The Bankruptcy-Law Safe Harbor for Derivatives: A Path-Dependence Analysis

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Abstract: U.S. bankruptcy law grants special rights and immunities to creditors in derivatives transactions, including virtually unlimited enforcement rights. This article argues that these rights and immunities result from a form of path dependence, a sequence of industry-lobbied legislative steps, each incremental and in turn serving as apparent justification for the next step, without a rigorous and systematic vetting of the consequences. Because the resulting “safe harbor” has not been fully vetted, its significance and utility should not be taken for granted; and thus regulators, legislators, and other policymakers—whether in the United States or abroad—should not automatically assume, based on its existence, that the safe harbor necessarily reflects the most appropriate treatment of derivatives transactions under bankruptcy and insolvency law or the treatment most likely to minimize systemic risk.

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Bankruptcy law in the United States, which serves as an important precedent for the treatment of derivatives under insolvency law worldwide, provides unique protections to creditors in derivatives transactions. Unlike other creditors of a debtor, derivatives counterparties have special rights and immunities in the bankruptcy process, including virtually unlimited enforcement rights against the debtor (hereinafter, the “safe harbor”). This article shows that these rights and immunities accreted over time, primarily due to industry lobbying and without a systematic and rigorous vetting of the consequences.

This type of legislative accretion process is not uncommon. It is a form of path dependence—a process in which the outcome is shaped by its historical path. Because the resulting legislation—in our case, the safe harbor—is not fully vetted, its significance and utility should not be taken for granted.

This article first provides background on U.S. bankruptcy law and derivatives transactions. Thereafter, it explains the concept of path dependence, including legal path dependence. The article then reviews the evolution of the safe harbor for derivatives and shows why that evolution has been largely path dependent. Finally, the article reviews the scholarship that substantively engages the merits of the safe harbor. That scholarship suggests there is a serious question whether the benefits of the safe harbor exceed its costs, and that the safe harbor may even have unintended consequences.

I. Background

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4 ISDA, the international financial trade association which represents financial institutions from forty-seven countries on six continents in the privately negotiated, or over-the-counter (“OTC”), derivatives industry, often looks to U.S. derivatives legislation and bankruptcy exemptions as the basis for proposed foreign derivatives legislation and exemptions. See, e.g., David Mengle, ISDA Research Notes, The Importance of Close-Out Netting 4-5 (Nov. 1, 2010) (using the U.S. bankruptcy law safe-harbor exemption for close-out netting to “illustrate[] the types of safe harbor provisions that are necessary to make netting enforceable”); William J. Bergman, Robert R. Bliss, Christian A. Johnson, & George G. Kaufman, “Netting, Financial Contracts, and Banks: The Economic Implications,” Fed. Res. Bk of Chicago Working Paper No. 2004-02 (Jan. 2004) (observing that the “widespread adoption of carve-outs, providing pro-creditor protection for payment systems and derivative instruments, particularly in the form of collateral arrangements and netting agreements, represents one of the few successes in international legal harmonization. This process has been shepherded by” ISDA). Cf. Letter from Katherine Darras, General Counsel, Americas, of ISDA to representatives of the National Association of Insurance Commissioners (June 3, 2011) (observing that “over thirty-seven countries have enacted legislation that expressly recognizes close-out netting for derivatives transactions,” and suggesting some correlation between that foreign legislation and U.S. bankruptcy law recognition of close-out netting).

5 A debtor is any person or entity that is the subject of a bankruptcy case.

6 See Part I, infra.

7 See Part II, infra.

8 See Part III, infra.

9 See Part IV, infra.

10 See Part V, infra.

11 See id.
Broadly speaking, bankruptcy law, which in the United States is governed by the federal Bankruptcy Code, favors derivatives (including repurchase agreements) counterparties in three main ways. Most prominently, it allows derivatives counterparties to exercise their contractual enforcement remedies against a debtor or its property—including closing out, netting, and setting off their derivatives positions and liquidating collateral in their possession—notwithstanding the automatic stay of enforcement actions. Secondly, bankruptcy law exempts derivatives counterparties from the so-called “trustee-avoiding powers,” such as preference rules and constructively fraudulent transfers, regarding any payments and collateral received prior to the bankruptcy. For example, a derivatives counterparty that receives a preferentially large repayment from an insolvent debtor shortly before the debtor’s bankruptcy will not have to return it. Lastly, bankruptcy law allows derivatives counterparties to enforce bankruptcy-termination (“ipso facto”) clauses, and to net all existing derivatives contracts with the debtor. This effectively exempts derivatives contracts from a debtor’s ability to terminate unfavorable contracts.

To fully grasp the significance of these exemptions, we must first discuss the rationales underlying bankruptcy law’s debtor protections. The most notable of the Bankruptcy Code’s debtor protections is the automatic stay, which prevents the debtor’s creditors from executing their rights against the debtor or its property. The automatic stay thereby not only protects the debtor but also prevents creditors from taking enforcement actions in pursuit of their narrow self-interests. The stay’s legislative purpose is to allow companies attempting to restructure their debt under Chapter 11 “a breathing spell and time to work constructively with their creditors.”

The automatic stay is a core element of any attempt to reorganize under the Code. By shielding the debtor's assets and preventing a race that rewards the first creditor to the courthouse, it avoids dismemberment of a

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14 Bankruptcy Code §§ 362(b)(6), (7), (17), & (27); § 553(b)(1); §§ 555-556, §§ 559-562.
15 Bankruptcy Code §§ 546 (g) & (j).
17 Upon default of a debtor, derivatives counterparties are allowed to terminate all existing derivatives trading with the debtor and reduce the contracts to a single “net” claim. This ability effectively eliminates a debtor’s ability to terminate unfavorable contracts. See infra notes 54 & 104 and accompanying text.
18 Debtors otherwise have this ability in 11 U.S.C. § 365.
firm with going-concern value and facilitates a collective proceeding in which the parties (debtor and creditors) can negotiate the terms under which the firm will continue as a going concern.22

Preference rules are aimed at enabling debtors in bankruptcy proceedings to revoke transfers that were made in a manner that prefers certain creditors over others. The governing principle underlying preference rules is equality of distribution. Preference rules apply to transactions executed within the 90 days prior to bankruptcy filing.23

Section 365 of the Bankruptcy Code provides debtors with the ability to “assume or terminate” executory contracts. A debtor may “cherry pick” which executory contracts to assume and which to terminate. The governing principle underlying this exceptional legal power is one of debtor rehabilitation and is aimed at assisting the debtor to successfully reorganize.24

II. The Concept of Path Dependence

A. Defining Path Dependence

Path dependence is a term describing sequential processes that evolve gradually in a direction that is determined and influenced by previous stages in the process:25

In broad terms, "path dependence" means that an outcome or decision is shaped in specific and systematic ways by the historical path leading to it. It entails, in other words, a causal relationship between stages in a temporal sequence, with each stage strongly influencing the direction of the following stage. At the most basic level, therefore, path dependence implies that what happened at an earlier point in time will affect the

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22 Franklin R. Edwards & Edward R. Morrison, Derivatives and the Bankruptcy Code: Why the Special Treatment?, 22 YALE J. REG. 91, 95 (2005). See also Bryan G. Faubus, Narrowing the Bankruptcy Safe Harbor for Derivatives to Combat Systemic Risk, 59 DUKE L.J. 801, 828-829 (2009-2010) (“In other words, the automatic stay restrains creditors not only to preserve the resources of the debtor firm but also to ensure that resources are distributed to creditors in an efficient and equitable fashion. In this way, bankruptcy law avoids the unnecessary costs that a grab race would otherwise impose on both the debtor and slower creditors.”).

23 See 11 U.S.C. § 547; In re Erin Food Servs., Inc., 980 F.2d 792, 801 (1st Cir. 1992) (“The preference rules in § 547(b) ultimately are concerned with fostering equality of treatment among creditors of the same class.”).

