Derivatives at Bankruptcy: Lifesaving Knowledge for the Small Firm

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I. The Importance of Derivatives

Since Jacob had fallen in love with Rachel, he said, "I'll serve you for seven years in exchange for your younger daughter Rachel."¹

Over four-thousand years ago, Jacob entered into a derivatives contract granting him the option to marry Rachel, the youngest daughter of Laban.²

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¹. Genesis 29:19. Genesis Chapter 29 describes the two marriages of Jacob, both the ultimate result of derivative agreements with his future father-in-law Laban. Genesis 29. Jacob’s first agreement took the form of an option contract whereby he earned the right to marry Rachel following seven years of labor. Genesis 29:19.

². See id. (outlining Jacob’s first derivative agreement, an option contract).
Although Jacob paid for the marriage right with seven years of labor, the actual value of the option correlated directly with his ability to marry Rachel at the close of the term. Had Rachel died prior to the close of the seven-year term, for instance, the option would have been worthless. Accordingly, the value of his contract with Laban was derived from Jacob’s underlying ability to enter into marriage with Rachel.

Although Jacob upheld his end of the agreement, Laban deceived Jacob—secretly substituting Rachel with his firstborn daughter Leah on the couple’s wedding night.³ Regrettably, Jacob sits in history as the first known holder of an option contract, as well as the first known victim of a default.⁵ After marrying Leah according to his custom, and subsequently purchasing another option with an additional seven years of service, Jacob finally earned the right to marry his true love, and with both women he fathered the twelve tribes of Israel.⁶ In some respects, the entire nation of Israel owes its genesis to a series of derivatives.

While modern derivatives contracts are no longer used to arrange marriages and found nations, their importance is undiminished. Today, derivatives are significant financial tools that provide opportunities to "measure, manage, distribute, and transfer risk.”⁷ The President’s Working Group on Financial Markets (PWG) states:

³ See Genesis 29:20–27 (describing Laban’s breach of the agreement). According to these verses, Laban sought to marry his eldest daughter before his younger daughters. Id. In following this custom, Laban gave his daughter Leah to Jacob for sexual relations rather than his daughter Rachel. Id. Because Jacob did not recognize the deception until the following morning, after he had consummated the relationship, he became obligated to marry Leah—a result contrary to that provided in his option contract with Laban. Id.

⁴ See The President’s Working Group on Financial Markets, Over-the-Counter Derivatives Markets and the Commodity Exchange Act 4 (1999) [hereinafter President’s Working Group] (defining an option contract as "an instrument that provides the holder with the right, but not the obligation, to buy (call option) or sell (put option) a specified amount or value of a particular underlying interest at a specified price on, and in some cases before, its specified expiration date").


⁶ See Genesis 29:27 (outlining the second derivative agreement between Jacob and Laban). The agreement provides that Jacob shall "complete [the older] daughter’s bridal week . . . [t]hen we will give the younger one too, in exchange for seven more years of work." Id. Rather than relying on Jacob to marry Leah out of his own sense of obligation, Laban adds an additional condition precedent to the derivative agreement which requires Jacob to marry Leah in addition to the required labor in order to earn the option to marry Rachel. Id.; see also Don M. Chance, A Brief History of Derivatives, in Essays in Derivatives, at 1 (John Wiley & Sons eds., 1998) (adding that "[s]ome argue that Jacob really had forward contracts, which obligated him to the marriages").

⁷ Emil E. Henry Jr., Assistant Sec. of the Treasury, Remarks Before the Fixed Income
One of the most dramatic changes in the world of finance during the past fifteen years has been the extraordinary development of the markets for financial derivatives. Over-the-counter varieties have transformed the world of finance, increasing the range of financial products available to corporations and investors and fostered more precise ways of understanding, quantifying, and managing risk.8

A recent survey conducted by the International Swaps and Derivatives Association (ISDA) concluded that over 92% of the world’s 500 largest companies use derivatives to manage and hedge risk.9 Of the 196 U.S. companies included in the survey, 94% use derivatives—a percentage only surpassed by companies in the United Kingdom.10 According to Robert Pickel, Executive Director and Chief Executive Officer of ISDA, "[t]he survey demonstrates that derivatives today are an integral part of corporate risk management among the world’s leading companies."11 Additionally, finance professors from top business schools overwhelmingly agree that "derivatives help companies manage financial risk more effectively," thereby facilitating continued growth in their use and application.12

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8. Letter from Lawrence H. Summers, Sec’y Dep’t of the Treasury, to the Honorable Al Gore, President of the Senate (Nov. 9, 1999), reprinted in PRESIDENT’S WORKING GROUP, supra note 4.

9. See Press Release, International Swaps and Derivatives Association, Over 90% of the World’s 500 Largest Companies Use Derivatives to Help Manage Their Risks, According to New ISDA Survey (Apr. 9, 2003), http://www.isda.org/statistics/surveynewrelease 030903v2.html (last visited Jan. 22, 2007) [hereinafter ISDA Business Survey] (presenting the results of a 2003 survey conducted by ISDA regarding the use of derivatives by the world’s 500 largest companies as ranked by 2001 year-end revenue) (on file with the Washington and Lee Law Review). The companies surveyed are located in twenty-six countries and represent a "broad variety of industries, ranging from aerospace to wholesalers of office and electronic equipment." Id. The International Swaps and Derivatives Association, Inc., chartered in 1985 with over 590 member institutions, is the "global trade association representing lending participants in the privately negotiated derivatives industry." Id.

10. See id. (breaking down the survey results by geographic region). Of the world’s 500 largest companies, 94% of the 196 U.S. companies use derivatives, as do 100% of the 35 U.K. companies, 91% of the 89 Japanese companies, 92% of the 37 French companies, and 94% of the 34 German companies. Id.

11. Id.

12. See INTERNATIONAL SWAPS AND DERIVATIVES ASSOCIATION, A SURVEY OF FINANCE PROFESSORS’ VIEWS ON DERIVATIVES 2, 4 (2004) [hereinafter ISDA ACADEMIC SURVEY] (presenting the results of a March 2004 survey conducted by ISDA of finance professors at the top fifty business schools worldwide "to explore perceptions of derivatives, as well as their impact on the global financial system").
Today, derivatives penetrate geographic regions and industry sectors, with the vast majority of the world’s most financially successful companies relying on derivatives "to hedge a range of risks to which they are exposed in the normal course of business." Derivatives permit companies "to focus on their primary business or core competence instead of worrying about fluctuations in financial markets." By using derivatives, firms can "eliminate those risks that they do not control" while taking "additional risks that they believe contribute[] to their firm’s values."

Despite a cloud of legal uncertainty that hangs over the derivatives market in the United States, derivatives show no sign of slowing. Widespread use of these instruments has led to an exponential growth in the worldwide derivatives market. In the first half of 2006 alone, the total notional value of global derivatives contracts grew by an estimated 20.1% from $235.8 trillion to $283.2 trillion. These figures dwarf the modest total notional value of $0.86 trillion in the 1980s, which grew to only $29 trillion by 1997. The total notional value then rocketed upward in 1998 to near $80 trillion, a 175% increase over the previous year.

Nevertheless, a general dearth of understanding surrounds derivatives instruments, both in Washington and on Wall Street. Their "complexity breeds
a certain amount of skepticism and fear.\textsuperscript{20} In response to the trepidation of lawmakers, Emil E. Henry Jr., Assistant Secretary of the Treasury, suggests:

Instead, perhaps what we should fear most is the paucity of knowledge and/or interest around a space that is so dynamic and worthy of our attention. And of course, we must guard against knee-jerk impulses that might impede the growth of an asset class that adds to the efficiency and liquidity of our capital markets. Instead, fact finding and education are necessary threshold steps prior to a political response.\textsuperscript{21}

Beginning in 1999, the PWG called for legislative changes designed to provide legal certainty for derivatives thereby reducing systemic risk and removing impediments to innovation.\textsuperscript{22} Efforts to reduce systemic risk continued through a series of amendments to the Bankruptcy Code, culminating with the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA).\textsuperscript{23} With BAPCPA, Congress renewed its contention that derivatives instruments must be afforded special consideration in order to reduce the risk of disruption in financial markets upon the bankruptcy of a key market participant.\textsuperscript{24} In particular, Congress chose to exempt financial derivatives contracts from the "automatic stay"—a luxury which permits creditors to terminate a derivatives contract with the debtor in bankruptcy and seize the underlying collateral.\textsuperscript{25} No other creditor enjoys such freedom.\textsuperscript{26}

Yet less than one year after Congress passed BAPCPA, Assistant Secretary Henry admitted that "derivatives suffer from a lack of understanding by many in Washington and for that matter on Wall Street."\textsuperscript{27} The complexity

\textsuperscript{20} Henry, \textit{supra} note 7 (noting lawmakers’ unfortunate lack of knowledge regarding derivatives instruments).

\textsuperscript{21} Id.

\textsuperscript{22} See Summers, \textit{supra} note 8 (recommending changes to the Commodity Exchange Act designed to "promote innovation, competition, efficiency, liquidity, and transparency in OTC derivatives markets, by providing legal certainty for OTC derivatives and removing impediments to innovation").


\textsuperscript{26} Id.

\textsuperscript{27} Henry, \textit{supra} note 7.
of derivatives breeds misunderstanding. Misunderstanding "breeds skepticism and fear." While the provisions of BAPCPA targeting derivatives represent a highly supported, bipartisan resolve to protect American financial markets from the "ripple effects" of bankruptcy, the Act fails to fully consider the effects of its exceptions on smaller market entities. Additionally, the Bankruptcy Code is incapable of greatly reducing systemic risk and may actually aggravate it. By permitting unilateral termination of derivatives contracts by nondebtor counterparties, BAPCPA allows sophisticated parties to "opt-out of bankruptcy" and essentially rob firms of their chance for survival.

This Note analyzes the negative effects of the "opt-out" provisions of BAPCPA, particularly in the context of the small business entity. So that the ramifications of these opt-out provisions may be more effectively understood, Part II provides a general introduction to derivatives agreements. Part III supplements this introduction to derivatives by analyzing the rapid growth of over-the-counter derivatives in the small business context. Part IV continues by detailing the provisions of BAPCPA that affect derivatives instruments and the resulting consequences in light of the continually expanding derivatives market. This Note concludes, in Part V, with a prediction of the future supported by warnings to business entities desiring to engage in derivatives agreements. Rudolph Giuliani wrote:

"Preparation—thus eliminating the need to make assumptions—[is] the single most important key to success, no matter what the field. Leaders may possess brilliance, extraordinary vision, fate, even luck. Those help;
but no one, no matter how gifted, can perform without careful preparation, thoughtful experiment, and determined follow-through.\textsuperscript{34}

Ultimately this Note serves to prepare, educate, and inform, so that businesses can engage in knowledgeable decisionmaking regarding the risks associated with entering into derivatives agreements. Hopefully this Note will eliminate the need for "thoughtful experiment," leaving more room for "determined follow-through."

\textbf{II. Defining Derivatives}

A derivative . . . is an instrument whereby a small down payment buys a big exposure to price movements in an underlying asset.\textsuperscript{35}

A. Mathematical Derivatives

In mathematics, a derivative is the instantaneous rate of change of a function at any point in time.\textsuperscript{36} In other words, a derivative gives you a picture of the rate at which a quantity is changing over time at any particular moment.\textsuperscript{37}

\begin{align*}
\lim_{\Delta x \to 0} \frac{\Delta y}{\Delta x}.
\end{align*}

\textsuperscript{34} RUDOLPH W. GIULIANI, LEADERSHIP 52 (2002).


\textsuperscript{36} See A. ALBERT KLAF, CALCULUS REFRESHER FOR TECHNICAL PEOPLE 22 (1944) (providing a concise review of elementary differential calculus). Defined more fully, a derivative is the limiting value of the average rate of growth of a function as the interval of the independent variable approaches the limit zero. Id. This can be expressed by the equation

\begin{align*}
\lim_{\Delta x \to 0} \frac{\Delta y}{\Delta x}.
\end{align*}

\textsuperscript{37} See GILBERT STRANG, CALCULUS 44 (1991) (defining the derivative equation in terms of an underlying distance equation, $f(x)$ over a particular time period, $x$). At time $x$, the derivative

\begin{align*}
f'(x) = \lim_{x \to 0} \frac{f(x + \Delta x) - f(x)}{\Delta x} = \frac{dy}{dx} = \lim_{\Delta x \to 0} \frac{\Delta y}{\Delta x}.
\end{align*}

Id. This equation provides the instantaneous change in distance, or the instantaneous velocity at a given time, $x$. Id. Thus, a derivative is said to provide the instantaneous rate of change of a function at any point in time whether the underlying function is a distance function, as in this case, or an underlying function of another subject matter. Note that the symbol $\frac{dy}{dx}$ is simply shorthand notation for the limiting value of the quotient $\frac{\Delta y}{\Delta x}$. KLAF, supra note 36 at 23.
The value of a derivative, therefore, relies on the underlying base quantity and its rate of change. As the value of the underlying asset experiences positive change, the value of the derivative increases positively in relation to that change. The value of the derivative becomes negative and increases in that direction in relation to the rate of change. Derivatives have no meaning without an underlying quantity to measure.

B. Financial Derivatives

Financial derivatives are a specific subset of general mathematical derivatives. Simply stated, a financial derivative is an agreement regarding an underlying asset over a span of time, the value of which is derived from the performance of the underlying asset. The United States Department of the Treasury defines a derivative as "a financial instrument whose price is derived from the value of one or more underlying assets, liabilities, or indices." Under this definition, a derivatives transaction is any "financial contract under which either or both of two parties (each referred to as a ‘counterparty’) agree[] to make payments or deliveries to the other based on the performance or change in the value of a reference rate or asset."

Unlike a mathematical derivative, whose value directly correlates to the change in the underlying function, the value of a financial derivative depends on the contractual rights associated with the underlying asset or rate. The underlying asset or rate is commonly an interest rate, currency exchange rate, or a physical commodity, but it can be as esoteric as a measure of weather conditions. Essentially, "anything that can be quantified and objectively verified can be the subject of a derivative."

