of the debtor" (and, conceptually, does not diminish the returns to the other creditors). Because of this feature and the nature of repos, most repos will not be subject to attack under § 547. With a typical repo in which the debtor promises to buy back property that had been previously sold to a counterparty, fluctuations in the value of that property due to market forces between the sale and repurchase are not preferences under § 547; recharacterizing the transaction as a secured loan does not change the underlying preference analysis. Preference law would matter in cases where notwithstanding the sale/repurchase form, the property subject to the repo declines in value and the repurchaser (the failed financial institution) posts additional property. Treated as a secured loan, this is equivalent to the posting of collateral with an original value of $70,000 that declines within the preference period to $60,000, leading to a requirement that the debtor post an additional $10,000 of collateral. Preference law would treat this additional posting as a voidable preference.

Preference law, however, looms larger for swaps and other derivatives, where collateral is in fact used to secure an underlying obligation. Here, however, it is still the case that increases in the value of collateral due to market forces are not themselves preferential. And there is a second, important situation in which "new" collateral would not be preferential, which we call "rollover" derivatives. To see this, consider the following reasoning. While the definition of "new value" in § 547(a)(2) excludes "an obligation substituted for an existing obligation," that definition would not exclude treating "rolled over" derivatives as constituting new value, as long as the "rollover" occurs upon the maturing of one derivative. That is to say, if derivative 1, with $20,000 of collateral securing a $15,000 obligation matures, is paid off (which involves no preference, as the counterparty is fully secured) and is replaced by derivative 2, with $40,000 of collateral securing a $15,000 obligation, there is no preference issue, even if the collateral (in both cases) declines by 50 percent by the time a bankruptcy case is commenced. Thus, even if a predictable response to subjecting derivatives to preference law would be to shorten the maturity of derivatives and rely on "rollover" derivatives, there is a world of difference between "opting out" of bankruptcy concerns with an *existing* transaction, and a series of shorter but independent transactions that run their ordinary course.

The preference concerns of a counterparty thus would focus on two other issues: **(a)** payment on the derivative within 90 days of bankruptcy when the payment exceeded the value of the collateral (that is, the counterparty was undersecured) and **(b)** transfers of new collateral to the counterparty within the 90-day preference period that increase (rather than through market forces) the value of the aggregate collateral securing the obligation to the counterparty. While **(a)** is a straight-out preference, **(b)** is more complicated.

To delve into that complication, it is useful to return to the analogy of the "two-point net improvement test" for cases where the collateral is inventory or receivables. The original idea behind the "two-point net improvement test" for inventory or receivables follows the image of a "pool" of collateral. One takes (for example) a security interest in "inventory," and knows that the inventory will fluctuate in value, not because of a change of market valuation of each individual item in that inventory, but because the nature of inventory is that it fluctuates in size. Thus, in the completely ordinary course of business, a security interest in an inventory of widgets, with each widget always worth $10, may fluctuate because the number of widgets in the inventory might be 8,000 on one day, 12,000 a week later, and 10,000 the following week. Viewing that this is unlikely to be the result of opt-out activity,[15] the Bankruptcy Code provides a safe harbor for such fluctuations, except to the extent that the creditor's overall position is better at the time of the commencement of the bankruptcy case than it was at a point 90 days earlier (or when credit was first extended within that 90-day period), § 547(c)(5). Thus, if the debtor owes $100,000 to the lender and the "pool" of widget inventory was worth $80,000 90 days before bankruptcy, declined to $60,000 30 days before bankruptcy, and then increased so that it was valued at $90,000 on the date of bankruptcy—all because of fluctuations in the number of widgets in the inventory—the creditor would have a potential voidable preference of $10,000, rather than $30,000.[16]

Derivatives are rarely secured by inventory or receivables, and therefore are not able to claim the protection of § 547(c)(5). But certain features of certain derivatives fit the underlying principle, in addition to being protected by the more general principle that changes in market values of underlying collateral are not themselves preferential, as discussed earlier.[17] For example, if a certain derivative transaction is secured by "all" of the debtor's mortgage-backed securities, and the quantity of those securities fluctuates, the

15. Which is not to say that it could not be, as where a creditor demands that its debtor "build up" its inventory within 90 days before bankruptcy.

16. The creditor may not even have a voidable preference in the amount of $10,000, as the trustee must also show that reduction in the creditor's unsecured claim was "to the prejudice of other creditors holding unsecured claims," § 547(c)(5), which may be difficult to show if all the debtor's other assets are worth exactly as much as before.

17. This would also protect the substitution of a new security as collateral when an old security matured, as long as the new security was not more valuable than the old.

analogy to inventory or receivables (which are protected by § 547(c)(2)) is strong and is deserving of comparable protection, which requires an amendment to § 547(c)(5) to include classes of securities or other "pool-like" collateral that might be the subject of derivative transactions in a Chapter 14 proceeding.