24 N.L.R.B. v. Bildisco & Bildisco, 465 U.S. 513, 528 (1984) (observing that “the authority to reject an executory contract is vital to the basic purpose to a Chapter 11 reorganization, because rejection can release the debtor’s estate from burdensome obligations that can impede a successful reorganization”).

possible outcomes of a sequence of events occurring at a later point in time.\textsuperscript{26}

For example, an 18th century fur trader, intent on avoiding wolves and other dangers, may cut a winding path through the woods.\textsuperscript{27} Later travelers follow this path, and in time it becomes a road. As generations pass, the road becomes paved, and houses and industry are erected alongside. Although the dangers that affected the fur trader are long gone, few question the road’s inefficiently winding route. And any who do question it could be stymied by the now immense cost of straightening the road, which (among other things) would require moving housing and industry; resources invested in the original road and its surroundings may well render the paving of a straight new road too costly.\textsuperscript{28}

Path dependence is not restricted to road development, but is widespread.\textsuperscript{29} A “range of technological, economic, social, and political arrangements, once in place,” can generate patterns of costs and benefits such that rational actors prefer to maintain the status quo even if an alternative might provide higher aggregate returns in the long run. Actors support the status quo not because change stands to generate some costs – which is true of almost all changes – but because change imposes significant net costs at least in the short term. The longer actors operate within such a status quo, the more any shift to an alternative is unattractive. Initial choices are thus ‘locked in.’\textsuperscript{30}

\begin{enumerate}
\item B. Legal Path Dependence
\item The evolution of legal rules through legislative accretion can likewise be path dependent if earlier legislated rules affect the nature of later legislated rules:
\item [Many scholars] describe changes in law as being “path dependent” in that, at any moment, law’s position along its path of change is the result of many prior choices of direction at forks along the way.\textsuperscript{31}
\end{enumerate}

This can occur, for example, when “changes in organized interest groups, constituent interests, or party influence . . . affect[] subsequent legislation.”\textsuperscript{32}

\begin{enumerate}
\item \textit{Id.} at 643.
\item Cf. Gerard Alexander, \textit{Institutions, Path Dependence, and Democratic Consolidation}, 13 J. THEORETICAL POLITICS, 249, 254 (2001) (observing path dependence in the decisionmaking of political institutions as well as major policy initiatives and state structures).
\item \textit{Id.}
\item Hansen & Hansen, \textit{supra} note 25, at 7.
\end{enumerate}
In the earlier fur-trader example, path dependence occurred because the resources invested in the original road and its surroundings rendered the paving of a straight new road too costly. Legal path dependence occurs when an initial path effectively blinds lawmakers to alternative paths. This blindness can occur, for example, when legislative patterns are locked-in due to informational and political burdens.

Informational burdens arise when the choice of one legislative course of action makes future assessments of alternative courses harder; actors become used to the “normal” state of affairs and find it hard to change course. Political burdens are created when groups or institutions sympathize with earlier legislative choices and wield their influence to maintain and perhaps magnify the patterns created by those choices. And that in turn can further increase the influence and political power of those groups or institutions, thereby further locking in and magnifying the patterns:

[R]ule-driven path dependence might arise from interest group politics . . . . If the initial pattern provides one group of players with relatively more wealth and power, this group would have a better chance to have … rules that it favors down the road. Positional advantages inside firms will be translated into positional advantages in a country's politics. And this effect on . . . rules will reinforce the initial patterns . . . .

Informational and political burdens discourage alternative views. Parties “do not know enough about the other path[, and] just thinking about change clashes with our path-induced perception of ‘normal’ mechanisms. The status quo therefore persists.” Professor Roe thus argues that the emergence of the decentralized corporate ownership model in the United States blinded policymakers to the alternative models in existence, such as the German and Japanese models of ownership through powerful financial institutions.

III. Evolution of the Bankruptcy-Law Safe Harbor for Derivatives

The special treatment of derivatives in bankruptcy exemplifies legal path dependence. As explained below, it is an outcome of decades of sustained industry pressure on Congress to exempt the derivatives market from the reach of the Bankruptcy Code, with each exemption serving as an historical justification for subsequent broader exemptions.

33 See supra note 28 and accompanying text.  
34 Roe, supra note 27, at 652.  
35 Id.  
38 Roe, supra note 27, at 651.  
39 Roe, supra note 27, at 646.
The 1978 Bankruptcy Code

The initial exemptions—which were included in 1977 in the bill that became the Bankruptcy Code—were promoted by a derivatives-industry representative, Stuart D. Root, who was invited to testify before a U.S. Senate subcommittee. Root suggested that Congress grant commodities brokers authority to “close out” an insolvent customer’s account, in order to prevent “a potential domino effect.” He argued that the commodities futures market “is a delicate, if not fragile, system depending for its success on capital adequacy of the many participants,” and unless the Bankruptcy Code addressed this fragility, “the system will remain unnecessarily exposed.”

As sole evidence of this fragility, Root cited a court case, Geldermann v. Lane. When a commodities-market trader failed to meet margin calls, the trader’s broker liquidated a short position in the trader’s account and sued the trader for the remaining balance due. The trader counterclaimed that the rules of the Commodities Futures Exchange, which permitted a broker to liquidate positions of customers that do not meet margin calls, were unconscionable and hence unenforceable. Rejecting the counterclaim, the court noted that liquidation rules promoted the interest and protection of the commission merchants, their customers and the investing public as a whole. Investors or speculators who have failed to deposit sufficient maintenance margins may have insufficient financial resources to withstand substantial losses on the market and, if so, continued trading on that account is a financial risk for the commission merchant, and ultimately for the commodities exchange if the loss suffered by the commission merchant exceeds its capital account.

41 Id. at 524.
42 Id.
43 Id.
44 Geldermann & Co. v. Lane Processing, Inc., 527 F.2d 571 (8th Cir. 1975).
45 Id. at 574.
46 Id. at 577.
Root did not explain, however, why the inability of a commodities broker to freely close out an insolvent customer’s account—or why a requirement that the broker seek court permission to close out that account—could cause the domino effect he warned against.47 Nonetheless, Congress followed Root’s suggestion and included several narrow exemptions in the Bankruptcy Code. The Code included, for example, an exemption from the power of a trustee-in-bankruptcy to avoid, as a preferential transfer, margin payments made by or to a commodity broker and liquidations of commodity contracts.48 The Code also included a limited exemption from the automatic stay for setoff of mutual debts and claims in connection with “commodity futures contracts, forward commodity contracts, leverage transactions, options, warrants, rights to purchase or sell commodity futures contracts or securities, or options to purchase or sell commodities or securities.”49 This exemption was “limited” because the legislative history indicated an intention that the debtor may request the bankruptcy court, on a case-by-case basis, to hold a hearing on whether a particular setoff might harm the bankruptcy—in which case it would be stayed.50 Congress was initially unwilling, in other words, to provide derivatives counterparties with a blanket exemption from the automatic stay.51

As will be shown, these exemptions were later used as precedent to justify broader exemptions, which in turn themselves served as precedent for increasingly broader exemptions.52

The 1982 Amendment

Amendments to the Bankruptcy Code, starting in 1982, further expanded the safe harbor exemptions. The potential “domino” (sometimes called “ripple”) effect

47 See Stephen J. Lubben, Repeal The Safe Harbor, 18 AM. BANKR. INST. L. REV. 319, 329-330 (2010) (claiming that this question has still not been answered by the derivatives industry).
48 PL 95–598 (HR 8200), PL 95–598, § 764(c), Nov. 6, 1978, 92 Stat 2549.
49 PL 95–598 (HR 8200), PL 95–598, § 362(b)(6), Nov. 6, 1978, 92 Stat 2549.
51 As will be discussed, subsequent amendments to the Bankruptcy Code included language that changed this limited exemption to a more blanket exemption. See, e.g., Whyte v. Barclays Bank PLC, 12 CIV. 5318 JSR, 2013 WL 2489925 (S.D.N.Y. June 11, 2013) (“Both the facial breadth of these provisions, and the corresponding legislative history, make plain that Congress intended to place swap transactions totally beyond the inherently destabilizing effects of a bankruptcy and its attendant litigation.”) (emphasis in original).
52 Indeed, “[t]he special treatment of derivative contracts is just one more example of the increasing tendency for special interest legislation to erode the efficiency of [C]hapter 11 by piecemeal repeal of the chapter.” Stephen J. Lubben, Derivatives and Bankruptcy: The Flawed Case for Special Treatment, 12 U. PA. J. BUS. L. 61, 63-64 (2009). This gradual process, by which financial instruments proliferate and grow over time in the shadow of certain legal arrangements, without systematic examination of consequences, is not unique to the Bankruptcy Code or the derivatives market. Others have identified similar occurrences that weakened the financial system and contributed to the 2007-2009 financial crisis. See, e.g., Jennifer Taub, The Great Betrayal: How Washington Bailed Out Wall Street But Left Main Street Underwater (forthcoming 2013) chapter 14; Kathryn Judge, Fragmentation Nodes: A Study In Financial Innovation, Complexity, and Systemic Risk, 64 STAN. L. REV. 657 (2012).
argument—essentially, concern about systemic risk—was repeatedly raised as a justification for introducing these exemptions.