38. See Strang, supra note 37, at 47 (noting that an increasing \( f(x) \) has a positive slope and positive derivative while a decreasing \( f(x) \) has a negative slope and a negative derivative).
39. Id.
43. Id.
44. See id. at 1128–29 (suggesting that virtually any quantifiable asset or rate can serve as a derivative’s underlying reference).
45. Id. at 1129.
Consider one basic derivative known as an option contract. An option may encompass either the right, but not the obligation, of the holder to buy an asset at a prescribed amount during a specified time (a call option), or conversely, the right, but not the obligation, to sell an asset at a prescribed amount during a specified time (a put option). While the holder of a call option is interested in seeing the price of an underlying asset rise, the holder of a put option is interested in seeing the price fall. Because the option cannot exist without the underlying asset, the option is said to be derived from the underlying asset itself thereby producing a new instrument, the financial derivative. Thus, the value of a financial derivative can provide an instantaneous picture of the change in value of the underlying asset or rate but only if considered in relation to the contractual rights and obligations provided by the particular derivatives agreement.

1. Categorizing Financial Derivatives

Regardless of the underlying asset, financial derivatives generally fall into two categories—exchange-traded derivatives and over-the-counter (OTC) derivatives.

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46. See KOLB, supra note 40, at 8 (defining an option contract as "the right to buy or sell, for a limited time, a particular good at a specified price").
47. See PAUL WILMOTT, ET AL., THE MATHEMATICS OF FINANCIAL DERIVATIVES: A STUDENT INTRODUCTION 6–7 (1995) (explaining the difference in valuation of a put option as opposed to a call option, noting specifically the converse payoff properties).
48. See id. (noting the differences in put and call options); see also International Swaps and Derivatives Association, Product Descriptions and Frequently Asked Questions, http://www.isda.org/educat/faqs.html (last visited Sept. 14, 2006) [hereinafter ISDA FAQ] (noting that "in an option, the buyer purchases protection from changes in a price or rate in one direction while retaining the ability to benefit from movement of the price or rate in the other direction") (on file with the Washington and Lee Law Review).
49. See KOLB, supra note 40, at 1–2 (examining the stock option and its relationship to the underlying stock and concluding that, because the stock is a financial instrument and the option is derived from the stock, the resulting stock option is a financial derivative).
50. Note that this conclusion is incomplete because derivatives instruments may also have value that is contingent on market timing. See INVESTOPEDIA, SHOULD I BUY OPTIONS THAT ARE IN THE MONEY OR OUT OF THE MONEY?, http://www.investopedia.com/ask/answers/05/buyingoptions.asp (last visited Mar. 9, 2008) (explaining the difference between in-the-money options and out-of-the-money options) (on file with the Washington and Lee Law Review). For instance, an out-of-the-money option may be valuable to some investors even though the instrument would be worthless if it expired today. Id. However, out-of-the-money options carry higher risk than in-the-money options because they are more likely to be worthless upon expiration. Id. For the purposes of this Note, the value of such out-of-the-money derivatives will be ignored.
derivatives. Exchange-traded derivatives, generically known as futures, "are standardized as to their material terms and conditions . . . . [and] are accessible to retail customers conducting transactions" through organized exchanges. Such financial instruments result in an opaque connection between buyer and seller with performance risk largely dependent on the solvency of the exchange. Because the performance of futures does not rely on the performance obligations of the individual counterparties to the agreement, performance risk associated with these instruments is practically eliminated.

In sum, exchange-traded derivatives, while standardized, "offer market participants the advantages of liquidity, price transparency, and minimal credit risk.

OTC derivatives, on the other hand, are privately negotiated contracts "conducted almost entirely between institutions on a principal-to-principal basis" and may be tailored to allow "customers to adjust individual risk positions with greater precision." Typical examples of OTC derivatives include forwards, swaps, and non-exchange-traded options. While futures are always traded on an exchange, OTC derivatives are traded on a bilateral basis typically between a business entity and a dealer. Dealers primarily include large commercial investment banks whose goal is to make money by collecting premiums and other up-front fees while end-users typically include

51. See ISDA FAQ, supra note 48 (dividing derivatives into two general categories—OTC and exchange-traded).
52. See Kolb, supra note 40, at 4 (defining the term "futures contract" as "a forward contract traded on an organized financial exchange with contract terms clearly specified by the rules of the exchange").
53. President’s Working Group, supra note 4, at 5.
54. See Rhett G. Campbell, The Current Status of the Bankruptcy Code, Forward Contracts, and Safe Harbors 2 (2002) (explaining the opaque connection between buyer and seller in futures contracts and noting that "after the trade is made, all connection[s] between buyer and seller [are] severed").
55. See id. (outlining basic differences between forward contracts and futures contracts and noting that futures contracts are typically standardized and transferable).
56. President’s Working Group, supra note 4, at 5.
57. Id.
58. See Kolb, supra note 40, at 1 (defining the term "forward" as "an agreement reached at one time in place calling for the delivery of some commodity at a specified later date at a price established at the time of contracting").
59. See id. at 10 (defining the term "swap" as "an agreement between two or more parties to exchange sets of cash flows over a period in the future").
60. See id. at 8 (defining the term "option" as "the right to buy or sell, for a limited time, a particular good at a specified price").
61. See ISDA FAQ, supra note 48 (noting that OTC derivatives, generically called swaps, are not traded on an exchange in contrast to futures).
entities seeking "to shift certain market risk associated with the company’s assets or liabilities to the dealer."62 Unlike exchange-traded derivatives, OTC derivatives result in a transparent connection between buyer and seller. Consequently, OTC derivatives place the risk of default not on the exchange but on the individual actions of the OTC counterparty.63 Performance risk, therefore, remains a paramount concern to parties entering into OTC derivatives.

In addition to the differing risk structures of exchange-traded and OTC derivatives, there is also an immense difference in the regulatory regimes governing these instruments. In the United States, the futures market is governed by the Commodity Exchange Act,64 which is administered and enforced by the Commodity Futures Trading Commission.65 The futures market also is subject to congressionally recognized self-regulation by the National Futures Association.66 OTC derivatives, to the contrary, are categorically excluded from the Commodities Exchange Act and, as a result, are regulated mainly by the common law of contracts.67 Consequently, OTC

62. Guinn & Harvey, supra note 42, at 1129 n.7. As a result of acquiring additional risk from an end-user in the derivative transaction, the dealer will, in turn, hedge that market risk by entering into additional agreements with third parties. Id.

63. CAMPBELL, supra note 54, at 2.


65. See DONNA KLINE, FUNDAMENTALS OF THE FUTURES MARKETS 10 (2001) (noting that the Commodities Futures Trading Commission is the regulatory body responsible for administering and enforcing the provisions of the Commodity Exchange Act).

66. See id. (analyzing the regulation, both public and private, of futures contracts).

67. See CAMPBELL, supra note 54, at 3 (stating that, unlike futures contracts, forward contracts are "largely unregulated other than by the common law of contracts"); Guinn & Harvey, supra note 42, at 1129 n.6 (providing that the Commodity Futures Modernization Act of 2000 (CFMA) "excludes from regulation under the Commodities Exchange Act (CEA) a broad range of treasury products... and other OTC derivatives that are entered into between ‘eligible contract participants’"); see also 7 U.S.C. § 1(a)(12) (defining "eligible contract participant"). An eligible contract participant is: (1) a financial institution acting for its own account; (2) an insurance company regulated by the state; (3) an investment company subject to regulation under the Investment Company Act of 1940; (4) a commodity pool with total assets exceeding $5,000,000; (5) a corporation, partnership, proprietorship, organization, trust, or other entity that has total assets exceeding $10,000,000, a net worth of $1,000,000 and enters into "an agreement, contract, or transaction in connection with the conduct of the entity’s business or to manage the risk associated with an asset or liability owned or incurred or reasonably likely to be owned or incurred by the entity in the conduct of the entity’s business;" (6) an employee benefit plan with total assets exceeding $5,000,000; (7) a governmental entity; or (8) a multinational or supranational government entity. Id. Guinn and Harvey note that the CFMA also amended the Securities Act of 1933 and the Securities Exchange Act of 1934 to provide that "certain individually negotiated swap transactions between ‘eligible contract participants’... are not securities under those statutes.” Guinn & Harvey, supra note 42, at
derivatives entered into by financial institutions, insurance companies, investment companies, capital businesses, and governmental entities must seek protection through private conditions and covenants in the derivatives agreement.

2. Standardizing OTC Derivatives

To facilitate private protection through contractual covenants, there has been much effort to standardize the form of derivatives agreements.\(^{68}\) Because OTC derivatives include a wide range of bilateral contracts, which are typically entered into quickly with the same dealer over time, the ISDA developed a set of standardized agreements "[t]o accommodate the need of market participants for written documentation that is standardized, yet customizable, and able to handle any type of derivatives transactions in a rapid-paced, trading environment.\(^{69}\) OTC counterparties typically enter into a master agreement (ISDA Master Agreement)\(^{70}\) and a customizable schedule to the master agreement, resulting ultimately in an "individually negotiated agreement, based on an industry standard form of contract."\(^{71}\) Counterparties may choose from three published versions of the ISDA Master Agreement—1987, 1992, and 2002 versions—as well as from updates that are frequently promulgated by ISDA.\(^{72}\) Because derivatives agreements often are made orally (such as in a telephone conversation), the ISDA Master Agreement can provide a written confirmation of the verbal agreement that contains all the economic and legal terms and conditions of the transaction.\(^{73}\) Once complete, the pre-printed ISDA Master Agreement, the Schedule to the Master Agreement, and any other written confirmations constitute a single, binding agreement between the

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68. See CAMPBELL, supra note 54, at 3 (tracing the efforts to create uniform documentation for OTC derivative contracts).
69. Guinn & Harvey, supra note 42, at 1133.
71. Guinn & Harvey, supra note 42, at 1134.
72. See CAMPBELL, supra note 54, at 3 (outlining the various versions of the ISDA Master Agreement).
73. See Guinn & Harvey, supra note 42, at 1134 ("[O]nce the parties have executed an ISDA Master Agreement, they will have created an individually-negotiated agreement, based on an industry standard form of contract.").
Standing alone, the ISDA Master Agreement is meaningless; however, when it is customized by two or more parties, it represents a fully enforceable agreement.

III. OTC Derivatives Explosion

The rapid growth, development, and widespread use of over-the-counter (OTC) derivatives have accompanied, and in many ways made possible, the modernization of commercial and investment banking and the globalization of finance.75

Because OTC derivatives are traded between private parties, there is no reliable source of statistics regarding their involvement in the market.76 In addition to the general opaqueness of private OTC agreements transacted outside a monitored exchange, there is some dispute among industry professionals as to the best method of measuring OTC derivatives activity.77 Thus, figures compiled by individual banks and dealers are not necessarily comprehensive or consistent with reports from similar institutions.78 Nevertheless, the trade of OTC derivatives is one of the fastest growing and most competitive areas in the financial marketplace.79 Regardless of accuracy, the conclusion is clear: The OTC derivatives industry is big, and it is getting bigger.

74. See MASTER AGREEMENT, supra note 70, § 1(c) (“All transactions are entered into in reliance on the fact that this Master Agreement and all Confirmations form a single agreement between the parties . . . .”).
77. See id. (finding that “[s]ome bankers dislike notional figures, arguing that it is better to track the gross market value of these outstanding contracts instead, netting off against each other”).
78. See id. (noting that the Bank for International Settlements (BIS) figure of $370 trillion may not be comprehensive).
79. Natasha De Teran, FX & Derivatives: Painting a New Landscape—Electronic Trading of Over-the-Counter Derivatives Is Just Beginning and Is Expected to Boost Volumes Considerable in the Future, Driven By Both The Buy-Side and the Sell-Side, BANKER, May 1, 2006, at 40 (noting that OTC derivative industry and the electronic trading industry are two of the "fastest growing and most competitive areas of the financial markets").
A. Growth of OTC Derivatives—New Products and New Investors

As of November 17, 2006, the Bank for International Settlements (BIS) recorded the total notional value of all outstanding derivatives contracts in the OTC market at $370 trillion, a growth of 24% over the previous six months.80 This growth data highlights the increasingly important role OTC derivatives play in the financial sector—one partly due to a growing pool of clients that use derivatives to hedge unique market risks. ISDA head Robert Pickel reports:

[T]he flexibility that derivatives offer in their ability to isolate and hedge specific risks makes them a uniquely useful tool for businesses to offset or take on exposures that best suit their financial profile at any given time. Continual innovation, in new products to parse out risk, new applications of existing products, and new entrants also account for much of the growth in derivatives.81

Additionally, Mark O’Donnell, head of structured products at Jefferies & Co. in New York, sees tremendous growth in OTC trading, noting that "it gives customers greater flexibility and a more customized product."82 And perhaps most importantly, "[l]iquidity on OTC products such as forwards and swaps has improved, enabling . . . participants to readily get in and out of the market,"83 thereby allowing volume growth in OTC derivatives to outpace exchange traded derivatives.84

1. Pension Funds

The dramatic growth of these flexible instruments is highlighted by the expansive use of derivatives by one particular market newcomer, the pension fund. At the end of 2006, Pensions Week, a division of the Financial Times, reported that "pension funds are increasingly using over-the-counter (OTC) derivatives in their investment strategies."85 JPMorgan Worldwide Securities Services reported that pension funds have experienced 100% growth in the use

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80. Tett, supra note 76.
81. Id.
83. Id.
84. See id. (noting that the "[v]olume growth in over-the-counter derivatives is outpacing that of exchanges" and that "the trend will continue").
85. Atherton, supra note 35.
of derivatives between 2005 and 2006.\footnote{See id. (reporting the historic growth in derivatives that JPMorgan Services has seen by clients in the past two years and that U.K. pension funds are likewise expanding to historic levels).} Pension funds, which have normally employed swaps only to manage their inflation and interest rate risks, are now looking to new instruments such as property derivatives and credit derivatives to manage additional specific risks.\footnote{See id. (noting that "property derivatives . . . and longevity bonds are just some of the new ways derivative instruments are used to hedge specific risks").}

2. Mortality Derivatives

Deutsche Bank and BNP Paribas have developed a mortality derivative for pension fund investors, essentially enabling a hedge on death rates.\footnote{See id. (reporting that two major European banks, Deutsche Bank and BNP Paribas, have been developing and have attempted to market mortality derivatives).} For instance, if a pension fund buys mortality derivatives, it can protect the fund from the risk of an unexpected rise in the longevity of its pensioners.\footnote{See id. (providing that mortality derivatives may be used to hedge against the risk of long life, specifically the long life of pensioners).} Although BNP Paribas did not sell any longevity derivatives when it initially released the product in 2004, some industry experts believe that "it is only a matter of time before pension funds embrace longevity bonds, because there is not enough capital in the life insurance industry to absorb the entire longevity exposure in pension schemes."\footnote{Id.}

3. Weather Derivatives

Weather derivatives, which are traded on organized exchanges and over-the-counter, provide another example of growth and innovation.\footnote{See Michael J. Moody, \textit{Weather Risk Management}, ROUGH NOTES, May 1, 2006, http://findarticles.com/p/articles/mi_qa3615/is_200605/ai_n17182354 (last visited Mar. 3, 2008) (analyzing financial instruments used to manage weather risks) (on file with the Washington and Lee Law Review).} Armed with the knowledge that as much as 20\% to 25\% of the U.S. economy is directly affected by weather, financial firms developed hedging instruments "that help utilities offset sub-par results due to the vagaries of the weather."\footnote{Id.} The weather, although mainly a meteorological issue, affects the revenues and
profitability of virtually every sector, including construction, travel, entertainment, and agriculture. Essentially, any business that depends either directly or indirectly on weather conditions to operate may profit from the use of weather derivatives. Accordingly, weather risk management has become a large enterprise and the prospects for future expansion are colossal.