SUMMARY OF PROPOSED REVISIONS

I. Creation of a New Chapter 14

- Add a definition of a financial institution to § 101 to pick up institutions (including their subsidiaries) with assets more than $100 billion that are substantially engaged in providing financial services or financial products.
- Create a new Chapter 14 for financial institutions and require that financial institutions use it.
- Amend § 109 to provide that a financial institution must concurrently file for a Chapter 7 liquidation or a Chapter 11 reorganization at the time that it files for Chapter 14, and that all resulting proceedings will be conducted pursuant to Chapter 14.
- Create designated district court judges in the Second and DC Circuits to hear Chapter 14 cases, by adding a new provision to Title 28. Provide that these designated district court judges have exclusive jurisdiction over Chapter 14 cases notwithstanding the provisions of 28 U.S.C. § 157, and prohibit them from delegating the case to bankruptcy judges, but permitting them to assign to a special master, from a designated panel of special masters, the case and its proceedings as if it were a

designation to a bankruptcy judge under 28 U.S.C. § 158. Provide for the ability of the district judge to hire additional experts, as well as rely on the assistance of bankruptcy judges (subject to the prohibition on delegation of cases to such judges).

II. Commencing a Chapter 14 Case

- Revise § 109 to eliminate the exclusion from bankruptcy of insurance companies when Chapter 14 applies.
- Revise § 109 to eliminate the exclusion of stockbrokers and commodity brokers from Chapter 11 when Chapter 14 applies.
- Provide that the special subchapters in Chapter 7 for stockbrokers (§§ 741 et seq.) and commodity brokers (§§ 761 et seq.) do not apply when Chapter 14 applies.
- Adopt existing rules for the treatment of customer accounts currently in §§ 763 and 766 to apply to proceedings (whether liquidations or reorganizations) under Chapter 14.
- Provide that the SIPC (for stockbrokers) and the CFTC (for commodity brokers) have a right to be parties in relevant Chapter 14 cases.
- Amend § 303(b) and (h) to provide that the primary regulator may commence an involuntary case against a financial institution.
- Amend § 303(h) to permit an involuntary case commenced by the primary regulator to go forward if the financial institution's assets are less than its liabilities, at fair valuation, or the financial institution has unreasonably small capital.

III. Role of the Primary Regulator in Chapter 14; DIP Funding

- Provide that the regulators of the business of a covered financial institution or any subsidiary thereof would have standing with respect to the financial institution or the particular subsidiary to be heard or to raise motions relevant to their regulation with the Chapter 14 court.
- Amend § 363 to provide that the primary regulator has the power to file motions for the use, sale, or lease of property.
- Amend § 1121 to provide that, in a Chapter 14 case, notwithstanding § 1121(c), the primary regulator or a creditors' committee can file a plan of reorganization at any time after the order for relief.
- Amend § 364(b), (c), and (d) to make clear that, in a Chapter 14 case, DIP financing is permitted, upon court approval after motion and hearing instigated by the debtor-in-possession, the trustee, or the primary regulator, for the purpose of providing partial or complete payouts to some or all creditors, with petitioners for such funding bearing the burden of proof on **(a)** the necessity (for liquidity or other systemic reasons) of such payout (including its amount and the identified parties), **(b)** that such payout is less than or equal to a conservative estimate of the amount the creditors would receive in the bankruptcy proceeding without such funding, **(c)** that any such prepayments were not likely to favor particular creditors or otherwise undermine the operation of bankruptcy's priority rules, and **(d)** it shall be a provision of any such funding that, should the payout exceed the amount that the creditors would have received in the bankruptcy proceeding in the absence of such funding, either the creditors receiving

such advanced payout agree to repay to the estate the amount by which their advanced payout exceeded that amount or the funder agrees to subordinate his claim to that of the other creditors to the extent necessary to allow them to receive what they would have received in bankruptcy in the absence of such funding. In addition, if the government is the source of the funds to make these prepayments, the petitioners for such funding will additionally be required to show that such funds are not available from a private party on reasonably equivalent terms.

IV. Qualified Financial Contracts in Chapter 14

- Automatic stay and repos: Amend § 362 to give the counterparty, in Chapter 14, the right to sell cash or cashlike collateral in its possession at any time, as well as the right to sell, upon petition, other financial (non–firm-specific) collateral in its possession upon a determination of the reasonable value of such collateral.
- Automatic stay and repos: Amend § 362 to give, in Chapter 14, a right of relief from the automatic stay upon petition by a counterparty seeking to sell collateral in the possession of the debtor to the extent the collateral consists of highly marketable securities or other cashlike collateral as well as, to the extent the collateral consists of other non–firm-specific collateral, upon the court's determination of its fair market value.
- Automatic stay and swaps: Limit the applicability of § 560 (as well as §§ 555 and 556) in Chapter 14 cases to the expiration of three days from the filing of a bankruptcy petition. After the expiration of that period, the counterparty has the right

to sell collateral in parallel to the provisions for collateral sales by repo counterparties in Chapter 14.

- Automatic stay and swaps: Clarify § 362(b)(17) so that a counterparty cannot offset, net out, or sell collateral until the debtor rejects the contract or the time period specified in § 560 expires.
- Automatic stay and repos/swaps: Make explicit that cross-termination and cross-collateralization provisions in master agreements remain effective notwithstanding termination—but not from repos to swaps (or vice versa) until both have been terminated.
- Trustee's avoiding powers, repos, and swaps: Provide that the provisions of § 546(f), (g), and (j) do not apply in a Chapter 14 proceeding.
- Trustee's avoiding powers, repos, and swaps: Amend § 547(c)(5) so that its "two-point net improvement" test applies to swaps in a Chapter 14 proceeding when the collateral can be identified as a defined "pool."