The 1982 amendment expanded the safe harbor beyond commodities futures markets. The amendment added narrow exemptions from the automatic stay for “mutual debt and claim” setoff by securities counterparties and liquidation of derivatives contracts. The new “contractual right to liquidate” also accorded certain counterparties this power to terminate and liquidate derivatives contracts upon insolvency of the debtor, thereby circumscribing the Bankruptcy Code’s ban on “ipso facto” clauses.

The 1982 expansion of the safe harbor was viewed by Congress as merely continuing the goal of preventing systemic risk. But that risk, which was described in 1978 as a “potential domino effect,” was now termed a threat of market collapse. Also, the 1982 legislative history does not reference the 1978 legislative intention that part of the safe harbor would only be construed as a shift of legal burden, with its actual application being developed by judicial analysis. The 1982 amendment thus signified a significant next step in a gradual process toward the complete severance of the derivatives market from debtor protections in bankruptcy.

As we next discuss, this perception shift—from what previously was seen as merely a potential risk, to a real systemic threat—accompanied all subsequent amendments to the Bankruptcy Code’s safe harbor.

The 1984 Amendment

In 1984 Congress added repurchase agreements to the classes of derivatives exempted from the Bankruptcy Code’s automatic stay. The amendment also broadened the range of parties entitled to the exemptions beyond derivatives-market actors. Thus, the safe harbor exemption was granted to a “repo participant,” i.e., any party to a repurchase agreement. On the other hand, the amendment imposed a time limit in the definition of “repo participant,” providing the safe harbor only to “an entity that, on any

58 See supra note 50 (describing the 1978 legislative intention that courts should determine, on a case-by-case basis, whether a particular action which may be harming the estate should be stayed).
day during the period beginning 90 days before the date of the filing of the petition, has
an outstanding repurchase agreement with the debtor.”61

A repurchase agreement was narrowly defined as well, and the amendment
restricted the exemptions to agreements for the transfer of certificates of deposit, bankers’
acceptances, or U.S. government securities.62 In contrast to the 1982 restrictive definition
of “contractual right to liquidate,” the 1984 amendment introduced a flexible meaning to
the term, referring not only to a rule or bylaw of an exchange, a securities association, or
a clearing agency63 but also to “a right, whether or not evidenced in writing, arising under
common law, under law merchant or by reason of normal business practice.”64 In
addition, the authorization to liquidate a repurchase agreement notwithstanding the
automatic stay included permission to foreclose on the underlying collateral.65

This authority to go against the underlying collateral exceeded previous
contractual rights to liquidate commodities and forward transactions that involved the
writing of an offsetting position.66 It paved the way for subsequent amendments that
allowed derivatives counterparties a broad right of foreclosure on security interests,
notwithstanding bankruptcy of the debtor (which had granted the security interest). The
1984 amendment thus can be seen as continuing a shift in Congress’s approach towards
the derivatives market. While the 1978 Bankruptcy Code and the 1982 amendment were
relatively restrained in exempting derivatives counterparties from the Code’s protections,
the 1984 amendment moved toward a broader exemption of derivatives in bankruptcy.67

The 1990 Amendment

With the ongoing development of financial markets and new financial
instruments, the derivatives industry became concerned that the existing safe harbor
would be insufficient.68 In 1988, Senators DeConcini and Grassley introduced a bill to
amend the Bankruptcy Code regarding swap agreements.69 The bill was endorsed by
ISDA, which urged Congress to eliminate the risk that market liquidity would be
restricted due to application of the Bankruptcy Code to swap transactions, “particularly in
periods of volatility.”70 In a classic example of interest-group politics intervening to lock-
in path-dependent legislative patterns, ISDA noted that “Congress has for many years

61 Id.
62 Id.
63 Id.
64 Id.
65 Id.
66 The “contractual right to liquidate” derivatives contracts previously granted to derivatives counterparties
“was limited to the right to close out an open position.” Hance, supra note 54, at 742 (referring to PL 97–
222 (HR 4935), PL 97–222, JULY 27, 1982, 96 Stat 235, 237, which stated that the “contractual right to
liquidate” does “not constitute the right to transfer cash, securities, or property held with respect to such
contracts”). Due to the nature of repurchase agreements (essentially collateralized loans), this restriction
was not included in the 1984 amendment.
67 Hance, supra note 54, at 742.
68 Morrison & Riegel, supra note 13, at 647.
69 S.2279 (100th Congress, 2nd session) [cite properly].
recognized the need for certainty and speed in the treatment of securities and other similar financial transactions in bankruptcy,” and that former amendments to the Bankruptcy Code with regard to securities, commodities, and repurchase agreements “worked well in practice and have provided needed certainty.” ISDA argued that the requested new protections “closely paralleled” those provided by the 1982 and 1984 amendments.

The proposed amendment deviated, however, from the former amendments at least in one aspect: it explicitly exempted netting. Derivatives are traded between parties according to rules established in a master agreement. The master agreement serves as a contractual framework for multiple transactions, providing “the general terms of the agreement between counterparties with respect to general questions such as credit support arrangements, netting, collateral, definition of default and other termination events, calculation of damages (on default), documentation, and so forth.” ISDA’s standard master agreement provided that all swap transactions between parties are terminated and netted in the event of a default. Without an explicit exemption in the Bankruptcy Code, the derivatives industry feared that the practice of netting would be prevented by the automatic stay.

The 1990 amendment provided this exemption. A “swap agreement” was expansively defined, encompassing any conceivable form of a swap transaction, any option to enter a swap transaction, any combination of the foregoing, and even a master agreement “for any of the foregoing together with all supplements.”

The 1990 amendment nonetheless continued, as in former amendments, a somewhat transaction-specific expansion of the safe harbor. This transaction-specific approach fostered an intricate patchwork of rules, which led to market confusion. The exemptions sometimes lacked coherence, with rights available to counterparties differing from one financial product to another without clear economic rationale.

**The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005**

By the time a further expansion to the safe harbor was considered in 2005, the 1998 near failure of the Long-Term Capital Management hedge fund ("LTCM") provided a dramatic example of the possible association between derivatives and systemic risk.

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71 *Id.*
72 *Id.*
73 *Id.*
75 Netting allows “any potential liability of a defaulting party [to be] reduced by the value of any swap transaction that favored that party.” Statement of International Swap Dealers Association, *supra* note 70, at 674.
77 Morrison & Riegel, *supra* note 13, at 646-47.
78 *Id.* at 647-48.
79 Bliss & Kaufman, *supra* note 74, at 57.
LTCM started its operations in early 1994. Its portfolio increased rapidly, and by the end of 1997, LTCM was already “significantly larger than any other reporting hedge fund family at that time.” By August 1998, after only four years of operation, LTCM’s gross notional amounts of derivatives contracts exceeded $1.4 trillion. LTCM’s rapid growth in trading was contrasted with a gradual thinning of its capital and assets base, resulting in a leverage ratio of more than 25-to-1 on the eve of the events that caused its near collapse.

An unexpected series of market movements during August of 1998, due to devaluation of the Russian Ruble, caused LTCM to suffer equity losses of over 50 percent. LTCM found it harder and harder to raise capital as its condition deteriorated. By mid-September 1998, the possibility of LTCM’s collapse became a reality, and markets were frantic about its implications.

In an effort to prevent a financial disaster, the New York Federal Reserve organized a creditors’ bailout of LTCM. Grouping together 14 of the most concerned LTCM counterparties, the NY Fed orchestrated an out-of-court recapitalization scheme under which the firms would inject $3.6 billion in new equity into LTCM in return for 90% of the ownership interest in the firm. The recapitalization scheme was accepted by LTCM, and the crisis was resolved with LTCM primary counterparties assuming responsibility for allowing “the hedge fund to build up its positions in the first place.”

In April 1999, the President’s Working Group on Financial Markets (the “PWG”) issued a report on the LTCM crisis (hereinafter, the “PWG Report”). Among other things, the PWG Report observed that if LTCM had defaulted, the use of close-out netting rights by derivatives counterparties that are not subject to the automatic stay would have mitigated counterparty losses and reduced the likelihood of instability in the financial markets. Therefore, it argued, “The 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.” Terminating derivatives transactions alone is not enough; termination “goes hand in hand with netting,” which serves as a “domino

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81 PWG at 29.
82 PWG at 11-12.
83 PWG at 12.
84 PWG at 12.
85 PWG at 12-13.
87 Edwards & Morrison, supra note 22, at 100.
88 PWG at 13-14.
89 PWG at 14.
90 PWG at 19.
91 PWG at 19.
92 PWG at 20.
effect” constrainer, because it reduces the exposure of counterparties to a failed debtor. Based on these findings, the PWG urged Congress to further expand the Bankruptcy Code safe harbor in order to improve market stability.