4. Electronic Trading Mechanisms

The growth of new OTC derivatives largely correlates with the expansion of electronic trading mechanisms that have eased the acquisition cost of otherwise expensive instruments. Along with OTC derivatives themselves, the development and use of electronic platforms to trade OTC derivatives is one of the fastest growing and most competitive areas of finance. In 2003, Barclays Capital (BarCap) launched the first fully electronic trading platform for interest rate swaps and, since then, has introduced new electronic platforms for almost every asset class. Despite initial skepticism over BarCap’s attempt to move the pencil-and-paper OTC trade into the digital age, "clients were quick to respond to the offer—especially hedge funds, which account for 50% of flow business and embraced e-commerce wholeheartedly." To date, over 41% of BarCap’s global clients trade using online services.

93. See id. (explaining that the profitability of virtually every industry depends, to a certain extent, on the weather).

94. See, e.g., id. (noting the vast economic impact of weather). Further, former Commerce Secretary William Daley has noted: "Weather is not just an environmental issue; it is a major economic factor. At least $1 trillion of our economy is weather sensitive." Id.

95. See id. (forecasting continued growth in the weather derivatives industry).

96. See De Teran, supra note 79, at 40 (examining the relationship between OTC derivatives and electronic trading, noting specifically the link between the two burgeoning industries and how their relationship is changing the lucrative OTC derivative business).

97. See id. (noting that while electronic trading, in general, is not a new offering for most banks, the move to offer electronic trading to clients in OTC derivatives is relatively infant).

98. See id. at 41 (reporting on the growth of the first financial institution to offer electronic trading of OTC derivatives).

99. Id.

100. See id. (reporting that, as of 2006, over 11,000 users, constituting 41% of the firm’s global clients, are signed up to trade electronically with BarCap).
B. Growing Pains

Despite the benefits, the growth of OTC derivatives and electronic trading has its problems. While technology is making it cheaper and easier for banks to conceive new derivatives products, the growth of new instruments is outpacing the financial infrastructure and knowledge-base necessary to enter into these agreements. According to Chandresh Iyer, the North American Head of Securities and Fund Services for Citigroup Corporate and Investment Banking, "[t]he OTC derivatives space is causing a need for the back-office infrastructure to scale to growth and provide more-sophisticated capabilities for managing risk, reconciliation of complex securities and pricing of hard-to-value securities." Sang Lee, an analyst for the Aite Group, notes that "as hedge funds move more aggressively into OTC instruments, the infrastructure necessary to manage the entire life cycle of the investment process can be quite cost prohibitive." The general scarcity of knowledge of those purchasing OTC derivatives contracts, however, is even more hazardous than the dearth of support-structure.


102. See Support Services, supra note 101 (noting the challenge that lies ahead of fund administrators as they cope with the challenges created by electronic trading of OTC derivatives, particularly the need to have the technology in place to cope with those instruments and the need to have the right people with the right talents run the infrastructure).


104. Id.
1. Scarcity of Knowledge

Because a larger variety of OTC derivatives are more widely available and easily accessible through electronic trading, the pool of firms capable of entering into such agreements has widened beyond the narrow group of large, sophisticated financial institutions who once monopolized the OTC market. As a result, customers without specific expertise and experience in derivatives agreements are now capable of entering into OTC contracts even though they frequently fail to understand fully the implications of these potentially risky transactions. More often than not, the stance of investment banks is transactional, rather than relational. Banks "only look at the commission they earn from these products, which is directly related to the product’s complex nature."

Banks that refuse to issue credit to a customer with a bad credit history, for instance, may lure customers to buy derivatives products instead because derivatives involve relatively little risk for the dealer. Unlike the scrutiny that follows a bank loan, examination of the customer will likely culminate with the routine filing of a mere customer questionnaire. Because banks are

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105. See De Teran, supra note 79, at 44 (showing the increase in derivative business by noting that activity at one online broker, Tradeweb, has increased from $150 billion in the first year of service to $150 billion by early afternoon each day). This increased level of activity is due largely to an increase in customer base to over 2000 customers each day—customers that would likely not enter into such transactions without the ease of access that online trading offers. Id.

106. See id. (noting that for one particular financial institution, Barclays Capital, electronic trading "has helped the bank . . . by allowing it to grow its market share, particularly in areas where it was not previously perceived to be a market leader").


108. See Atherton, supra note 35 (noting that some customers are mistrustful of investment banks because, in some cases, they do not fully understand the product; however, this mistrust is due more often to the transactional, rather than relationship-based, nature of investment banks).


110. See id. (stating the report of an officer from a major public bank that "banks that do not give credit try to lure customers to buy derivative products").

111. See id. (noting that for derivative products, "scrutiny of the customer is purely on the basis of a questionnaire").
relatively unconcerned with the financial status of their derivatives customers, banks often withhold from clients information that reveals the real risks involved with derivatives agreements in an effort to make the sale. Griff Williams, an institutional product strategist at Pioneer Investments, notes that "[i]t is not always obvious how much the proposed strategies will cost and where exactly the investment banks’ motivations sit within the implementation of these strategies."113

2. Bifurcating the Client Pool and Widening the Knowledge Gap

Electronic trading systems have only magnified the paucity of knowledge commonplace among less sophisticated derivatives counterparties. Generally speaking, electronic mechanisms facilitate quick opportunistic trading by allowing a growing variety of relatively unsophisticated purchasers access to the market.114 As trading activity explodes, almost no derivatives investment falls outside the realm of possibility.115 Even pension plans, which have historically considered derivatives nonviable investment tools, are exploring opportunities to invest in weather derivatives;116 this indicates "nothing short of a fundamental reassessment of risk parameters and return objectives."117 While investment banks usually conduct the most complicated derivatives trades through complex negotiation and counseling, many have migrated smaller and simpler "vanilla trades" onto electronic platforms.118

Alexander Hodge, head of listed derivatives and e-commerce at BarCap, claims that this migration will result in better customer service:

For us the ability to push vanilla flow is efficient, while for the customers it opens up liquidity pools, new product trading opportunities and provides

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112. See id. (noting that banks do not really consider their clients’ needs in relationship to particular derivatives products, only their commissions).

113. Atherton, supra note 35.

114. See Sponsored Report, supra note 101 (providing pension plans as one example of the explosive growth and variety of clients in the OTC derivatives marketplace).

115. See id. (illustrating the breadth of derivative investment tools).


117. Id.

118. See De Teran, supra note 79, at 42 (stating that by migrating vanilla trades to the electronic platforms, dealers are better able to focus on the more complex transactions).
ease of access... By pumping through the vanilla business on electronic platforms, our salesforce can focus on our customers better, giving them more time in the value-added area where direct interaction is more valuable to both the sales person and the client.\textsuperscript{119}

Nevertheless, by migrating the simplistic, vanilla trades to electronic systems, investment banks have effectively separated their derivatives clients into two distinct groups—those who want to "trade opportunistically and agnostically with the best price provider in any given instance, and those [who] want to establish or continue closer relationships with the banks that give them insight or colour, research and ideas."\textsuperscript{120}

Ironically, e-trading has shifted the emphasis of customer service away from those parties who need it most; those customers with the least information face the most risk. By essentially limiting the customer service and information flow to the most sophisticated consumers, financial institutions have left the smaller, unsophisticated purchasers to fend for themselves.\textsuperscript{121} While potential for continued customer service for derivatives counterparties exists, the focus tends to concentrate on the behemoth parties who seek more complicated transactions.\textsuperscript{122}

On the other side of the table, the huge growth in available derivatives products has pushed hedge fund managers, pension fund managers, corporate executives, and even private investors to invest in nontraditional products and markets in order to maximize performance and remain competitive.\textsuperscript{123} As a result of the increasingly open derivatives market, fund administrators face a huge knowledge gap, and the scope of the challenge has led some in the asset management industry to ponder whether fund administrators are actually up to the undertaking.\textsuperscript{124} According to Shilpa Amin, director of fund derivatives for Nomura Asset Management Co., Ltd.,\textsuperscript{125} administrators "often have no

\textsuperscript{119} Id.

\textsuperscript{120} Id.

\textsuperscript{121} See id. (asserting that there is potential for real client service in the world of electronic trading; however, this potential is among the sophisticated parties performing complex transactions).

\textsuperscript{122} See id. (claiming that, as a result of e-trading, managers on the buy-side are able to think strategically about their more complex investment decisions while sell-side sales associates have more time to contemplate more complicated products).

\textsuperscript{123} See Sponsored Report, supra note 101 (providing that "the huge growth in the number of hedge funds has created an intense competitive environment which has pushed managers to invest in non-traditional products and markets in an effort to maximise performance").

\textsuperscript{124} See Support Services, supra note 101 (reviewing the difficulties of fund administrators, especially the knowledge gap, in the growing derivatives industry).

personnel or resources to deal with derivatives.\footnote{126} Managers of large, sophisticated funds have reduced this knowledge gap through significant training and development—a key to "feeling more comfortable in understanding what the instruments are and how they can be used to reduce risk and/or enhance returns."\footnote{127}

Yet most managers, especially those of smaller, less sophisticated funds, are in the process of gathering knowledge to fully understand the risks and rewards of derivatives.\footnote{128} Steve Aukett, financial solutions product specialist at Insight Investments, suggests:

Some schemes have now acquired knowledge about the characteristics and potential advantages of using inflation and interest rate swaps, and in a relatively small number of cases have implemented solutions using these instruments. In general, however, many schemes are still at the stage of acquiring further knowledge, both about the nature of the many risks they face, including their sensitivity/exposure to future changes in interest rates and inflation expectations, as well as knowledge about the different techniques and instruments that can be used to better manage risks. The spread of knowledge between different schemes is very wide.\footnote{129}

Growing use of derivatives instruments by uninformed managers, coupled with an absence of customer service and support from financial institutions, places counterparties in a precarious position. In order to stay competitive, managers must enter the market blind. Nevertheless, the largest failure of unknowledgeable managers is not their inadequate understanding of the structure and financial risks of various derivatives but the failure to fully comprehend and appreciate the legal risks associated with derivatives instruments. The legal risks associated with derivatives agreements are especially noteworthy in the context of bankruptcy.

Management Co., a subsidiary of Nomura Holdings, Inc. which is a services group comprising consolidated subsidiaries located mainly in Japan) (on file with the Washington and Lee Law Review). Nomura Asset Management (NAM) was established in October of 1997 and today has investment trust assets of ¥18,797 billion and institutional investments ¥7,110 billion. \textit{Id.} "NAM has grown to become Japan’s largest asset management firm by developing products that meet customers’ needs, expanding research capabilities, increasing overseas clients, and by continuing to employ advanced risk management practices.” \textit{Id.}

\footnote{126} Support Services, \textit{supra} note 101.\\
\footnote{127} Atherton, \textit{supra} note 35.\\
\footnote{128} \textit{Id.} (reporting on the general lack of knowledge regarding derivatives that challenges most fund managers).\\
\footnote{129} \textit{Id.}
IV. Derivatives at Bankruptcy—BAPCPA and the Unsophisticated Party

A cynic might argue that the financial safe harbors are indeed a ‘bankruptcy opt-out clause’ for a certain class of capitalists because their money is more important than everyone else’s.130

A. The Automatic Stay

In most instances, when a firm files a bankruptcy petition, it immediately enjoys the protection of the Bankruptcy Code’s automatic stay provision, which generally prohibits creditors from immediately acting to repossess, or exercise control over, property of the estate.131 The automatic stay is a core element of the bankruptcy reorganization process.132 Because a firm in distress is akin to a scarce resource, without regulation of its assets, creditors would have unlimited, nonexclusive rights of access to the debtor’s property.133 The first creditors to utilize the debtor’s resources would be satisfied, while those who arrive late in the game would leave with nothing.134 Without the protection of the automatic stay, creditors who are first in time will be satisfied, "even if the [debtor’s] resource[s] would have more value per user if exploited in a more restrained manner."135 By temporarily shielding the debtor’s assets, the automatic stay helps prevent a footrace to the courthouse, theoretically resulting in a more efficient distribution of the debtor’s resources.136 Thus, the stay avoids the sporadic and unorganized dismemberment of a firm by facilitating a cooperative proceeding where both debtors and creditors can negotiate terms that allow a firm to continue as a going concern.137

130. Campbell, supra note 32, at 712.
131. See 11 U.S.C. § 362(a)(3) (2000) (providing that "[e]xcept as provided in subsection (b) of this section, a petition [for bankruptcy] . . . operates as a stay, applicable to all entities, of . . . any act to obtain possession of property of the estate or of property from the estate to exercise control over property of the estate").
132. See Edwards & Morrison, supra note 25, at 95 (analyzing the treatment of derivatives under the Bankruptcy Code).
133. See id. ("[A] firm in distress is analogous to a scarce resource (e.g., fish in a lake) to which users have unlimited, non-exclusive rights of access.").
134. See id. (noting that once the resources of the debtor are used up, remaining creditors will be left with nothing).
135. Id. at 106 (suggesting that debtors in bankruptcy are like a scarce resource which, left unprotected, will be exploited inefficiently).
136. See id. (analyzing the inefficient effects caused by sporadic overuse of a debtor’s resources).
137. See id. at 95 (providing that the automatic stay facilitates negotiation between debtors
Additionally, the automatic stay prevents secured creditors (who have no need to take part in the footrace to the courthouse) from seizing collateral when the debtor fails to repay the loan and subsequently files a bankruptcy petition.\footnote{\textit{Id.} § 362(a)(3) (2000) (providing that a party, whether or not secured, is prohibited from engaging in any act to "obtain possession of property of the estate"). Because secured parties, in general, are not listed in the exceptions of part (b) of this section, it is clear that the automatic stay applies to both unsecured parties, as to judgment liens, and secured parties, as to the repossession of collateral. \textit{Id.} § 362(a)(5).} Removal of collateral—especially collateral that is vital to the firm’s survival as a going concern—benefits the individual secured creditor but harms other creditors by crippling the firm’s operation and destroying its value.\footnote{\textit{Id.} § 362(a)(5).} An individual secured creditor "has nothing to gain from waiting and attempting to keep the firm intact, but . . . can do worse if the firm continues and its fortunes decline."\footnote{\textit{Id.}} Thus, even secured creditors have strong incentives to remove collateral in a first come, first served fashion.