The PWG’s call for a broadening of the safe harbor was not left unheard. The recommendations of PWG were incorporated into an amendment to the Bankruptcy Code as part of the Bankruptcy Reform Act of 1999, ultimately enacted as the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (“BAPCA”). BAPCA gave free rein to derivatives counterparties to completely circumscribe the Bankruptcy Code’s automatic stay and preference rules. First, it expanded the Code’s definitions of “securities contract,” “commodities contract,” “forward contract,” “repurchase agreement,” and “swap agreement” to include a long list of specific types of known derivatives, as well as any other similar agreement or transaction, any combination of the defined derivative transaction, any option to enter a derivative transaction of the kind defined in the specific clause, a master agreement that provides for the defined derivative transaction, or any security agreement or arrangement or other credit enhancement related to the defined transaction. The purpose was to enable the safe harbor to encompass any future version of existing derivative transaction and “to avoid the need for future amendments.”

BAPCA also expanded the safe harbor by creating a new category of parties eligible for safe harbor protection. In order to make certain that closeout and netting will be available to derivatives counterparties even if they do not fit neatly into one of the

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93 PWG at 20.
94 PWG at 26.
95 See Statement of Representative Leach: "Title X contains legislative proposals forwarded to Congress by the nation's financial regulators in order to guard against systemic risk to the nation's financial system… The specific proposals are derived from the President's Working Group on Financial Markets" BANKRUPTCY REFORM ACT OF 1999: hearings before the Subcommittee ON COMMERCIAL AND ADMINISTRATIVE LAW OF THE COMMITTEE ON THE JUDICIARY, United States Senate, ONE HUNDRED SIXTH CONGRESS, first session, on H.R. 833, Part III at 18, MARCH 18, 1999; Representative Roukema: "This Title will harmonize banking and bankruptcy law with respect to the netting of financial contracts. It was produced by the President's Working Group on Financial Markets and is strongly supported by the Federal Banking agencies. I support Chairman Leach on this and appreciate that the Committee has included this Title in the Bankruptcy Bill." (at 31); Statement of Oliver Ireland, associate general counsel, Board of Governors, Federal Reserve System: "Title X includes a number of proposed amendments to the Federal Deposit Insurance Act and the Bankruptcy Code, as well as other statutes relating to financial transactions. Most of these provisions incorporate or are based on amendments to these statutes that were endorsed by the President's Working Group on Financial Markets. The Board supports enactment of the provisions recommended by the President's Working Group. Enactment of these provisions would reduce uncertainty in the financial markets." (at 347).
97 BAPCA § 907, § 101(25), § 101(53B), § 741(7), §761(4). For some reason, repos did not enjoy this specific expansion.
98 BAPCA § 907, § 101(25), § 101(47), § 101(53B), § 741(7), §761(4).
99 Id.
100 Id.
101 Campbell, supra note 86, at 704.
102 Hance, supra note 54, at 757.
specific definitions available in the Code, BAPCA created a general definition of “Financial Participant” to include any entity that, at the time it enters a securities contract, commodity contract, swap agreement, repurchase agreement, or forward contract, or at the time of filing of its bankruptcy petition, holds a total of $1 billion in notional or actual principal amount of derivatives transactions, or gross mark-to-market positions of not less than $100,000,000 (aggregated across counterparties), in one or more agreements with the debtor on any day during the prior fifteen month period. The intention was to include very large institutions whose collapse would pose imminent threat to the sustainability of the market.\footnote{Id. at 758.}

BAPCA also introduced the concept of cross-product netting into the Bankruptcy Code.\footnote{Id. at 758.} Adding the terms “master netting agreement” and “master netting agreement participant” to the list of contractual relationships and parties exempted from the automatic stay,\footnote{BAPCA § 907, § 101(38A).} it enabled derivatives counterparties to document a wide variety of derivatives transactions and to execute netting between different products traded with the debtor.\footnote{House Comm. on Judiciary, Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Report to Accompany S. 256, H.R. Rep. No. 109-31, 109th Cong. 1st Sess. 130 (2005).}

These expansions to the safe harbor—which as always, were justified as a means to reduce systemic risk\footnote{Id.}—were not unopposed. The National Bankruptcy Conference, which includes some of the nation’s leading bankruptcy scholars and practitioners, advised Congress’s Subcommittee on Commercial and Administrative Law that “[t]here is no indication that the absence of such cross-product netting features has led to widespread difficulties or systemic disruptions in the financial markets for such products.”\footnote{Bankruptcy Reform Act of 1999 (Part III), Hearing on H.R. 833 Before the Subcomm. on Commercial and Administrative Law of the House Comm. on the Judiciary, 106th Cong., 1st Sess. 369 (statement of Randal Picker, on behalf of the National Bankruptcy Conference), available at http://commdocs.house.gov/committees/judiciary/hjlu63847.000/hjlu63847_0.HTM.} Professor Randal Picker of the National Bankruptcy Conference also warned Congress, although to no avail, that “master netting could deprive a debtor of much-needed cash collateral, which in some instances may lead to conversion and liquidation to the detriment of other creditors[, and therefore that] the master netting provisions should be deleted.”\footnote{Bankruptcy Reform Act of 1999 (Part III), Hearing on H.R. 833 Before the Subcomm. on Commercial and Administrative Law of the House Comm. on the Judiciary, 106th Cong., 1st Sess. 369 (statement of Randal Picker, on behalf of the National Bankruptcy Conference), available at http://commdocs.house.gov/committees/judiciary/hjlu63847.000/hjlu63847_0.HTM.}

\textbf{The Financial Netting Improvements Act of 2006}

\footnote{In practice, cross product netting was not new to the industry. However, prior to BAPCA it was not clear whether this practice is permitted by law. BAPCA solved this uncertainty by providing a legislative right to cross product netting in bankruptcy. See Morrison & Riegel, supra note 13, at 647 & 649 and references therein.}
Notwithstanding the expectation that BAPCA’s expansion of the safe harbor would be sufficient, Congress once again amended the Bankruptcy Code in 2006. This is its most recent effort to “update the [safe harbor] language to reflect current market and regulatory practices, and help reduce systemic risk in the financial markets by clarifying the treatment of certain financial products in cases of bankruptcy or insolvency.”

The 2006 amendment focused, among other things, on improving “the netting process for financial contracts . . . by strengthening and clarifying the enforceability of early termination and close-out netting provisions.” The belief was that stronger netting capacity can help to enhance market stability; counterparties of a distressed debtor will have less incentive to terminate their positions because they can net (thereby reducing) their exposure to the debtor’s credit risk. Little thought appears to have been given to whether stronger netting might backfire by motivating increased counterparty concentration, thereby increasing systemic risk.

IV. Is the Derivatives Safe Harbor Path Dependent?

The foregoing discussion shows that the derivatives safe harbor is at least largely path dependent. Recall that legal path dependence occurs when an initial path blinds lawmakers to alternative paths. This blindness can occur when legislative patterns are locked-in due to informational and political burdens, which discourage alternative views.

The origin of the path dependence was the lobbyist-sponsored limited exemption, included in the bill that became the Bankruptcy Code, for the allegedly fragile commodities futures market. The untested justification for the initial exemption—concern about systemic risk—was reiterated for subsequent expansions of the safe harbor, often without questioning, much less careful investigation, of the merits of the expansions to protect against systemic risk. Thus, rights that were initially provided to specific counterparties were later granted to any counterparty. Exemptions from certain procedures given to one counterparty were later given to another, with no questioning of the need for or the consequences of such actions. As the legislative history demonstrates, Congress usually assumed that an expanding safe harbor would help protect against

110 See supra note 101 and accompanying text.
112 Id.
113 Bliss & Kaufman, supra note 74, at 62.
114 See infra notes 144-146 and accompanying text (observing that stronger netting can motivate increased counterparty concentration).
115 See supra notes 33-39 and accompanying text.
116 Cf. James Mahoney, Path Dependence in Historical Sociology, 29 THEORY & SOCIETY 507, 513 (Aug. 2000) (observing that “once a particular option is selected it becomes progressively more difficult to return to the initial point when multiple alternatives were still available”).
117 The PWG Report (see supra notes 89-93 and accompanying text) constituted the most important study of the merits of the safe harbor. That Report, however, has been criticized. See infra notes 160-164 and accompanying text (arguing that unrestricted close-out netting, the Report’s central recommendation, can trigger the equivalent of a bank run).
systemic risk; and with each passing amendment, that assumption became more entrenched as a truth.\textsuperscript{118} This reflects an informational blindness, discouraging alternative views. Building on this informational blindness, the derivatives industry succeeded to completely exempt itself from the restrictions of the Bankruptcy Code.

The informational blindness was almost certainly exacerbated by both the complexity of derivatives and uncertainty over how systemic risk is created and transmitted.\textsuperscript{119} Conceptualizing alternative paths is always difficult, and the more complex the alternatives the more difficult it is.\textsuperscript{120} From its inception, the discussion in Congress of the safe harbor was overshadowed by the extreme complexity of the derivatives markets.\textsuperscript{121} In the face of complexity, people tend to see what they expect to see,\textsuperscript{122} the expectation in this case being driven by lobbyist pressure.

The safe harbor expansion, accomplished through incremental amendments to the Bankruptcy Code, was accompanied in part by liberal judicial interpretation of the safe harbor’s reach. That liberality also appears to be explained by the informational burden. Courts could not independently investigate, and thus had little choice but to accept, the merits of the systemic risk justification for the safe harbor reflected in the legislative history.

For example, in the \textit{National Gas Distributors} case,\textsuperscript{123} a trustee-in-bankruptcy alleged that gas supply contracts entered into by the debtor with customers during the year preceding its bankruptcy petition created fraudulent conveyances and therefore should be avoided. The customers countered that the contracts were “commodity forward agreements” within the Bankruptcy Code’s definition of “swap agreements,” and thus were exempt from avoidance.\textsuperscript{124} Looking to the legislative history, the court noted that in enacting the safe harbor, “Congress intended to protect the financial markets” from “the destabilizing effects of bankruptcy.”\textsuperscript{125} Accordingly, the court held that the contracts

\textsuperscript{118} See, e.g., Statement of International Swap Dealers Association, \textit{supra} note 70, at 674 (observing that “Congress has for many years recognized” the need for the safe harbor).
\textsuperscript{119} See \textit{Roe}, \textit{supra} note 27, at 651 (observing that one cause of the information burden is that decisionmakers do not know enough about alternative paths).
\textsuperscript{120} Cf. \textit{Ruhl & Ruhl}, \textit{supra} note 31, at 452 (explaining that “Society is also faced with the unpredictable ripple effects the law’s failure will have on the proper functioning of many other laws and, consequently, the other social institutions with which the laws are intertwined. As this failure reverberates through the legal system, society responds with more inherently (but not intentionally) interdependent laws designed to patch up the system, adding to the vulnerability of the system. Structural complexity breeds vulnerability, which breeds more structural complexity, which breeds more vulnerability, and so on.”).
\textsuperscript{121} Cf. \textit{Morrison & Riegel}, \textit{supra} note 13, at 641 (observing that Congress was so intimidated by the complexity of the derivatives market that it directed professional bankruptcy judges to apply a formalistic inquiry that is detached from the transaction’s characteristics and is wholly dependent on industry custom).
\textsuperscript{122} Cf. Steven L. Schwarcz & Lucy Chang, \textit{The Custom-To-Failure Cycle}, 62 \textit{Duke L. J.} 768, 768 (2012) (observing that, being “limited-capacity information processors,” human beings “tend to compensate [in areas of complexity] by relying heavily on . . . simplifications of reality that allow us to make decisions in spite of our limited ability to process information”).
\textsuperscript{123} \textit{In re Nat’l Gas Distributors, LLC}, 556 F.3d 247 (4th Cir. 2009).
\textsuperscript{124} Id. at 250.
\textsuperscript{125} Id. at [cite].
were exempt, notwithstanding that they were rather ordinary agreements to purchase commodities. ¹²⁶

The 2005 expansion of the safe harbor accomplished in BAPCA, which exempted all derivatives transactions (broadly defined) from bankruptcy law, in part reflects a corollary form of a path-dependent informational burden. The pre-BAPCA Bankruptcy Code contained inconsistent definitions of exempted derivatives transactions and parties—an outcome of the gradual path-dependent progression of the exemptions based on the constant emergence of new derivatives and market practices. That in turn caused additional uncertainty as to which derivatives counterparties and transactions were covered by the safe harbor. ¹²⁷ That additional uncertainty created an incentive for Congress to follow ISDA’s recommendation and include all derivatives counterparties and transactions in the safe harbor. ¹²⁸

To the extent BABCA’s 2005 expansion of the safe harbor was recommended by the PWG Report, issued by the President’s Working Group on Financial Markets, ¹²⁹ such expansion might not appear to represent legal path dependence. Nonetheless,

ISDA played a significant role in the drafting of the relevant provisions of [BAPCA and] worked in close collaboration [with the President’s Working Group on Financial Markets.] . . . ISDA prepared a position paper in 1996 setting forth the need for amendments to the Bankruptcy Code . . . and proposing language for many of the provisions eventually amended by BAPCA. ISDA also participated in many of the hearings that led up to the eventual adoption of the provisions that were passed as part of the BAPCA. ¹³⁰

Indeed, ISDA’s significant influence reflects the fact that as the derivatives industry skyrocketed in size, ¹³¹ lobbyists such as ISDA became much more powerful, creating a

¹²⁶ Id. at 251. The court further observed that although “these particular contracts were not traded in financial markets—and perhaps were not even assignable—they nonetheless could have an influence on markets in which participants enter into hedging agreements. A business can enter into a forward agreement with a party who then, in reliance on that forward agreement, enters into another contract with yet another market participant, who in turn may enter into even other contracts. And so a simple forward agreement may readily become tied into the broader markets that Congress aimed to protect in BAPCPA.” Id. at 257.

¹²⁷ Morrison & Riegel, supra note 13, at 646-47.

¹²⁸ Id.

¹²⁹ See supra note 89-90 and accompanying text.

¹³⁰ Pp. 1-2 and note 1 of ISDA’s Amicus Curiae brief in In re Nat’l Gas Distributors, LLC, 556 F.3d 247 (4th Cir. 2009).

¹³¹ The size of the derivatives market grew immensely during the three decades that passed since the initial enactment of the first safe harbor provisions in 1978. See, e.g. Rene M. Stulz, Financial Derivatives: Lessons from the Subprime Crisis, MILKEN INST. REV., First Quarter 2009, 61 (“Over the last three decades, outstanding derivatives have increased 300-fold.”); Waldman, supra note 21, at 1031-32 (“Totaling only $3 billion in notional principal in 1982, the market for swaps, the most common form of derivative, has risen over 1200-fold in ten years.”); Alan Greenspan, Financial Derivatives, Remarks Before the Futures Industry Association, Boca Raton, Florida March 19, 1999 (available at: http://www.federalreserve.gov/boarddocs/speeches/1999/19990319.htm) (“At year-end [1998], U.S.
political burden that discouraged alternative views. This parallels the observation that
the legislative creation of incumbents “cause[s] changes in the costs and benefits of
interest group organization” and “affect[s] the resources available to an interest group
[such as ISDA] and thus its ability to provide resources to legislators.” Ironically, the
increase in the size of the derivatives industry was itself partly fostered by the safe
harbor, which encouraged firms to deviate away from traditional financing into exotic
derivatives, to avoid application of bankruptcy law. And that, in turn, has made the
financial system even more complex, further reinforcing the informational blindness.

The safe harbor has by now become so embedded in the norms regarding
bankruptcy treatment of derivatives that changes would be costly. This also parallels
the observation that the choice of a certain legal path can encourage affected actors to
invest resources in practices that conform to that path, thereby further locking it in:

[I]nstitutions and structures might have already developed to address needs and
problems arising under these rules. … Various players-managers, owners,
lawyers, accountants, and so forth-might have invested in human capital and
modes of operation that fit the existing . . . rules. Replacing these rules would
require these players to make new investments and to adapt to the new rules,
[thereby] reinforc[ing] [the] existing rules . . . .

V. Reassessing the Derivatives Safe Harbor

Path-dependent legislation is not necessarily bad. Nonetheless, if such legislation
is not fully vetted, its significance and utility should not be taken for granted. In this Part,
we review the existing scholarship that substantively engages the merits of the safe
harbor. Although we have not made an independent analysis of the merits of the safe
harbor, our review indicates that some scholars seriously question whether its benefits
exceed its costs.

A. Does Market Concentration Justify the Safe Harbor?

commercial banks, the leading players in global derivatives markets, reported outstanding derivatives
contracts with a notional value of $33 trillion, a measure that has been growing at a compound annual rate
of around 20 percent since 1990.”).

132 ISDA took a leading role in the promotion and drafting of the safe harbor. See, e.g., p. 7 of ISDA’s
participated in the enactment of the 1990 amendments to the Bankruptcy Code”). See also supra note 130
and accompanying text.