\section{Exceptions to the Automatic Stay}

By preventing the individually motivated race to the courthouse for unsecured creditors, and the race to reclaim collateral for secured creditors, the automatic stay establishes "a collective proceeding that preserves firms with going concern surplus and reduces creditor collection costs."\footnote{\textit{Edwards & Morrison, supra note 25, at 107.}} Nevertheless, there are exceptions to the reach of the automatic stay.\footnote{\textit{See 11 U.S.C. § 362(b) (providing that the filing of a bankruptcy petition does not operate as a stay for the circumstances listed in this section).}} For instance, the debtor cannot avoid "the commencement or continuation of a criminal action or proceeding against the debtor."\footnote{\textit{Id.}} Likewise, a debtor cannot avoid the continuation of a civil action or proceeding "for the establishment of paternity,"\footnote{\textit{Id.} § 362(b)(2)(A)(i).} "concerning child custody or visitation,"\footnote{\textit{Id.} § 362(b)(2)(A)(ii).} or "for the dissolution
of a marriage." These exceptions to the automatic stay "exempt creditor
collection efforts that raise no common-resource problem or other externalities
that reduce the debtor's going-concern value." Additionally, the bankruptcy
judge is given general discretion, under 11 U.S.C. § 362(d), to grant a
creditor's request, after notice and hearing, for relief from the stay with respect
to specific assets that are inadequately protected. With this broad judicial
discretion in mind, the automatic stay merely creates "a reputable presumption
that a debtor's assets are firm-specific and therefore necessary to an effective
reorganization." Other exceptions, especially those dealing with derivatives transactions,
are less intuitive. Typically, derivatives transactions take the form of executory
contracts with offsetting obligations, although offsetting obligations often arise outside the context of derivatives. Generally, when a debtor files for
bankruptcy, it is a party to many contracts through which both the debtor and
the creditor have ongoing obligations to one another. Some of these contracts
will be profitable to the debtor (in-the-money) and others will be unprofitable
(out-of-the-money). A typical example of an offsetting obligation is the
issuance of an investment loan in return for pledged securities as collateral. In that case, the creditor has an obligation to deliver an investment loan, offset
by the obligation of the debtor to pledge collateral as security. While the firm

146. Id. § 362(b)(2)(A)(iv).
148. See 11 U.S.C. § 362(d) (2000) (granting the general discretion to provide relief from
the automatic stay). The relevant portion states:
On request of a party in interest after notice and a hearing, the court shall grant
relief from the stay provided under subsection (a) of this section, such as by
terminating, annulling, modifying, or conditioning such stay—(1) for cause,
including the lack of adequate protection of an interest in property of such party in
interest.

149. Edwards & Morrison, supra note 25, at 108.
150. BRUCE S. NATHAN ET AL., BANKRUPTCY ABUSE PREVENTION AND CONSUMER
PROTECTION ACT OF 2005: A SUMMARY OF THE PROVISIONS AFFECTING DERIVATIVE
AGREEMENTS 1 (2005) (stating that most derivative agreements are executory contracts) (on file
with the Washington and Lee Law Review). While the term "executory contract" is not defined
in the Bankruptcy Code, "the accepted definition is a contract on which performance remains
due to some extent on both sides." Id.
151. See Edwards & Morrison, supra note 25, at 110 (noting that "[f]requently a firm and
its creditor have offsetting obligations").
152. See id. at 96 (claiming that some offsetting contracts may be profitable and others may
be unprofitable).
153. See id. (providing examples of offsetting obligations).
is indebted to the creditor (it must repay the loan), the creditor is also indebted to the firm (it must return the collateral once the loan is repaid). Under state law, each party has a right of setoff. For instance, the debtor may setoff debts owed by the firm with obligations owed to the firm. Upon a bankruptcy filing, however, the setoff right partially is limited by the automatic stay. 155 The stay prevents a creditor from exercising its setoff right, thus preventing it from eliminating the debtor’s interest in the creditor’s obligations. 156 The bankruptcy trustee, on the other hand, has the exclusive right to "assume" profitable contracts and "reject" or breach unprofitable ones. 157 Even though the debtor party to the rejected contract will receive only an unsecured claim for damages, "the Bankruptcy Code generally allows debtors to ‘cherry-pick’ profitable from unprofitable contracts." 158 Yet for derivatives instruments, the tables are turned in favor of the creditor. Because of the special privileges the Bankruptcy Code affords derivatives contracts, nondebtor counterparties may terminate ongoing contracts when a debtor enters bankruptcy. 159 Additionally, if a derivatives counterparty has entered into multiple contracts with the same debtor, the nondebtor counterparty is free to do a little cherry-picking of its own by setting off in-the-money contracts with out-of-the-money contracts. 160

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154. See id. (stating that each party to an offsetting obligation has the right of setoff under state law).
155. See 11 U.S.C. § 553(a) (2000) (granting setoff rights except those blocked in § 362 by the automatic stay). The statute provides that:

Except as otherwise provided . . . in section 362 . . . , this title does not affect any right of a creditor to offset a mutual debt owing by such creditor to the debtor that arose before the commencement of the case . . . against a claim of such creditor against the debtor that arose before the commencement of the case.

Id. Section 362 provides that the filing of a bankruptcy petition "operates as a stay, applicable to all entities, of . . . (7) the setoff of any debt owing to the debtor that arose before the commencement of the case under this title against any claim against the debtor." Id. § 362(a)(7).

156. See id. § 362(a)(7) (restricting the creditor, in non-derivative contexts, from exercising its right of setoff).

157. See id. § 365(a) (providing that "the trustee, subject to the court’s approval, may assume or reject any executory contract or unexpired lease of the debtor"); see also id. § 362 (restricting the creditor from exercising setoff rights). It is important to note that § 362 does not restrict the right of the debtor to exercise his setoff rights, thereby giving the debtor unilateral power to assume or reject such contracts—assuming that the setoff rights are provided for in the contractual agreement. Id.

158. Edwards & Morrison, supra note 25, at 96.

159. See id. (analyzing the different treatment that the Bankruptcy Code affords derivatives).


In addition to the opportunity to exercise setoff rights, the Bankruptcy Code contains numerous provisions which offer special treatment to financial derivatives—including a general exemption from the automatic stay.161 These exceptions, known as "safe harbor provisions," permit nondebtor counterparties to terminate derivatives agreements held by the debtor and reclaim any underlying collateral.162 No other creditor enjoys such luxury. For all other credit relationships, the automatic stay protects the debtor’s limited assets until they can be distributed in an economically efficient fashion. Thus, under normal operation, the automatic stay "prohibits [creditors] from undertaking any act that threatens the debtor’s assets."163 But if the creditor is party to a derivatives contract and the debtor has put up sufficient collateral to cover the obligation, the creditor essentially faces no risk of loss.164

B. Bankruptcy Amendments—Expanding the Safe Harbor

The endowed "super-status" of derivatives agreements is not a recent phenomenon. With each amendment to the Bankruptcy Code, Congress has expanded the scope of financial instruments covered under the safe harbor provisions. When the Bankruptcy Code was first enacted in 1978,165 the Code provided special treatment to transactions involving securities and commodities markets.166 Specifically, the first safe harbor provisions only provided an exception from the automatic stay for nondebtor forward merchants and brokers with respect that the filing of a bankruptcy petition does not operate as a stay under § (a) "of the exercise by a master netting agreement participant of any contractual right . . . to offset or net out any termination value, payment amount, or other transfer obligation arising under or in connection with . . . such master netting agreement[]." 161. See id. § 362(b)(6), (7), (17), (27) (outlining provisions that protect the derivative counterparty’s right to terminate contracts and seize collateral).

162. See id. (exempting a wide variety of financial derivative agreements from the automatic stay).


164. See id. at 96 (finding that because of exemptions to the automatic stay, "derivatives counterparties can minimize their exposure to losses arising from the insolvency of a debtor").


to a narrow band of transactions involving margin payments or deposits received from a debtor under commodities contracts.167 Under the Code, certain margin payments could not be avoided as preferential transfers, but otherwise, special treatment for derivatives in 1978 was nonexistent.168 Subsequent amendments to the Bankruptcy Code in 1982, 1984, and 1990 expanded the safe harbor exceptions to include specific provisions for "derivatives securities," including swaps, repurchase agreements (repos), commodities contracts, and forward contracts.169 Each series of amendments attempted to create stability and certainty for an expanding derivatives market by providing broader protection for a greater variety of instruments.170

1. 1982 Amendment

Under the 1982 Amendment,171 Congress sought to "make a number of technical, clarifying and substantive changes in the provisions of the Bankruptcy Code affecting commodity and securities brokers . . . intended to minimize the displacement caused in the commodities and securities markets in the event of a major bankruptcy affecting those industries."172 In the accompanying House Report, Congress noted that the commodities and securities markets operate "through a complex system of accounts and guarantees," and because of the volatile nature of these markets, "certain protections are necessary to prevent the insolvency of one commodity or security firm from spreading to other firms and possibly threatening the collapse of the affected market."173 Congress thus sought to avoid a "ripple effect"174 in the market caused by one firm's bankruptcy. While some level of risk is inherent in any financial transaction, an industry "ripple effect,"

167. See Edwards & Morrison, supra note 25, at 96 (looking at the original Code provisions that exempted a limited group of specialized financial transactions from the provisions of the automatic stay).
168. See Redd, supra note 166, at 37 (examining the scope of the Bankruptcy Act of 1978 in relation to derivatives contracts).
170. See Redd, supra note 166, at 37 (providing that "concerns over the stability of established and expanding markets prompted Congress over time to provide additional and broader protections for a variety of financial markets").
173. Id.
174. Id. (using the term "ripple effect" to refer to the systemic risk inherent in the derivatives market).
commonly referred to as "systemic risk," is a particular concern for OTC derivatives.

\[ \textit{a. Systemic Risk} \]

"Systemic risk" is a term "generally used to describe the risk of a widespread global financial failure resulting either from the domino effect of one bank’s failure to meet its payment obligations or from attempts by multiple parties to effect dynamic hedges during a market downturn."

For instance, the failure of a bank in bankruptcy to meet its obligations would leave its counterparty in that particular derivatives trade unable to make payments on its obligations, thereby causing a global domino effect as defaults are transferred from one firm to another. The ultimate theoretical result is a colossal global bankruptcy. Because most OTC derivatives transactions are unsecured, transferred failure from one firm to another could be catastrophic. Congress responded to the doomsday forecasts with the 1982 Amendments, stating that:

> The amendments will ensure that the avoiding powers of a trustee are not construed to permit margin or settlement payments to be set aside except in cases of fraud and that, except as otherwise provided, the stay provisions of the Code are not construed to prevent brokers from closing out the open accounts of insolvent customers or brokers. The prompt closing out or liquidation of such accounts freezes the status quo and minimizes the potentially massive losses and chain reactions that could occur if the market were to move sharply in the wrong direction.

While in most circumstances the 1978 Act allowed only the bankruptcy trustee to reject executory contracts, in 1982, Congress extended the affirmative right to assume or reject special classes of executory contracts

\[ \text{175. Desmond Eppel, Risky Business: Responding to the OTC Derivative Crises, 40 COLUM. J. TRANSNAT'L L. 677, 688 (2002).} \]
\[ \text{176. See id. (providing a typical illustration of the systemic risk problem).} \]
\[ \text{177. See id. (declaring ultimate doom for situations involving systemic risk).} \]
\[ \text{178. See id. at 688–89 (noting that because OTC derivatives are unsecured, the resultant harm from a "ripple effect" default would likely be more harmful than for secured transactions).} \]
\[ \text{180. See Act of Nov. 6, 1978, Pub. L. No. 95-598, § 365(a), 92 Stat. 2549, 2574–75 (codified as amended at 11 U.S.C. § 365(a) (2000)) (granting the bankruptcy trustee the affirmative right to assume or reject an executory contract).} \]
to additional classes of creditors. Accordingly, § 555 and § 556 of the Code exempt from the automatic stay the contractual right of a nondebtor to terminate securities contracts, commodities contracts, and forward contracts in the event of a counterparty’s petition for bankruptcy.

With this amendment, Congress recognized that certain financial markets may change significantly in a matter of days and that a nonbankrupt counterparty may face significant losses unless allowed to promptly resolve transactions with a bankrupt entity. For financial instruments, such as forward contracts and commodities contracts, timely completion "is considered critical to the stability and smooth operation of the financial markets" and therefore, with the 1982 Amendment, Congress expressed its conclusion that the ability to liquidate these agreements must not be delayed by the automatic stay. As stated in the House Report, "[t]he prompt liquidation of an insolvent’s position is generally desirable to minimize the potentially massive losses and chain reaction of insolvencies that could occur if the market were to move sharply in the wrong direction." While Congress’s motive was genuine, the 1982 Amendment, for all intents and purposes, gave birth to the modern safe harbor provisions that today plague the unsophisticated investor. Initially, however, the safe harbor provisions were quite narrow.

182. Id., sec. 6, § 555, 96 Stat. at 236. Section 555 states that:
   The exercise of a contractual right of a stockbroker or securities clearing agency to cause the liquidation of a securities contract . . . because of a condition of the kind specified in section 365(e)(1) of this title shall not be stayed, avoided, or otherwise limited by operation of any provision of this title or by order of a court or administrative agency in any proceeding under this title.
183. Id., sec. 6, § 556, 96 Stat. at 236–37. Section 556 provides that:
   The contractual right of a commodity broker or forward contract merchant to cause the liquidation of a commodity contract . . . or forward contract because of a condition of the kind specified in section 365(e)(1) of this title . . . shall not be stayed, avoided, or otherwise limited by operation of any provision of this title or by order of a court in any proceeding under this title.
185. Redd, supra note 166, at 76.
187. See infra Part IV.C (describing one example of a financial disaster that resulted largely due to the expanded safe harbor provisions).
In contrast to BAPCPA, which widely expanded the scope of exceptions under the safe harbor provisions, Congress, in 1982, granted a limited set of exceptions to the automatic stay for a small variety of extremely complicated financial instruments whose markets are most vulnerable to systemic risk. As added in 1982, § 555 and § 556 only extended safe harbor protections to a select group of financial instruments—each narrowly defined to provide only those exceptions to the automatic stay considered absolutely necessary. For instance, the term "securities contract," as used in § 555, was defined as a "contract for the purchase, sale, or loan of a security, including an option for the purchase or sale of a security, or the guarantee of any settlement of cash or securities by or to a securities clearing agency." Notice that a "securities contract" is limited to contracts with a "securities clearing agency"—a term which is also narrowly defined. Additionally, the right to liquidate a securities contract was granted to only a limited group of actors narrowly defined to include stockbrokers and securities clearing agencies. Other parties to a securities contract remained bound by the automatic stay.

In addition to the limited scope of protected parties and agreements, the actual rights protected by the safe harbor were highly constrained. The safe harbor only exempted from the automatic stay the contractual right to cause liquidation, and even this right was strictly limited by a narrow definition of the term "contractual right." As used in § 555, the term "contractual right" included only those rights "set forth in a rule or bylaw of a national securities exchange, a national securities association, or a securities clearing association." Accordingly, only those "contractual rights" that originated in sources outside the securities contract itself qualified for protection under the

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188. See Act of July 27, 1982, Pub. L. No. 97-222, sec. 6, §§ 555-56, 96 Stat. 235, 236 (extending safe harbor protections only to securities contracts, commodities contracts, and forward contracts—each of which is narrowly defined).

189. Id., sec. 8, § 741(7), 96 Stat. at 237 (defining the term "securities contract").

190. See id., sec. 1, § 101(35), 96 Stat. at 235 (defining narrowly the term "securities clearing agency" to mean a "person that is registered as a clearing agency under section 17A of the Securities Exchange Act of 1934 . . . or whose business is confined to the performance of functions of a clearing agency with respect to exempted securities").

191. See id., sec. 1, § 101(40)(B), 96 Stat. at 235 (defining the term "stockbroker" to be a person "that is engaged in the business of effecting transactions in securities—(i) for the account of others; or (ii) with members of the general public, from or for such person’s own account").

192. See id., sec. 6, § 555, 96 Stat. at 236 (defining the term "contractual right" as relates to the safe harbor for securities contracts).

193. Id.
safe harbor. In essence, § 555 did not protect bargained-for contractual rights, but rather protected published rules of nationally recognized securities organizations. Similarly, the liquidation right in § 556 (with respect to commodities contracts and forward contracts) was limited to the right to close out an open position, and "[d]id not constitute the right to transfer cash, securities, or property held with respect to such contracts."\(^{194}\) Moreover, this right to liquidate was limited to those contractual rights "set forth in a rule or bylaw of a clearing organization or contract market or in a resolution of the governing board thereof."\(^{195}\) In summation, the 1982 Amendments wisely provided only select financial institutions a narrow thread of safe harbor protection for specialized derivatives agreements most subject to systemic risk. Nevertheless, the narrowness of the 1982 Amendments lasted less than two years.

2. 1984 Amendment

In the derivatives market, where development and innovation are the rule rather than the exception, Congress has struggled to enact legislation capable of matching the fluid development of derivatives instruments. As new financial instruments have developed, "Congress has amended the 1978 Bankruptcy Code to keep pace in promoting speed and certainty in resolving complex financial transactions."\(^{196}\) For instance, just two years after the 1982 Amendments, Congress widened the scope of the automatic stay exemptions, thus continuing the theme of financial market stabilization initiated by its first safe harbor provisions. As a part of the Bankruptcy Amendments and Federal Judgeship Act of 1984,\(^{197}\) Congress extended safe harbor protection to yet another derivatives instrument—the repurchase agreement.\(^{198}\) The 1984 Amendment added § 559 to the Bankruptcy Code thereby replicating for

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198. See BLACK’S LAW DICTIONARY 1331 (8th ed. 2004) (defining the term "repurchase agreement" as "a short-term loan agreement by which one party sells a security to another party but promises to buy back the security on a specified date at a specified price").
repurchase agreements the safe harbor protections already in place for commodities contracts, forward contracts, and securities contracts.\(^{199}\)

Most significantly, Congress choose to define the term "contractual right"\(^{200}\) more broadly for repurchase agreements than it previously did for securities contracts, commodities contracts or forward contracts. While the exception granted under § 559 was limited to the "contractual right to liquidate a repurchase agreement" the term "contractual right" was defined to include any right "whether or not evidenced in writing, arising under common law, under law merchant or by reason of normal business practice."\(^{201}\) In contrast to the definitions of "contractual right" under the 1982 Amendment, this definition specifically included unwritten rights as well as those rights arising under common law in addition to rights evidenced in writing by securities organizations.\(^{202}\) This policy change not only created general uncertainty as to which contractual rights qualified for safe harbor protection but also evidenced a liberalization of the automatic stay in favor of derivatives agreements. Interestingly, no one in Congress seemed to notice.\(^{203}\)

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> The exercise of a contractual right of a repo participant to cause the liquidation of a repurchase agreement because of a condition of a kind specified in section 365(e)(1) of this title shall not be stayed, avoided, or otherwise limited by operation of any provision of this title or by order of a court or administrative agency in any proceeding under this title.

Id.

200. Id. Section 559 further provides that:

> As used in this section, the term ‘contractual right’ includes a right set forth in a rule or bylaw, applicable to each party to the repurchase agreement, of a national securities exchange, a national securities association, or a securities clearing agency, and a right, whether or not evidenced in writing, arising under common law, under law merchant or by reason of normal business practice.

Id.

201. Id.


3. 1990 Amendment

Congress followed the liberalization of the safe harbor provisions in 1984 with another amendment in 1990, this time extending special protection to the newly developed swap agreement. 204 According to Congress, the purpose of the 1990 Amendment was "to ensure that the swap and forward contract financial markets are not destabilized by uncertainties regarding the treatment of their financial instruments under the Bankruptcy Code." 205 By adding § 560 206 to the Bankruptcy Code, the Amendment extended the same safe harbor exemptions to interest rate and foreign currency rate swap agreements that previous amendments provided to other similar types of derivative financial instruments, including repurchase agreements, securities contracts, commodities contracts, and forward contracts. 207 The Amendment also limited the bankruptcy trustee’s ability to avoid any transfer made under a swap agreement before commencement of the bankruptcy case, or any setoff in connection with a swap agreement. 208 Additionally, the 1990 Amendment attempted to augment market certainty by modifying the definitions applicable to

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204. See Act of June 25, 1990, Pub. L. No. 101-311, 104 Stat. 267 (amending the Bankruptcy Code to ensure that the swap and forward contract financial markets are not destabilized by uncertainties regarding their treatment under the Bankruptcy Code). Section 101 of this Act also amends the Bankruptcy Code by adding a definition for the term "swap agreement." Id. sec. 101, §§ 101, 104 Stat. at 267. Swap agreement is defined as "an agreement . . . which is a rate swap agreement, basis swap, forward rate agreement, commodity swap, interest rate option, forward foreign exchange agreement, rate cap agreement, rate floor agreement, rate collar agreement, currency swap agreement, cross-currency rate swap agreement, currency option, any other similar agreement . . . ." Id. Essentially, the term "swap agreement" is a catch-all term for radically different types of swap agreements. Id.


The exercise of any contractual right of any swap participant to cause the termination of a swap agreement because of a condition specified in section 365(e)(1) of this title or to offset or net out any termination values or payment amounts arising under or in connection with any swap agreement shall not be stayed, avoided, or otherwise limited by operation of any provision of this title or by order of a court or administrative agency in any proceeding under this title.

Id.


208. See Act of June 25, 1990, tit. I, sec. 103, § 546(g), 104 Stat. at 268 (stating, in part, that the "trustee may not avoid a transfer under a swap agreement, made by or to a swap participant, in connection with a swap agreement that is made before the commencement of the case").
forward contracts to match those evidenced in standard financial practice. 209

a. Swap Agreements and Safe Harbor Expansion

As amended in 1990, the Bankruptcy Code departed significantly from the minimal automatic stay exceptions that accompanied the 1978 Act. 210 Unlike previous amendments which slowly opened up the safe harbor to limited configurations of derivatives agreements, § 560 extended safe harbor protections to all swap participants—a term broadly defined to include any "entity that, at any time before the filing of the petition, has an outstanding swap agreement with the debtor." 211 The language originally proposed in House Resolution 2057 placed a reasonable time limitation on the scope of swap participants. 212 Under the proposed definition, a swap participant is any "entity that, on any day during the 90-day period ending on the date of the filing of the petition, has an outstanding swap agreement with the debtor." 213 Thus, only participants to swap agreements entered into 90 days prior to the bankruptcy filing would receive safe harbor protection. 214 Nonetheless, Congress rejected this reasonable time limitation in favor of a virtually limitless definition, further indicating its general propensity to liberalize the safe harbor. 215

Furthermore, Congress defined the term "swap agreement" to include not only specific types of swap agreements listed in the definition, but "any combination" of swap agreements, any "option to enter into" a swap agreement, and any "master agreement" that includes a swap agreement. 216 Under this

209. See H.R. REP. NO. 101-484, at 1, as reprinted in 1990 U.S.C.C.A.N. at 223 (noting that "the bill modifies certain definitions, already appearing in the Bankruptcy Code, related to the existing exemption of forward contracts from the automatic stay and trustee avoidance provisions, to conform to current standard practices in the forward contract markets").
210. See id. at 2, as reprinted in 1990 U.S.C.C.A.N. at 223–24 (providing, for example, that § 560(e) of the 1978 Bankruptcy Act accorded special treatment to "stockbroker bankruptcies by creating a separate fund" for their customers, thus providing their customers priority over general creditors).
213. Id.
214. See id. (proposing a time limitation for the classification of a swap participant).
definition, any transaction that incorporates a swap agreement or an option to enter into a swap agreement arguably qualifies as a swap agreement under the Bankruptcy Code and is therefore entitled to safe harbor protections. As a result, the 1990 Amendment expanded the reach of the safe harbor provisions to a variety of derivatives agreements not originally anticipated by the 1978 Act—including agreements between unsophisticated counterparties and those relatively immune to systemic risk.  

b. Contractual Rights and the Plunge into Liberalization

Using the newly enlarged definitions of "swap agreement," and "swap participant" as a backdrop, Congress took the ultimate plunge into liberalization. Prior to 1990, the safe harbor provisions protected undocumented rights of liquidation (or termination) for only one type of derivative—the repurchase agreement. For all other derivative types, the safe harbor provisions merely guarded rights of liquidation and termination documented in the rules or bylaws of organizations governing the particular transaction. Rather than taking a conservative stance and limiting the rights of termination and liquidation for repurchase agreements, Congress broadened the scope of liquidation and termination rights for forward contracts and swap agreements. In 1990, Congress extended the safe harbor to cover any liquidation or termination of a forward contract—even those arising from "any right . . . under common law, under law merchant, or by reason of normal business practice, whether or not evidenced in writing." Likewise, Congress redefined the type of rights that triggered a statutory right to terminate a swap agreement without any reference to rights expressed in the rules or bylaws of a governing organization. Only the

217. See supra Part III (describing the explosive growth in OTC derivatives agreements, especially among unsophisticated counterparties).

218. See Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L. No. 98-353, sec. 369, § 559, 98 Stat. 333, 366 (defining the term contractual right to include rights, "whether or not evidenced in writing").

219. See, e.g., Act of July 27, 1982, Pub. L. No. 97-222, sec. 5, § 556, 96 Stat. 235, 236–37 (limiting the contractual right to liquidate a commodities contract or forward contract to those rights "set forth in a rule or bylaw of a clearing organization or contract market or in a resolution of the governing board thereof").

220. See, e.g., Act of June 25, 1990, Pub. L. No. 101-311, tit. I, sec. 106, § 560, 104 Stat. 267, 269 (providing that the term contractual right "includes a right, whether or not evidenced in writing, arising under common law, under law merchant, or by reason of normal business practice").


contractual right to liquidate a securities contract remained limited to written rights, although this section was subsequently amended in 2005 to match the other protections for other derivatives instruments.

c. Inconsistencies Foreshadow Future Liberalization

The 1990 Amendment also foreshadowed future swelling of the safe harbor provisions culminating with BAPCPA and the utter elimination of the automatic stay for derivatives agreements. Specifically, language in the 1990 Amendment resulted in the inconsistent treatment of very similar derivatives instruments. Although § 560 (added in 1990) accomplishes primarily the same purpose for swap agreements as §§ 555, 556, and 559 do for securities contracts, forward contracts, and repurchase agreements, respectively, the specific right protected differs considerably. Sections 555, 556, and 559 protect the contractual right to liquidate a commodities contract yet § 560 protects the contractual right to terminate a swap agreement. Essentially, each section protects the nondebtor’s right to close-out a derivatives agreement existing prior to the bankruptcy filing; however, the specific right protected depends on the type of derivative.

d. 1990 Amendments—Popular but Ineffective

Ironically, this amendment was greatly supported by the financial community as an effort to quell concerns regarding systemic risk and market

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223. See Act of July 27, 1982, sec. 6, § 555, 96 Stat. 222 at 236 (defining the term "contractual right" to include a right set forth in a rule or bylaw of a national securities exchange, association, or clearing agency).