133 Hansen & Hansen, supra note 25.

134 Mark J. Roe, The Derivatives Market’s Payment Priorities as Financial Crisis Accelerator, 63 Stan. L.
Rev. 539, 559 (2010-2011).

135 Cf. supra note 28 and accompanying text (observing that resources invested in an original road and its
surroundings may well render the paving of a straight new road too costly).

136 Bebchuk & Roe, supra note 36, at 156.
The characteristics of the derivatives market have contributed to the belief that a collapse of a derivative counterparty might precipitate a systemic meltdown.\textsuperscript{137} The trade in derivatives is concentrated among relatively few major firms.\textsuperscript{138} It therefore is feared that the collapse of a single firm, especially a highly connected one, might systemically disrupt the derivatives market, which could then impact the financial system more broadly:

Much OTC [over the counter] derivatives activity in the United States is concentrated among 15 major U.S. dealers that are extensively linked to one another, end-users, and the exchange-traded markets. This combination of global involvement, concentration, and linkages means that the sudden failure or abrupt withdrawal from trading of any of these large dealers could cause liquidity problems in the markets and could also pose risks to the others, including federally insured banks and the financial system as a whole.\textsuperscript{139}

This systemic risk story, however, is far from proved. There is “little actual evidence to support” the story.\textsuperscript{140} On the other hand, based on a 2004 ISDA study, economists Bliss and Kaufman estimated that the net exposure of the major derivatives dealers to their five largest dealer counterparties (adjusting for collateral) averaged only 1.15%.\textsuperscript{141} If this estimate is correct—the estimate might be inaccurate in individual cases

\textsuperscript{137} Waldman, supra note 21, at 1055 (“Following substantial market losses, there is the risk that the failure of one significant participant to make payments could result in their counterparty's suspension of payments, causing a rapid, global transmission of defaults to numerous participants wedded to the initial failed participant by OTC derivatives contracts. \textit{This risk is heightened by the fact that much of the derivatives business is concentrated in a small number of banks.”). \textit{See also} \textsc{David Skeel}, \textsc{The New Financial Deal: Understanding the Dodd-Frank Act and Its (Unintended) Consequences}, 135 (2011) (“The argument that serious counterparty risk was at stake was based on the concentration of the derivatives industry, with the major players – known before the crisis as the Fourteen Families – heavily connected with one another. If one fell, some have argued, the others could fall.”).

\textsuperscript{138} \textsc{The Financial Crisis Inquiry Report} released in January 2011 found that "Much of the risk of CDS and other derivatives was concentrated in a few of the very largest banks, investment banks, and others—such as AIG Financial Products, a unit of AIG—that dominated dealing in OTC derivatives. Among U.S. bank holding companies, of the notional amount of OTC derivatives, millions of contracts, were traded by just five large institutions (in, JPMorgan Chase, Citigroup, Bank of America, Wachovia, and HSBC)—many of the same firms that would find themselves in trouble during the financial crisis. The country’s five largest investment banks were also among the world’s largest OTC derivatives dealers." \textsc{Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States}, 50 (January 2011)

\textsuperscript{139} United States General Accounting Office, “Financial Derivatives: Actions Needed to Protect the Financial System,” Report to Congressional Requestors, GAO/GGD-94-133, 7 (May 1994). \textit{See also} Edwards & Morrison, supra note 22, at 98 (observing that “Fear that a counterparty insolvency could trigger a systemic meltdown in the 'over-the-counter' derivatives market stems partly from the fact that this huge market is dominated by a few large international banks and securities firms”). Based on a 2009 Office of the Comptroller of the Currency study, Professor Roe reports that “[t]he derivatives market is strongly centralized, with five firms accounting for nearly 90% of the industry’s net credit exposure.” Roe, supra note 134, at 561.

\textsuperscript{140} Lubben, supra note 47, at 331. Professor Lubben observes that “there is little actual evidence to support even th[e] narrow claim” that “the special interrelations among financial firms, combined with some special volatility of derivatives, necessitates altering the Bankruptcy Code to prevent a systemic crisis.” \textit{Id.}

\textsuperscript{141} Bliss & Kaufman, supra note 74, at 67.
because its adjustment for collateral does not take into account dealers’ increased exposure due to asset firesales runs, and the estimate is somewhat circular insofar as it is based on full netting which might be facilitated by the safe harbor\textsuperscript{142}—it is highly unlikely that a collapse of one dealer could directly cause the failure of another major dealer.\textsuperscript{143}

It is also ironic that the safe harbor itself may have exacerbated the movement toward market concentration of the derivatives industry, including by reducing derivatives traders’ incentives to diversify their counterparties’ profile. For example, the safe harbor enables creditors to ignore counterparty risk because a creditor can foreclose on the collateral notwithstanding the counterparty’s bankruptcy.\textsuperscript{144} This means that creditors “are not overly concerned with their debtor’s financial stability, because they protect themselves with the debtor’s collateral, rather than with their understanding of the firm itself.”\textsuperscript{145} As a result, systemic risk actually may increase:

[I]f the superpriorities had not been in place when Lehman built its capital structure and derivatives portfolio, Lehman's derivatives and repo counterparties’ incentives to insist upon a more stable Lehman would have been greater. And Lehman itself would have been incentivized to keep to a safer capital structure to encourage its counterparties to keep dealing with it at low cost.\textsuperscript{146}

Lack of information regarding the financial condition and resiliency of derivatives counterparties can also make market participants more likely to overreact to new information regarding liquidity constraints in financial markets. Unable to distinguish “good” firms from “bad,” market participants may overreact, posing a threat to the entire financial system.\textsuperscript{147} This adverse selection was seen in the financial crisis “when there was a run on the investments banks and money market funds after Lehman Brothers failed. . . . Like past runs, the runs on investment banks and money market funds occurred because there was uncertainty and lack of information about the health of these institutions . . . .”\textsuperscript{148}

\textsuperscript{142} The estimate is not, however, entirely circular: it does not necessarily assume unrestricted collateral enforcement, nor does it assume close-out of derivatives positions. Bliss & Kaufman, \textit{supra} note 74, at 67.
\textsuperscript{143} Bliss & Kaufman, \textit{supra} note 74, at 68. \textit{See also} Skeel, \textit{supra} note 137, at 135 (referring to the concentration argument in favor of the safe harbor, Skeel observes that “we know now that Lehman’s bankruptcy filing did not lead to the failure of any of the bank’s counterparties . . . . Within a couple of weeks, the vast majority [of Lehman’s derivatives trades] had been closed out, without any of the counterparties failing.”).
\textsuperscript{144} PWG, \textit{supra} note 80, at 8.
\textsuperscript{145} Roe, \textit{supra} note 134, at 559.
\textsuperscript{146} \textit{Id.} at 554.
\textsuperscript{147} Judge, \textit{supra} note 52, at 696 (“One well-recognized mechanism through which local financial distress can spread to the banking system generally is ‘similarity’ or ‘common mode failure’. This arises when the failure of one financial institution sends signals to the marketplace about the financial well-being of other institutions with similar exposures. If market participants were perfectly informed, of course, a failure would not convey any new information.”).
The safe harbor’s close-out netting provisions, which are exempted from the automatic stay, can also contribute to increased market concentration. Unrestricted close-out netting permits derivatives positions to be adjusted by executing an offsetting position with the same party without incurring additional costs (in terms of cash flow, collateral, credit risk management, or even being required to engage the market for an alternative offsetting position from a weak bargaining stand). That in turn allows market participants to concentrate their positions with relatively few dealers. Without unrestricted close-out netting, “the concentrations we see in the dealer market which give rise to systemic concerns simply would likely not exist [because the] capital available to support gross credit risk exposures would far exceed the capital currently needed to support net exposures.”

B. Is the Safe Harbor Focused on the Right Parties?

Professors Edwards and Morrison observe that the fear of derivatives-induced systemic risk is warranted only in the case of an insolvency of a major financial market participant holding a massive derivatives portfolio. The safe harbor’s exemptions, however, operate independently of the size of the counterparty or its portfolio. Furthermore, they apply not only to financial firms but to any firm that holds a derivative. Thus a bank that makes a secured loan cannot enforce its collateral against a bankrupt borrower, whereas an ordinary business firm can enforce its collateral against a bankrupt derivatives counterparty. The safe harbor exemptions may go well beyond the underlying goal of reducing systemic risk.

It is unclear if that breadth is needed. Some argue, for example, that although the systemic risk argument cannot justify a blanket protection to all market participants, it is impractical to base laws on the size of the affected party. Others acknowledge that while a “more fine-grained approach that applied the automatic stay to [only] some derivatives . . . would complicate the treatment of derivatives in bankruptcy,” a “more

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149 Bliss & Kaufman, supra note 74, at 62.
150 Id. at 61 (observing that this creates “incentives to deal with one counterparty rather than many”).
151 Id. at 67. Although ISDA has expressed concerns regarding the increase in exposure that could result from limiting the safe harbor (see Mengle, supra note 4, at 6), such an increase would likely be temporary, diminishing as market participants rearrange their portfolios to adapt to the changed risk.
152 Edwards & Morrison, supra note 22, at 98.
153 Id.
154 Lubben, supra note 47, at 328. Lubben observes, for example, that “the argument for the safe harbors is quite simple: the safe harbors reduce systemic risk by giving large financial institutions special treatment. This argument only holds, if at all, with regard to derivative transactions among financial institutions, and thus supports only a much narrower version of the existing safe harbors.” Id. at 331.
155 Lubben, supra note 52, at 75; Hance, supra note 54, at 759-61; Vasser, supra note 13, at 1542.
156 Bliss & Kaufman, supra note 74, at 58. But cf. [Dodd-Frank Act’s special treatment of SIFIs—cite1].
nuanced approach is preferable to adopting a blanket rule that invites strategic termination by non-debtors.”

C. Possible Unintended Consequences

In its current form, the safe harbor may well have unintended consequences. In this subpart, we will discuss the possibility that close-out netting can cause the equivalent of a “bank run,” and also the likelihood that the safe harbor’s breadth enables virtually any financial contract, including an ordinary secured loan, to be documented as a derivatives transaction, thereby exempting the contract from the automatic stay and other critical bankruptcy provisions.

Close-out Netting Can Trigger the Equivalent of Bank Runs. Recall that the PWG Report’s central recommendation was that close-out netting should be exempted from the Bankruptcy Code’s automatic stay and other restrictions. The Report’s rationale was that close-out netting would help to mitigate counterparty losses and thus reduce the likelihood of instability in financial markets. Professors Edwards and Morrison argue to the contrary, however, that unrestricted close-out netting can trigger the equivalent of a bank run.

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158 Id. at 1050. The safe harbor might itself facilitate systemic risk. For example, the Financial Stability Oversight Council identified the absence of a bankruptcy mechanism to facilitate the orderly liquidation of a defaulted dealer’s collateral as one of “ongoing vulnerabilities” in the repo market. 2012 Annual Report of the Financial Stability Oversight Council, at 133, [hyperlink]. This vulnerability created a systemic risk of market collapse caused by the “firesale” of a defaulting dealer's collateral. Id. As the FSOC observed, the exclusion of derivatives from bankruptcy’s automatic stay left financial markets in a void with no protection against abrupt liquidity changes.

159 We already have mentioned other potential unintended consequences of the safe harbor: that stronger netting might backfire by motivating increased counterparty concentration, thereby increasing systemic risk (see supra notes 113-114 & 144-146 and accompanying text), and that master netting could deprive a debtor of much-needed cash collateral, which in some instances may lead to conversion and liquidation to the detriment of other creditors (see supra notes 108-109 and accompanying text). The safe harbor might have an additional unintended consequence. The PWG Report’s favoring of netting provisions, being focused on damage to the derivatives market as a whole, overlooks the danger of systemic risk as a result of a specific counterparty collapse. For example, if netting provisions were subject to the automatic stay, LTCM would have had to engage a larger number of counterparties in order to reach the same gross positions. This, in turn, would have meant that each counterparty was less exposed to an LTCM default because the individual gross positions of each counterparty with LTCM would have been smaller. Thus, if LTCM had gone into bankruptcy under a no-safe-harbor regime, the market as a whole would have suffered the same gross damage, but its sustainability would have been higher. Market diversity reduces the possibility of any given firm sustaining larger losses than its loss absorption capability. See SKEEL, supra note 137, at 161-162 (noting that due to safe harbor privileges, “rather than spreading their derivatives business among a multitude of counterparties, [derivatives participants] can feel free to load up on derivatives with [a single counterparty.] … By lowering the risks of having a large exposure to any given counterparty, the special derivatives rules have thus diminished the incentives for a bank to spread its derivatives business around…. If derivatives and other financial instruments were subject to the same core principles as other contracts[,]… derivatives creditors would pay much closer attention to a debtor’s financial condition, and they would be much more careful to limit their exposure to any particular institution…”). See also Roe, supra note 134, at 561-62.

160 See supra notes 90-93 and accompanying text.

161 Id.
Using LTCM as an example, they contend that unrestricted close-out netting would have motivated LTCM’s creditors to rush to net and close out their positions. That, in turn, could have caused or exacerbated “liquidity shortages, resulting in systemic illiquidity with the potential to cause widespread contagion.” They also argue that such a rush “could have resulted in the immediate and widespread liquidation of assets at firesale prices.” Absent unrestricted close-out netting, however, Edwards and Morrison believe that LTCM’s major creditors almost certainly 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. Indeed, as subsequent events showed, it was clearly in the collective interest of LTCM’s counterparties and creditors to avoid a “run” on LTCM and the accompanying firesale of its assets. Thus, in the absence of the Bankruptcy Code’s special treatment of derivatives, Fed intervention may have been unnecessary.

We do not purport in this discussion to independently critique the merits of unrestricted close-out netting. Our point is simply that it has been the subject of serious criticism by respected scholars. ISDA’s Head of Research has responded to such criticism but only in generalities, including observing the international legal harmonization towards allowing unrestricted close-out netting. The fact that something

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162 Edwards & Morrison, , supra note 22, at 101.
163 Id. Other scholars suggest that these systemic illiquidity and liquidation concerns could be muted, however, by steps such as allowing regulators a limited period of time (e.g., 24 hours) to transfer derivatives of a failed counterparty to third parties. See Viral V. Acharya, Thomas P. Cooley, Matthew Richardson, & Ingo Walter, Regulating Wall Street: The Dodd-Frank Act and the New Architecture of Global Finance 27-28 (2011). But cf. Mengle, supra note 4, at 6 (cautioning that delays longer than 24 hours “might unnecessarily expose market participants to market risks”).
164 Edwards & Morrison, , supra note 22, at 103.
165 For an overview of the criticism, see Mengle, supra note 4, at 5 (observing that “a handful of academics and bankruptcy lawyers in the United States [have] suggest[ed] that the [close-out netting] safe harbor[] be abolished altogether[,] cit[ing] a variety of justifications: one commentator argues that the ability to terminate can lead to systemic crisis; others suggest that close-out netting and other risk mitigation mechanisms reduce incentives to monitor credit quality; and still others argue that close-out netting works at cross-purposes to the objectives of bankruptcy by redistributing risk from derivatives participants to other parties.”).
166 Beyond maintaining that “inability to terminate or net contracts with an insolvent firm would leave surviving firms vulnerable to losses caused by sudden market changes”—an argument that takes into account ex post but not ex ante implications, disregarding how increased exposure would motivate counterparties to diversify and monitor (see supra notes 150-151 and accompanying text)—Mengle observes that, “more generally, changing the treatment of derivatives and other financial contracts would represent a major departure by the United States from the trend toward cross-border convergence of the treatment of derivatives in insolvency and from the widespread acknowledgement by policy makers of the contribution of netting to financial stability”). Id. Cf. Bergman et al., supra note 4 (observing that the safe harbor types of exemptions “represent[] one of the few successes in international legal harmonization”).
is occurring does not necessarily mean, however, that it should be occurring\textsuperscript{167}—especially when lobbying is a cause of what is occurring.\textsuperscript{168}

\textit{The Safe Harbor’s Breadth Enables Ordinary Financial Contracts to be Documented as Derivatives Transactions.} Because derivatives transactions are exempted from bankruptcy law, another unintended consequence is that parties are tempted to try to document ordinary financial transactions as derivatives transactions in order to benefit from the exemption. During the deliberations preceding the 1990 amendment to the safe harbor, Professor Picker even warned Congress that “[t]he expansion of these provisions would take us farther down the path of allowing sophisticated parties to opt out of bankruptcy.”\textsuperscript{169}

The safe harbor is now so broad that, it appears, virtually any ordinary financial transaction can be documented to fall within it.\textsuperscript{170} The safe harbor uses broad definitions of derivatives, no longer requiring that they be traded on financial markets or be physically settled. Although some courts have tried to resist overly broad categorization of ordinary financial contracts as derivatives, they have been overruled on appeal due to the breadth of the safe harbor.