224. See Bankruptcy Abuse and Consumer Protection Act of 2005, Pub. L. No. 109-8, sec. 907, § 555, 119 Stat. at 23 (to be codified at 11 U.S.C. § 555) (adding the phrase "a right, whether or not in writing, arising under common law, under law merchant, or by reason of normal business practice" to the definition of "contractual right").


226. See Act of July 27, 1982, Pub. L. No. 97-222, sec. 6, § 555, 96 Stat. 235, 236 (providing the contractual right to liquidate a commodities contract); Id. § 556, 96 Stat. at 236 (providing the contractual right to liquidate a forward contract); Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L. No. 98-353, sec. 369, § 559, 98 Stat. 333, 366 (providing the contractual right to liquidate a repurchase agreement).

uncertainty stemming from the previously unclear treatment of derivatives instruments at bankruptcy. 228 To highlight the popularity of the amendment and its potential for success, Congress noted that two derivatives experts—Hilary Ackerman, Vice President of Goldman, Sachs & Co. and Mark C. Brickell, Chairman of ISDA—agreed that an extended safe harbor could solve the market concerns. 229 Yet, a mere eight years later, the market proved otherwise. 230 Even with the support of market leaders, Congress failed to solve the derivatives disaster. The 1990 Amendment, rather than reducing market concerns, promoted systemic risk and exacerbated market uncertainty leading derivatives to become the "hallmark financial villain of the 1990s." 231

C. The Long-Term Capital Management Disaster

The near-failure of Long-Term Capital Management in 1998 provided a wake-up call for members of Congress and a backdrop for legislation in 2005. 232 Founded in 1994 by John Meriwether, Long-Term Capital Management (LTCM) grew by 1997 into an enormously successful private hedge fund with net capital of $4.8 billion and total assets of $129 billion. 233 Since its inception, "LTCM had a prominent position in the community of hedge funds both because of the reputation of its principals, and also because of its large initial capital stake." 234 Generally speaking, the fund was enormously successful, producing net returns of approximately 40% in 1995, 40% in 1996, and 20% in 1997. 235 Although 80% of the fund’s balance-sheet positions were in government bonds of the G-7 countries (the United States, Canada, France,
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Germany, Italy, Japan, and the United Kingdom), the fund was also highly active in securities markets, exchange-traded futures, and OTC derivatives. By August of 1998, LTCM reported over 60,000 trades on its books, with gross notional amounts of the fund’s futures exchange contracts exceeding $500 billion, swaps contracts exceeding $750 billion, and other OTC derivatives exceeding $150 billion.

LTCM set itself apart from other hedge funds through the enormous "scale of its activities, the large size of its positions in certain markets, and the extent of its leverage, both in terms of balance-sheet measures and on the basis of more meaningful measures of risk exposure in relation to capital." For instance, the fund maintained over $125 billion in assets but only reported a capital equity figure of $4.8 billion—implying a debt-to-equity ratio of 25-to-1. Additionally, the PWG estimated that the fund’s exposure to certain market risks was several times greater than that of the trading portfolios typically held by major dealer firms. Accordingly, because of the fund’s large stake in highly leveraged derivatives transactions, LTCM set the stage for its own failure following the unexpected market events that "sparked reductions in asset value and resulting losses in LTCM’s capital.

Following Russia’s devaluation of the ruble in August of 1998, investors increasingly sought to avoid risk thereby triggering a "flight to quality" where "shocked investors sought to avoid risk and gain liquidity." Consequently, LTCM suffered several acute losses resulting, by September, in a total loss of over 50% of its capital. With counterparties declining to extend additional credit, the fund’s liquidity situation was bleak and by mid-

236. See id. (outlining the holdings and positions of LTCM).
237. Id. (reporting the size, scope, and classification of LTCM assets).
238. Id. at 11–12.
239. Id. at 12 (surmising that the fund’s size and high leverage made it vulnerable to the extraordinary financial market conditions that ultimately resulted in its near-failure following Russia’s devaluation of the ruble).
240. Id.
242. See Eppel, supra note 175, at 677 (explaining that "the extraordinary conditions that prevailed in financial markets in the wake of Russia’s default challenged the risk management regimes of institutions and government agencies as risk spreads and liquidity premiums increased dramatically worldwide"). In the wake of the Russian devaluation, investors suffered far greater losses than anticipated, and because multiple traders sought to reduce their risk exposure simultaneously, they were unable to do so without incurring additional losses. Id.
243. Id.
244. See LESSONS OF LTCM, supra note 233, at 12 (reporting that "during the single month of August, the LTCM Fund suffered additional losses of $1.8 billion, bringing the loss of equity for the year to over fifty percent").
September, an LTCM default was a reality.\textsuperscript{245} Although LTCM’s trades were not recklessly speculative, they were structured to assure that each position was hedged with profits resulting from arbitrage—\textsuperscript{246} “the simultaneous buying and selling of identical securities in different markets, with the hope of profiting from the price difference in those markets.”\textsuperscript{247} To earn its profit through arbitrage, LTCM, among other agreements, entered into repurchase agreements with seventy-five counterparties, OTC derivatives trades with fifty counterparties, and loans and credit facilities with several dozen banks.\textsuperscript{248}

These primary trading counterparts and creditors were the firms most exposed to a default scenario. While they initially sought as much collateral as possible, their actions actually caused further cash-flow strains, which only aggravated concerns that LTCM would be unable to meet its payment obligations due at the end of September.\textsuperscript{249} Finally, recognizing that LTCM could not honor its obligations, a group of fourteen primary brokers, trading counterparties, and creditors (organized through the Federal Reserve Bank of New York) advanced $3.6 billion of fresh capital to the fund in return for a 90\% stake in its equity and operational control.\textsuperscript{250} While disaster was ultimately averted, the principals and investors in LTCM suffered substantial losses when their collective equity stakes in the fund were reduced to a mere 10\%.\textsuperscript{251}

Following the LTCM disaster, the PWG—comprised of the Department of the Treasury, the Board of Governors of the Federal Reserve System, the Securities and Exchange Commission, and the Commodities Futures Trading Commission—undertook a detailed analysis of market conditions and probable outcomes had LTCM been allowed to fail.\textsuperscript{252} The PWG found:

\begin{itemize}
\item \textsuperscript{245} See Campbell, \textit{supra} note 32, at 699 (noting that by mid-September an LTCM default was a reality and as a result, the market’s focus turned to the systemic impact of such a failure).
\item \textsuperscript{246} See Eppel, \textit{supra} note 175, at 678 (declining to describe the positions of LTCM as irresponsibly speculative).
\item \textsuperscript{247} \textit{BLACK’S LAW DICTIONARY} 112 (8th ed. 2004).
\item \textsuperscript{248} See Campbell, \textit{supra} note 32, at 699–700 (outlining the arbitrage positions of LTCM).
\item \textsuperscript{249} See \textit{LESSONS OF LTCM, supra} note 233, at 13 (outlining the series of individual occurrences that ultimately led to the near-default of the LTCM Fund).
\item \textsuperscript{250} See \textit{id.} at 14 (noting that the responsibility and burden of resolving LTCM’s difficulties remained with the counterparties that had allowed the fund to build these significant positions in the first place).
\item \textsuperscript{251} \textit{Id.}
\item \textsuperscript{252} See Campbell, \textit{supra} note 32, at 700 (listing the members of the President’s Working Group on Financial Markets and noting that a report on the LTCM crisis was issued in April of 1999). See \textit{generally} \textit{LESSONS OF LTCM, supra} note 233 (presenting the PWG’s report on the LTCM crisis).
\end{itemize}
[Because] LTCM Fund held a great variety of relatively large positions with numerous trading partners . . . those positions, combined with the market volatility and lack of liquidity might have led to a series of dramatic and punishing events for LTCM’s trading counterparties and the markets themselves in the event of a default by the LTCM Fund.253

In responding to a default, LTCM counterparties would have been forced to rapidly sell or purchase securities in the market to rebalance their portfolios to reduce their risk brought on by the default of the fund.254 By terminating a contract upon the default of a counterparty, "a participant can remove uncertainty as to whether a contract will be performed, fix the value of the contract at that point, and attempt to re-hedge itself against its market risk."n255 It was widely thought that had LTCM filed for bankruptcy, the use of contractual rights to terminate, closeout, and net derivatives contracts under the safe harbor provisions might have "mitigated counterparty losses" and "tempered any ensuing instability in the market."256 According to the PWG,

> the ability to terminate financial contracts upon a counterparty’s insolvency enhances market stability. Such close-out netting limits losses to solvent counterparties and reduces systemic risk. It permits the solvent parties to replace terminated contracts without incurring additional market risk and thereby preserves liquidity. The ability to exercise close-out netting also will generally serve to prevent the failure of one entity from causing an even more serious market disruption.257

Because the termination amount is typically based on the value of the contract at the time of closeout, "[t]he ability to terminate most financial market contracts upon an event of default is central to the effective management of market risk by financial market participants."n258

Nevertheless, under the Bankruptcy Code, as it existed in 1998, questions remained as to whether the immediate closeout and netting of contracts would have been possible for LTCM counterparties had the fund filed for bankruptcy.259 Although "the Bankruptcy Code provide[d] important rights to

253. See LESSONS OF LTCM, supra note 233, at 18 (providing an analysis of the market liquidity in September of 1998 and the potential effects of an LTCM default).
254. See id. at 19 (analyzing the effects of systemic risk at an LTCM default).
255. Id. at 20.
256. Id. Note that the term closeout, or termination, "refers to the right under a master agreement to terminate one or more contracts immediately upon certain specified events and to compute a termination amount due to, or due from, the defaulting party." Id.
257. Id. at 40.
258. Id. at 19.
259. See Campbell, supra note 32, at 700 (noting that immediate termination, netting, and setoff may not have been available under the 1998 Bankruptcy Code because the Code only
counterparties to repurchase agreements, securities contracts, commodity contracts, swap agreements, and forward contracts, . . . [t]hose rights . . . [were] limited by the definitions of the covered agreements and by the restrictions on the counterparties who [could] avail themselves of those rights. In particular, the Bankruptcy Code specifically permitted setoff of listed financial contracts of the same type. However, it may not have permitted counterparties to net dissimilar financial contracts against each other—even if a single master agreement governed the disparate transactions. For that reason, "[h]ad termination not been available to the LTCM Fund's counterparties in the bankruptcy process, the uncertainty as to whether these contracts would be performed would have created great uncertainty and disruptions in these same markets, coupled with substantial uncontrollable market risk to the counterparties." Therefore, the PWG advised that Congress enact legislation to "improve the netting regime under the Bankruptcy Code by expanding and clarifying the definitions of the financial contracts eligible for netting and by explicitly allowing eligible counterparties to net across different types of contracts, such as swaps, security contracts, repos, and forward contracts."

D. BAPCPA and the Erosion of the Safe Harbor

Jumping at the opportunity to reduce systemic risk, Congress immediately proposed legislation that expanded the safe harbor to cover more participants, more agreements, and most importantly, cross-product netting under master agreements. While the modifications are contained in a complex web of

provided these functions for a narrow group of derivatives instruments—even if they were all covered under a master agreement).

260. LESSONS OF LTCM, supra note 233, at app. E-5.


263. LESSONS OF LTCM, supra note 233, at 27.

264. Id. at 40.

definitions and substantive provisions sprinkled throughout the Code, BAPCPA generally affords special treatment to transactions considered critical to the "stability and smooth operation of the financial markets."\textsuperscript{266} BAPCPA thus expands the scope of the terms "forward contract," "repurchase agreement," and "swap agreement" while adding a new category of protection for master netting agreements and a broadly sweeping category of protection for any "financial participant."\textsuperscript{267} In 1982,\textsuperscript{268} 1984,\textsuperscript{269} and 1990,\textsuperscript{270} Congress widened the automatic stay. In 2005, Congress destroyed it—cutting the automatic stay into a sieve specifically designed to drain all transactions resembling a derivative directly into the safe harbor.

1. Expanded Definitions Erode the Automatic Stay

Congress’s decision to twist the definitions of the protected derivatives instruments into amorphous black holes with virtually limitless reach is indicative of the vast erosion of the automatic stay. To take advantage of the safe harbor provisions, the agreement in question must first fall within one of five protected derivatives categories: forward contracts,\textsuperscript{271} swap agreements,\textsuperscript{272} commodity contracts,\textsuperscript{273} securities contracts,\textsuperscript{274} and repurchase agreements.\textsuperscript{275} Prior to BAPCPA, these definitions included such expansive lists of agreements that oftentimes a particular instrument fit comfortably under more than one category.\textsuperscript{276} A securities option, for instance, might be considered a securities contract, a swap agreement, and an equity forward.\textsuperscript{277} Even so,

\textsuperscript{266} Redd, \textit{supra} note 166, at 76.
\textsuperscript{267} See \textsc{Nathan et al.}, \textit{supra} note 150, at 5 (providing a general overview of legislative changes to provisions of the Bankruptcy Code concerning derivatives); see also Pub. L. No. 109-8, sec. 907, § 101(22A) 119 Stat. 23, 175 (2005) (defining the term "financial participant" for purposes of the Bankruptcy Code).
\textsuperscript{272} See \textit{id.} § 101(53B) (defining the term "swap agreement").
\textsuperscript{273} See \textit{id.} § 761(1) (defining the term "commodity contract").
\textsuperscript{274} See \textit{id.} § 741(7) (defining the term "securities contract").
\textsuperscript{275} See \textit{id.} § 101(47) (defining the term "repurchase agreement").
\textsuperscript{276} See Redd, \textit{supra} note 166, at 77 (outlining the provisions in BAPCPA for defining which agreements constitute protected contracts under the safe harbor provisions).
\textsuperscript{277} See \textit{generally} Enron Corp. v. Bear, Stearns Int’l Ltd., 323 B.R. 857 (Bankr. S.D.N.Y.)
Congress determined that the definitions were still too narrow, arguing that each definition should "provide sufficient flexibility to avoid the need to amend the definition as the nature and uses" of each instrument changes.278

Thus, under BAPCPA, the definition of every protected derivatives contract, except repurchase agreements,279 includes catch-all language that incorporates any agreement that is considered similar to those specifically listed in each definition.280 For instance, prior to 2005, the term "forward contract" was defined to include specifically notated forward agreements as well as "any combination thereof or option thereon."281 Under this definition, the term forward contract encompassed any combination of the expressly listed types of forward contracts or any option to enter into a combination of the expressly listed types of forward contracts but did not allow further judicial expansion of the definition.282 However, BAPCPA amended the definition to encompass expressly listed derivatives instruments as well as "any other similar agreement . . . or any combination of agreements or transactions" referred to in the definition.283 Now, any agreement, regardless of its type, may fall under the protected status of a "forward contract" as long as a crafty litigant can convince a judge that its particular agreement is indeed similar to a forward contract. Past courts have not been particularly averse to expanding the term "forward

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279. But see id. (providing that the phrase "or any similar agreement" has been added to the definitions of "forward contract," "commodity contract," "repurchase agreement," and "securities contract"). It is unclear why Congress did not ultimately add the phrase to the term "repurchase agreement" although it appears that Congress intended all the protected derivative types to be expanded. Id.
280. See id. (explaining the provisions of BAPCPA).
281. NATHAN ET AL., supra note 150, at 13.
282. See id. (detailing the changes from previous Bankruptcy Code provisions to the language as amended by BAPCPA).
283. See 11 U.S.C. § 101(25) (2000) (defining the term "forward contract" as amended by BAPCPA). In pertinent part, this section provides that:

The term "forward contract" means . . . a contract (other than a commodity contract . . . ) for the purchase, sale, or transfer of a commodity . . . or any similar good, article, service, right, or interest which is presently or in the future becomes the subject of dealing in the forward contract trade, or product or byproduct thereof, with a maturity date more than two days after the date the contract is entered into, including, but not limited to, a repurchase or reverse repurchase transaction[,] . . . consignment, lease, swap, hedge transaction, deposit, loan, option, allocated transaction, unallocated transaction, or any other similar agreement.

Id.
contract” to fit a particular challenged agreement, and with Congress’s new catch-all definition, future courts are especially likely to follow suit.

Similarly, Congress determined that the term "swap agreement" was too limited to address the evolving nature of derivatives agreements. Congress found that some courts were fearful of expanding the definition as necessary to meet the onslaught of newly developed instruments for fear of setting precedent. But rather than carefully amending the definition to specifically include the newly developed derivatives instruments, Congress passed the responsibility for tailoring the definition to the courts. Protected "swap agreements" now include "any agreement or transaction that is similar to any other agreement or transaction referred to in [§ 101(53B) of the Bankruptcy Code] and that is of a type that has been, is presently, or in the future becomes the subject of recurrent dealings in the swap markets." Although Congress provides some guidance by noting that the expansive definition "should not be interpreted to permit parties to document non-swaps as swap transactions," this limitation is insufficient to ameliorate this definitional gaffe. Congress has escaped the need to amend the definition "as the nature and uses of swaps mature" but it has done so at the expense of market certainty.

2. Master Netting Agreements—A New Escape from the Stay

In addition to expanding the scope of already protected derivatives types, Congress added a new category of agreement—the master netting

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284. See, e.g., In re Olympic Natural Gas Co., 294 F.3d 737, 741 (5th Cir. 2002) (holding that a contract for the purchase and sale of specified quantities of natural gas, for delivery at specified future dates, was a forward contract and, thus, qualified for protection under the Bankruptcy Code’s safe harbor). The court decided that the definition of "forward contract" in the Code makes no distinction between cash-settled forward contracts and physically-settled forward contracts. Id. at 740–41.

285. See NATHAN ET AL., supra note 150, at 8 (detailing the BAPCPA amendments to the term "swap agreement").

286. See id. (noting that the hazard of a limited definition of "swap agreement" was compounded by a lack of "clarifying litigation for fear of setting precedent").


288. H.R. REP. NO. 109-31, pt. I, at 129 (2005). For example, traditional commercial arrangements, such as supply agreements, and other nonfinancial market transactions, including residential or consumer loans, cannot be treated as "swaps" under the Bankruptcy Code simply because the parties "purport to document or label the transactions as swap agreements." Id.

289. Vasser, supra note 30, at 1520.
agreement 290—to the list of automatic stay exceptions. Primarily a response to
the LTCM disaster, § 561 provides:

The exercise of any contractual right . . . to cause the termination,
liquidation, or acceleration of or to offset or net termination values,
payment amounts, or other transfer obligations arising under or in
connection with one or more . . . (1) securities contracts . . . ;
(2) commodity contracts . . . ; (3) forward contracts; (4) repurchase
agreements; (5) swap agreements; or (6) master netting agreements, shall
not be stayed, avoided, or otherwise limited by operation of any provision
of this title or by any order of a court or administrative agency in any
proceeding under [the Bankruptcy Code]. 291

This section, in conjunction with the new terms "master netting agreement" 292
and "master netting agreement participant," 293 is designed "to protect the
termination and close-out netting provisions of cross-product master
agreements between parties." 294

Master netting agreements allow parties "to document a wide variety
of securities contracts, commodities contracts, forward contracts, repurchase
agreements and swap agreements" in a single contract. 295 Prior to BAPCPA, it
was uncertain whether parties to master agreements that provided netting and
setoff across or between different derivative types could take advantage of the
safe harbor. 296 Congress responded to this uncertainty just as it did with every
other uncertainty since 1978—by widening the safe harbor. Under BAPCPA,
the Bankruptcy Code specifically grants the right to setoff any mutual debt or
claim under or in connection with a master netting agreement 297 as well as the


291. Id.

292. See id., sec. 907, § 101(38A), 119 Stat. at 176 (defining the term "master netting agreement" as "an agreement providing for the exercise of rights, including rights of netting, setoff, liquidation, termination, acceleration, or close out, under or in connection with one or more [derivatives] contracts").

293. See id., sec. 907, § 101(38B), 119 Stat. at 176 (defining the term "master netting agreement participant" as "an entity that, at any time before the date of the filing of the petition, is a party to an outstanding master netting agreement with the debtor").


295. Id.


ability to exercise contractual rights of termination, liquidation, and acceleration. However, this protection extends only to the extent that the master netting participant is eligible to claim the safe harbor protections.

Although a cursory analysis of BAPCPA tends to indicate a narrowing of parties eligible to claim this benefit, upon deeper inspection it is evident that virtually any party to a protected derivatives contract is entitled to invoke the safe harbor. Section 561 provides that "a party may exercise a contractual right [to terminate, liquidate, accelerate, or offset under a master netting agreement] only to the extent that such party could exercise such a right under [the sections governing] each individual contract covered by the master netting agreement in issue." Thus, the safe harbor protects master netting agreement participants only as far as those participants are protected under the individual derivatives agreements that make up the master contract. Several of the protected participants are defined in direct relation to a type of protected contract (i.e., "commodity broker" with "commodity contract") while other categories of protected parties are more narrowly defined in terms of regular participation in the applicable markets. A "forward contract merchant," for example, is defined in terms of an entity "the business of which consists in whole or in part of entering into forward contracts."

3. Financial Participants—A Catch-All Category

Following the LTCM disaster, Congress recognized the possibility that some participants to derivatives agreements might have slipped through the categorical cracks had LTCM filed for bankruptcy. In response to concerns regarding the possibility of systemic risk if large financial participants found themselves blocked by the automatic stay and unable to terminate positions quickly, Congress added the new category of "financial participant" to its list of protected entities. The new definition allows financial participants to close

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298. See id., sec. 907, § 561(a), 119 Stat. at 179–80 (protecting the contractual right to terminate, liquidate, accelerate, or offset under a master netting agreement).
299. See id., sec. 907, § 561(b), 119 Stat. at 179–80 (limiting the safe harbor protections for master netting agreements to eligible participants as defined in this section).
300. Id.
301. Redd, supra note 166, at 77.
out and net derivatives agreements even if such parties do not qualify as traditional financial institutions, forward contract merchants, stock or commodities brokers, securities clearing houses, repurchase participants, or swap participants. According to Congress, "this change will help prevent systemic impact upon the markets from a single failure" and "further the goal of promoting the clearing of derivatives and other transactions as a way to reduce systemic risk."

Fortunately, Congress limited the scope of protected "financial participants" to those parties particularly susceptible to systemic failures. While the definition is complex, it essentially refers to very large market players that are party to financial contracts of at least $1 billion in notional or actual principal amount on the day of the bankruptcy filing or at least $100 million in marked-to-market positions aggregated across all counterparties in one or more agreements with the debtor on any day during the 15-month period prior to filing. By limiting the scope of this catch-all provision, Congress implicitly recognized that a massive domino effect of defaults resulting in a global bankruptcy is only plausible when the initial default is to a contract of colossal magnitude in relation to the overall size of the market. Nevertheless, the narrowly defined category of "financial participant" is merely a subsidiary provision that encompasses parties that do not otherwise qualify for safe harbor protection. Most counterparties, on the other hand, fit nicely into one of the broadly defined agreement-based categories where no limitation is placed on the fiscal size of the market participant.

(Defining the term "financial participant"). BAPCPA states in relevant part:

A "financial participant" means . . . an entity that, at the time it enters into a securities contract, commodity contract, swap agreement, repurchase agreement, or forward contract, or at the time of the date of the filing of the petition, has one or more [derivative] agreements . . . with the debtor or any other entity of a total gross dollar value of not less than $1,000,000,000 in notional or actual principal amount outstanding on any day during the previous 15-month period, or has gross mark-to-market positions of not less than $100,000,000 (aggregated across counterparties) in one or more such agreements or transactions with the debtor or any other entity . . . on any day during the previous 15-month period.

Id.

305. See Nathan et al., supra note 150, at 10 (detailing the new definition of the term "financial participant").
307. See Bankruptcy Abuse Prevention and Consumer Protection Act, sec. 907, § 101(22A), 119 Stat. at 175 (to be codified at 11 U.S.C. § 101(22A)) (defining the term "financial participant").
308. See, e.g., 11 U.S.C. § 101(53C) (2000) (defining the term "swap participant" as "an entity that, at any time before the filing of the petition, has an outstanding swap agreement with the debtor").
4. Questioning the Effect of BAPCPA

That a vast number of parties may invoke safe harbor protections for virtually any derivatives agreement raises serious doubt as to the legitimacy of Congress’s purpose in passing BAPCPA’s derivatives-related provisions. Concern regarding systemic risk "is warranted only in cases involving the insolvency of a major financial market participant, with whom other firms have entered derivatives contracts of massive value and volume."\(^{309}\) Given the conditions under which systemic failure may arise, it is no surprise that such failures are rare—in fact, systemic failure is so rare that one has never been observed in modern economics.\(^{310}\) Nevertheless, derivatives live in the shadow of the LTCM disaster and the resultant fear of systemic risk which leads cynics to refer to them as "the 11-letter dirty word"\(^{311}\) that plagues the market and merits increased regulation. However, the derivatives environment that nearly led to the failure of LTCM is no longer present today.

At the time of the LTCM meltdown, the OTC derivatives market was dominated by a few large international banks and securities firms.\(^ {312}\) LTCM, for instance, was counterparty to more than 20,000 transactions with over 75 different counterparties holding a notional value of over $1.4 trillion in off-balance-sheet derivatives, of which $750 billion were OTC transactions.\(^ {313}\) According to the Bank for International Settlements (BIS), LTCM was "perhaps the world’s single most active user of interest rate swaps"\(^ {314}\) and in other arenas, "LTCM was considered a market maker with significant trading positions—a few of them over ten percent relative to activity in those markets."\(^ {315}\)

As recently as 2002, holders of derivatives continued to be concentrated among the largest banks. Seven commercial banks accounted for 96% of the total notional amount of derivatives in the commercial banking system and over

\(^{309}\) Edwards & Morrison, supra note 25, at 98.

\(^{310}\) See Eppel, supra note 175, at 689 (arguing that systemic risk is an oft-cited argument for special treatment of derivatives with little practical justification).

\(^{311}\) Id. at 692.

\(^{312}\) See Edwards & Morrison, supra note 25, at 98 (analyzing the derivatives market at year-end 2002).

\(^{313}\) See United States General Accounting Office, Long-Term Capital Management: Regulators Need to Focus Greater Attention on Systemic Risk 7 (1999) (responding to a congressional request for a report on the aftermath of Long-Term Capital Management).

\(^{314}\) Id.

\(^{315}\) Eppel, supra note 175, at 685.
99% was held by the top twenty-five banks.  