In \textit{In re} National Gas Distributors,\textsuperscript{171} for example, the lower court found that ordinary agreements to purchase commodities should not be treated as derivatives and therefore should not be exempt from bankruptcy law.\textsuperscript{172} The court feared a slippery slope, that exempting ordinary contracts as derivatives would disrupt the overall scheme of the Bankruptcy Code. If this agreement is a [derivative] agreement, then many of the most important aspects of the Code, including priorities of distributions to creditors and the automatic stay, will be eviscerated in even the smallest case of a farmer who contracts to sell his hogs at the end of the month for a set price. No public purpose would be served, and the result would be wholly at odds with the established aims and order of bankruptcy proceedings.\textsuperscript{173}

On appeal, however, the court’s decision was reversed, given the breadth of the safe harbor language.\textsuperscript{174}

\textsuperscript{167} G.E. MOORE, PRINCIPIA ETHICA 10-14 (1971).
\textsuperscript{168} Cf. Enrico Perotti, \textit{Systemic Liquidity Risk and Bankruptcy Exceptions}, DSF Policy Paper Series No. 8, Oct. 2010, at 4-5 (observing that the safe harbor provisions were “heavily lobbied by the financial industry”).
\textsuperscript{169} Bankruptcy Reform Act of 1999 (Part III), Hearing on H.R. 833 Before the Subcomm. on Commercial and Administrative Law of the House Comm. on the Judiciary, 106th Cong., 1st Sess. 369 (statement of Randal Picker, on behalf of the National Bankruptcy Conference), available at \url{http://commdocs.house.gov/committees/judiciary/hju63847.000/hju63847_0.HTM}.
\textsuperscript{170} See infra note 178 and accompanying text.
\textsuperscript{171} In re Nat’l Gas Distributors, LLC, 369 B.R. 884 (Bankr. E.D.N.C. 2007).
\textsuperscript{172} Id. at 899.
\textsuperscript{173} Id. at 899.
\textsuperscript{174} See supra notes 123-126 and accompanying text.
Similarly, in *In re MBS Management Services*, an appeals court held that an ordinary electricity supply contract was a derivatives contract and thus exempt from bankruptcy law: “Admittedly, even supply contracts have hedging or risk management attributes. By setting the price for electrical power, end users protect themselves against large fluctuations in price and stabilize their cost of power.” The court also approved the lower court’s reasoning, which cited with favor the proposition that there is “no reason . . . to distinguish between [derivatives] contracts, and ‘ordinary purchase and sale’ forward contracts, when the statutory language makes no such distinction.”

Under the current safe harbor language, virtually any financial contract, including an ordinary secured loan, might be able to be documented as a derivatives transaction, thereby exempting it from the automatic stay and other critical bankruptcy provisions. Some textbooks are openly encouraging parties to design financing contracts as derivatives transactions, in order to circumvent the Bankruptcy Code’s restrictions. Indeed, one of the authors was recently told, in confidence, by a prominent financing lawyer that it could be malpractice for lender’s counsel to draft a secured loan as an ordinary loan and security agreement, because drafting it as a derivatives contract would allow the secured lender to foreclose notwithstanding the automatic stay. Professors Partnoy and Skeel have observed, in this context, that the costs of completely excluding derivatives from the protections that bankruptcy law gives debtors are likely to rise, as firms increasingly turn to derivatives as a substitute for traditional financial instruments.

It thus is clear that the safe harbor is too broad; but if a safe harbor is needed—a question as to which we are agnostic—it may be difficult to design a more limited set of exemptions. One problem is that numerous bankruptcy judges, with varied backgrounds, preside over cases involving derivatives, so “predicting the treatment of complicated financial contracts upon a future bankruptcy filing would be quite difficult.” The resulting uncertainty “might have detrimental (i.e., inefficient) effects on the larger derivatives markets, which has importance well beyond the world of bankruptcy.” The

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175 *In re MBS Mgmt. Servs., Inc.*, 690 F.3d 352 (5th Cir. 2012).

176 Id. at 355.


178 Statement of Kenneth N. Klee, Professor of Law, UCLA School of Law, and Senior Partner, Klee, Tuchin, Bogdanoff, & Stern LLP, June 12, 2007, International Insolvency Institute, Seventh Annual Conference, panel on “Understanding Derivatives: Dissecting Complex Financial Instruments.” Others have made similar observations. See, e.g., Morrison & Riegel, supra note 13, at 642, 647, 660, & 663; Christopher J. Redd, *Treatment of Securities and Derivatives Transactions in Bankruptcy, Part I*, 24-6 ABIJ 36, 37 (2005); Campbell, supra note 86, at 712 (stating that a “cynic might argue that the financial safe harbor are indeed a “bankruptcy opt-out clause” for a certain class of capitalists because their money is more important than everyone else’s”).

179 Edwards & Morrison, supra note 22, at 121.

180 Prof. Schwarcz.


182 Partnoy & Skeel, supra note 157, at 1050.

183 Lubben, supra note 52, at 75.

184 Id.
experience of judges applying the safe harbor in its earlier (and narrower) years showed the pitfalls of trying to differentiate exempted and non-exempted transactions.\textsuperscript{185}

VI. Conclusions

In the United States, bankruptcy law grants special rights and immunities to creditors in derivatives transactions, including virtually unlimited enforcement rights. This article has argued that these rights and immunities are largely path dependent, resulting from a sequence of incremental industry-lobbied legislative steps, without systematic and rigorous vetting of the consequences.

Because the resulting derivatives “safe harbor” has not been fully vetted, its significance and utility should not be taken for granted. Regulators, legislators, and other policymakers—whether in the United States or abroad—should not automatically assume that the safe harbor necessarily reflects the most appropriate treatment of derivatives transactions under bankruptcy and insolvency law, or the treatment most likely to minimize systemic risk.

We do not argue that the safe harbor is necessarily bad. Because we have not made an independent investigation of the safe harbor’s merits, we are agnostic. A path-dependent result is neither intrinsically good or bad.\textsuperscript{186} For example, the path-dependent U.S. corporate management model, which favors strong managers over strong owners, is not necessarily better or worse than the converse; it is just that there has been neither a fully informed discussion in the United States regarding the benefits of one model over the other nor an economic “battle” between the two models.\textsuperscript{187} Stakeholders, legislators, and policymakers took for granted and adapted to the model that evolved, without questioning it.\textsuperscript{188} Sometimes, however, path-dependent outcomes can have adverse consequences.\textsuperscript{189}

\textsuperscript{185} Morrison & Riegel, supra note 13, at 645-47.
\textsuperscript{186} Cf. Roe, supra note 27, at 647-651 (describing three forms of path dependence, with only two leading to inefficient outcomes).
\textsuperscript{187} \textit{Id.} at 646.
\textsuperscript{188} \textit{Id.}
\textsuperscript{189} Professor Roe, for example, points to a regulation that bars bondholders from voting to approve recapitalization schemes if the scheme includes provisions that change the maturity date or the principal amount of the bonds. \textit{Id.} at 660. According to Roe, this regulation is rooted in a 1928 New York Appellate Division decision that interpreted the then New York Negotiable Instruments Law. The decision, that held that a bond allowing a vote to change the maturity date or principal is nonnegotiable, was turned into a regulation during the Great Depression. \textit{Id.} at 661. Changes in the structure of the bond market rendered the regulation superfluous and cumbersome, but despite having no economic rationale, the regulation still exists. \textit{Id.} at 661-62. To overcome it, the bond market and the surrounding legal infrastructure had to adapt to the existing legal frame. The 1978 Bankruptcy Code allowed such votes as part of a “pre-packaged bankruptcy”, and market pressure led authorities to permit numerous prohibited recapitalization schemes under an “emergency” financial necessity label. \textit{Id.} Nevertheless, the specific provision that bars certain recapitalization schemes was not revoked.
Because the derivatives safe harbor has important consequences for systemic risk, a more fully informed discussion of its merits—under U.S. bankruptcy law, and under foreign insolvency laws to the extent such laws incorporate similar derivatives exemptions—may well be timely.

Finally, our analysis suggests that heightened informational burdens can increase the influence of interest-group politics. That, in turn, can make complex legislation more vulnerable to legal path-dependency. Further research into the causes and consequences of path-dependency in complex rulemaking may be warranted.

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190 Cf. supra notes 119-122 (observing that the informational blindness was almost certainly exacerbated by the complexity of derivatives; and in the face of complexity, people tend to see what they expect to see, the expectation in this case being driven by lobbyist pressure).
191 Legal path-dependency is premised on two change-impeding features: information burdens and interest-group politics. Path dependency information burdens have two features: the difficulty to think on alternative paths, and customary perception that impedes change (human tendency to rely on simplifications in the face of complexity). As we demonstrated, both these features are inherent in complex systems.