And during the same year, the ten largest OTC derivatives dealers were counterparties to the majority of derivatives agreements. Such concentration of derivatives among a few players raises the possibility "that a problem (such as insolvency) with a major derivatives dealer (i.e., a commercial or investment bank) could reverberate throughout the entire OTC derivatives market and cause financial distress far beyond derivatives markets." However, the 2002 statistics also indicated a growing diversification of derivatives counterparties as the number of commercial banks holding derivatives increased from twelve to 391. The ongoing diversification of counterparties continues to narrow the gap between majority and minority holders and today over 92% of the world’s 500 largest companies use derivatives to manage and hedge risk. In the wake of LTCM, derivatives were a plaything for the world’s largest financial enterprises; today derivatives are ubiquitous.

a. The Safe Harbor is Inadequate

Given the current market conditions, Congress’s decision to quell systemic failure through the Bankruptcy Code is both unjustified and inadequate. While fear of systemic risk is only warranted in cases involving the insolvency of major market players capable of initiating a cascading series of defaults across the market, "the Code offers special treatment to derivatives no matter how large or small the counterparty." Additionally, large, dominant counterparties, like LTCM, are increasingly rare as a growing number of financial institutions, businesses, governments, and even individuals adopt derivatives to effectively manage their specific risks. Therefore, Congress’s justification—the reduction of systemic risk—is inadequate because it

317. See Edwards & Morrison, supra note 25, at 98 (taking a look at the derivatives economy as it existed in 2002).
318. Id.
319. OCC BANK DERIVATIVES REPORT, supra note 316, at 1.
320. See supra Part I (discussing the importance of derivatives).
322. See supra Part III (detailing the explosive growth of derivatives instruments).
addresses only a fading fraction of all parties that enter into derivatives contracts.\footnote{323}{See id. (arguing that the safe harbor provisions are inadequate because they benefit only a fraction of all firms that routinely enter into derivatives contracts).}

\textit{b. The Safe Harbor Is Unjustified}

Moreover, the narrow adequacy of the safe harbor provisions for high volume derivatives assumes that the automatic stay exceptions actually operate to mitigate the risk of systemic failure. Looking back at LTCM, such a deferential treatment of derivatives actually prevented, rather than assisted, LTCM from recovering from the Russian currency devaluation.\footnote{324}{See Eppel, \textit{supra} note 175, at 686 (explaining that the safe harbor provisions actually prevented LTCM from recovering from its own without the assistance of the Federal Reserve Bank of New York).} Following the LTCM disaster, William McDonough, the President of the Federal Reserve Bank of New York, stated that the "abrupt and disorderly close-out of LTCM’s positions would pose unacceptable risks to the American economy."\footnote{325}{See Edwards & Morrison, \textit{supra} note 25, at 100 (quoting William McDonough—the party primarily responsible for arranging the voluntary LTCM bail-out that prevented its failure).} McDonough’s concern stemmed from the worry that "the rush of more than seventy-five counterparties to close out simultaneously hundreds of billions of dollars of derivatives contracts would have adversely affected many market participants with no connection to LTCM and would have resulted in tremendous uncertainty about how far prices might move."\footnote{326}{Id.} If LTCM had filed for bankruptcy, most counterparties would have taken simultaneous steps to terminate and liquidate their derivatives contracts under the permissive safe harbor provisions.\footnote{327}{See, e.g., Douglas W. Diamond & Raghuram G. Rajan, \textit{Liquidity Shortages and Banking Crises}, 60 J. FIN. 615, 615 (2005) (exploring rationales behind contagious bank failures noting especially that "bank failures can shrink the common pool of liquidity, creating, or exacerbating aggregate liquidity shortages" that could lead to a "contagion of failures and a total meltdown of the system").} The resultant run on LTCM’s assets would have exacerbated liquidity shortages, ultimately resulting in the immediate and pervasive liquidation of assets at firesale prices.\footnote{328}{See Edwards & Morrison, \textit{supra} note 25, at 100.}
wholesale liquidation of LTCM’s assets.\textsuperscript{329} Due to the sudden price drops caused by simultaneous attempts to liquidate positions, many counterparties would have suffered large losses thereby causing them "to default on their own obligations to other parties, resulting in precisely the same chain reaction of insolvencies that Congress sought to avoid by exempting derivatives from the automatic stay.”\textsuperscript{330} The LTCM disaster suggests:

[T]he most important risk to financial stability may come from the possibility that derivatives counterparties, exempt from the automatic stay provisions of the Bankruptcy Code, may "run" on a financially distressed firm (or firms), causing a liquidity shortage that has the potential to spill over to other firms and markets and cause widespread instability in financial markets.\textsuperscript{331}

Thus, it was in the self-interest of LTCM’s largest counterparties to avert the crisis by funding LTCM an additional $3.6 billion to ensure that it remained solvent until the derivatives positions could be unwound in an orderly fashion.\textsuperscript{332} As the PWG stated, "[t]he self-interest of these firms was to find an alternative resolution that cost less than they could expect to lose in the event of default.”\textsuperscript{333} Without the safe harbor provisions, some LTCM counterparties may have suffered losses had they been stayed by the Code; however, it is unlikely that the losses would have been large enough to take down major financial institutions and securities firms.\textsuperscript{334}

Furthermore, the insolvency of a large firm, such as LTCM, should have no effect on overall market stability unless "its counterparties behaved imprudently in their dealings with the distressed counterparty.”\textsuperscript{335} The PWG suggests that LTCM’s counterparties did indeed behave irresponsibly by entering into under-collateralized derivatives contracts without verifying the scale or extent of LTCM’s trading operations, and by extending credit below-market rates.\textsuperscript{336} Effective risk management, therefore, is the solution to

\begin{itemize}
  \item \textsuperscript{329} See id. at 102 (noting that prices would have collapsed long before most counterparties had a chance to liquidate their positions).
  \item \textsuperscript{330} Id.
  \item \textsuperscript{331} Id. at 105–06.
  \item \textsuperscript{332} See id. at 102 (explaining why counterparties to LTCM did not allow the firm to enter bankruptcy).
  \item \textsuperscript{333} Lessons of LTCM, supra note 233, at 13.
  \item \textsuperscript{334} See Edwards & Morrison, supra note 25, at 103 (providing that if LTCM counterparties had been stayed by the Code, the major creditors would have opted "to facilitate a bankruptcy-supervised creditor ‘work-out’ by putting in more capital and reorganizing the ownership structure of LTCM, just as they did under the Federal Reserve arranged work-out").
  \item \textsuperscript{335} Edwards & Morrison, supra note 25, at 103.
  \item \textsuperscript{336} See Lessons of LTCM, supra note 233, at 14–17 (charting the reckless activities of
systemic failure, not amendments to the Bankruptcy Code that perpetually widen the available exceptions to the automatic stay for derivatives counterparties. BAPCPA not only fails to mitigate systemic risk, but does so at the expense of the debtor’s ability to reorganize and the creditor’s ability to reclaim its capital.

5. BAPCPA and the "Little Guy"

BAPCPA’s failure to mitigate systemic risk is particularly evident when the debtor is a small firm with little capital. The insolvency of small firms will not result in a "chain reaction" effect because the overall losses can be absorbed by the market. Nevertheless, these small firms remain needlessly and destructively covered by the safe harbor provisions.

Generally, bankruptcy reorganization is a framework that allocates losses and decides which businesses stay alive (and who pays the cost of keeping them alive) in order to further certain public policy goals, such as (a) preserving going concern values, (b) preserving jobs, (c) preserving equity of owners . . . , and (d) protecting the rights of creditors, both secured and unsecured.

Nonetheless, other goals, such as market stability, sometimes override the foregoing concerns. Blinded by the fear of systemic risk, Congress erroneously concluded that the reduction of such risk by expanding safe harbors promotes the stability of worldwide capital markets, therefore justifying less preservation of value for creditors in an individual bankruptcy. Yet this loss of capital for creditors and going concern value for debtors poses serious problems for smaller, nonfinancial firms.

Typically, when a counterparty cancels a derivatives contract, it seizes the underlying collateral. This loss of collateral may expose the firm to

LTCM counterparties prior to the LTCM collapse).

337. See Edwards & Morrison, supra note 25, at 103 (calling for effective risk management, rather than Bankruptcy Code amendments to quell the danger of systemic risk).
338. See id. (noting how the insolvency of a small firm affects market risk).
339. Campbell, supra note 32, at 711.
340. See id. (analyzing the effects of the expanded safe harbor provisions on the ability of creditors to reclaim capital or repossess collateral).
341. See Edwards & Morrison, supra note 25, at 114–15 (comparing the difference in results of the Bankruptcy Code safe harbor provisions when applied to a nonfinancial firm as opposed to a financial firm).
342. See id. at 115 (noting that the typical action of a counterparty to a derivatives contract at bankruptcy is to reclaim the financial or nonfinancial collateral underlying the derivatives
increased risk, ultimately reducing the value of its other nonfinancial assets. For instance, the firm may have entered a contract to hedge against a particular risk, such as interest rate fluctuations, but upon termination of the derivatives contract, the hedge disappears, leaving the firm fully exposed to interest rate instability. Increased exposure to a particular risk poses potential hardship for the firm and a resulting loss of value for other creditors. To make matters worse, the bankrupt firm will usually be unable to replicate the terminated contract on identical terms and will be forced to pay a premium for the hedge. Often this premium will be so high that the debtor firm will simply choose to deal with the risk—a decision potentially resulting in loss of firm value to the detriment of all creditors.

Although the ability of counterparties to avoid the automatic stay may lessen the risk of a systemic market failure in a few select instances, the continual expansion of the safe harbor is a slippery slope that threatens to destroy the ability of the bankruptcy system to facilitate the reorganization of debtors while preserving value for creditors. By protecting even the most miniscule contracts and counterparties, Congress has essentially transformed the safe harbor into a bankruptcy opt-out clause for certain classes of capital. Rather than providing structure and stability for creditors and debtors, BAPCPA creates a framework through which creative financial institutions can opt-out of bankruptcy by cloaking otherwise standard financial contracts in the skin of a derivatives agreement. As long as the instrument fits within a broad category of protected contracts, sophisticated parties may choose to avoid bankruptcy by unilaterally terminating their derivatives agreements. Justified as a measure to prevent systemic risk, BAPCPA paralyzes the bankrupt’s contract.

343. See id. (finding that unlike financial firms, nonfinancial firms face increased loss after a hedging contract is terminated due to the presence of nonfinancial assets within the firm).

344. See id. (explaining that loss of a hedging agreement will likely result in loss of going concern value for the firm).

345. See id. (questioning the ability of a firm to replace a particular hedging agreement with identical terms to the terminated contract).

346. See id. (postulating that a firm will often decide to simply live with a particular risk, rather than pay a high premium for the hedge).

347. See Campbell, supra note 32, at 712 (arguing that the expansion of the safe harbors to promote the stability of the worldwide capital markets is a slippery slope: "The expansion of these provisions would take us farther down the path of allowing sophisticated parties to opt out of bankruptcy").

348. See id. (noting that a cynic might argue that the safe harbors are a "bankruptcy opt-out clause for a certain class of capitalists because their money is more important than everyone else's").
ability to reorganize, effectively placing the "little guy" at the mercy of his creditors.

V. Protecting the "Little Guy"—Knowledge Is the Key

Every prudent man acts out of knowledge, but a fool exposes his folly.349

So what can the "little guy" do now to protect himself from BAPCPA? He can learn. With no help from Congress in sight, the "little guy" remains on his own. The latest amendment to the Bankruptcy Code, the Financial Netting Improvements Act of 2006,350 further widens the safe harbor in another misguided attempt to "help reduce systemic risk in the financial markets by clarifying the treatment of certain financial products in cases of bankruptcy or insolvency."351 Senator Oxley, in his report from the Committee on Financial Services, notes the technical changes in this Act "reflect years of work" by the PWG.352 Nevertheless, these years of work all stem from the same faulty conception of derivatives developed in the late 1990s following the near-collapse of LTCM.353 Until a systemic failure actually occurs and Congress witnesses the failure of the Bankruptcy Code to thwart cascading defaults, small firms should expect no help from Congress.

Thankfully, the best preventive measures are not found in the Bankruptcy Code but in individual knowledge and self-regulation. In general, governments and government agencies are inadequately equipped to regulate the risks associated with OTC derivatives.354 Unlike static government regulations which only respond to market developments post hoc, market participants have ready access to the information necessary to make informed and dynamic decisions regarding risk.355 According to Ben Bernanke, Chairman of the

352. Id. at 2.
353. See Ben S. Bernanke, Chairman of the Bd. of Governors of the U.S. Fed. Reserve Sys., Remarks on Hedge Funds and Systemic Risk at the Federal Reserve Bank of Atlanta’s 2006 Financial Markets Conference (May 16, 2006), available at http://www.bis.org/review/r060522a.pdf (last visited Mar. 3, 2008) (reporting that the years since the LTCM disaster "have offered an opportunity to consider whether the Working Group’s recommendations for addressing those issues have been effective and whether new concerns have arisen that warrant an alternative approach") (on file with the Washington and Lee Law Review).
354. See Eppel, supra note 175, at 702–03 (arguing that the government and government agencies are inadequate regulators of the risks associated with OTC derivatives).
355. See id. at 703 (noting that "market participants have the information and motivation to
Federal Reserve, "placing the onus on market participants to provide discipline makes good economic sense; private agents generally have strong incentives to monitor counterparties as well as the best access to the information needed to do so effectively." 356

The ability to adequately manage risk is directly proportional to the amount of information available to the counterparty when it enters an agreement. Thus, the "little guy" can protect himself by demanding specific information regarding the terms of the derivatives agreement prior to signing on the dotted line. The small firm should pay particular attention to the termination, liquidation, and setoff provisions of the agreement that may affect its market position should the firm find itself in a bankruptcy situation. Although large financial institutions may not volunteer this information, the small firm can always choose to seek out another derivatives dealer if unsatisfied. First and foremost, the firm should review the entire derivatives agreement with legal counsel. If possible, the firm should request a contract following the ISDA Master Agreement—a form which has become the standard for many OTC derivatives trades. 357 Careful attention should be paid to termination, liquidation, acceleration, and setoff provisions that may be triggered upon a default due to a voluntary or involuntary bankruptcy filing. The firm must understand that these rights will almost always be exercised by the derivatives dealer should the firm enter into bankruptcy. A small firm should expect to give up its derivatives agreement if it declares bankruptcy.

While in theory the firm can negotiate all terms of the ISDA Master Agreement, superior bargaining power rests in the hands of the dealer. The power and ability to seek an agreement that fits the particular needs of the firm ends once the derivatives contract is signed. Therefore, a mountain of knowledge is the best protection for the "little guy." By using a little foresight combined with a proficient understanding of the proffered derivatives agreement, the "little guy" can save himself from the safe harbor and its creditors. The “little guy” needs no help from Congress.

356. Bernanke, supra note 353.

357. See Eppel, supra note 175, at 698 (stating that the most significant achievement in the fight to create market certainty and quell systemic risk is the development of the ISDA Master Agreement, "which has become the standard contract for many OTC derivatives trades").