SUTHERLAND

LEGAL ALERT

August 12, 2013

Bankruptcy Safe Harbors Under Attack

The "safe harbor" provisions of the Bankruptcy Code protect firms that trade derivatives, and other participants in financial and commodity markets, from the rigidity that bankruptcy law imposes on most parties. Since their inception in 1982, the safe harbor statutes have gradually grown broader, to reflect a Congressional intent of protecting against secondary shocks reverberating through those markets after a major bankruptcy. The liberalizing of safe harbors traces – and may well be explained by – the rapidly expanding use of derivatives contracts generally.

Recent months, however, have revealed initiatives that could drastically narrow the scope of the safe harbor statutes. In June 2011, the American Bankruptcy Institute (the ABI) formed the Commission to Study the Reform of Chapter 11 (the Commission) to study various changes that may be needed in bankruptcy law, and it has heard testimony advocating limitations on the safe harbors. More concretely, legislation recently introduced by Senator Elizabeth Warren would fully repeal several of the safe harbor statutes.

History and Purpose of the Safe Harbors

The first safe harbor statutes were added to the Bankruptcy Code in 1982. Although the protections under the safe harbors were relatively narrow at that time, legislative history indicates that Congress was concerned about the same issues and policies that guide the debate today. For example, one piece of legislative history from 1982 states: "The 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."

Congress broadened the safe harbor protections in 1990, 1994, 2005 and 2006. Those amendments added new types of contracts and new types of market participants to the scope of those protected. In other instances, the amendments removed barriers to certain protections, such as the exemption from avoidance of certain transfers made to counterparties. Although the legislative history is seldom as clear as desired, statements of Congressional intent repeatedly emphasize a concern with systemic risk, and the follow-on effects of a major bankruptcy to financial and commodity markets.

Threat Posed by the ABI Reform Commission

The ABI formed the Commission in June 2011, seeking to study and propose necessary reforms to Chapter 11 of the Bankruptcy Code. In turn, the Commission formed 13 Advisory Committees, which, like the Commission itself, are comprised of leaders in the bankruptcy field. One of the advisory committees is the Financial Contracts, Derivatives and Safe Harbors Committee (the Committee).

Professor Stephen Lubben of Seton Hall University School of Law is among the members of the Committee. Professor Lubben is a frequent critic of the safe harbor statutes, particularly the scope of their protections to market participants. Professor Lubben's publications include a scholarly article entitled "Repeal the Safe Harbors" and a *New York Times* piece entitled "Too Much Protection for Derivatives in Bankruptcy." Other notable members of the Committee include the Honorable James M. Peck, who has overseen the Lehman Brothers bankruptcy.

© 2013 Sutherland Asbill & Brennan LLP. All Rights Reserved.
This communication is for general informational purposes only and is not intended to constitute legal advice or a recommended course of action in any given situation. This communication is not intended to be, and should not be, relied upon by the recipient in making decisions of a legal nature with respect to the issues discussed herein. The recipient is encouraged to consult independent counsel before making any decisions or taking any action concerning the matters in this communication. This communication does not create an attorney-client relationship between Sutherland and the recipient.

According to its minutes, the Committee is considering a variety of changes to current law. A common discussion topic has been whether to create a freeze during which non-defaulting parties would be prohibited from terminating contracts, while the debtor evaluates whether to assume or reject the contracts. Although similar provisions may appear in other insolvency regimes, they would mark a significant departure from current bankruptcy law, under which the safe harbors guarantee a non-defaulting party's right to terminate immediately upon a bankruptcy filing.

Other discussion topics have included the scope of permissible netting rights and whether to narrow the exemption from avoidance actions, including whether to allow the avoidance of a non-defaulting party's exercise of netting or setoff rights. While some members of the Committee appear to favor narrowing the exemption, that proposal remains controversial. The Committee recently heard testimony that "close-out netting is the single-most important tool for the reduction of credit risk in the financial markets, far more important ... than financial collateral arrangements and far more cost-effective, with fewer ancillary risks."

Ultimately, the varied composition of the Committee will likely moderate its recommendations; an endorsement of any radical change is unlikely. Nevertheless, some form of change appears likely – and virtually any change is likely to be unfavorable to traders. Indeed, the 2011 ABI Journal article that announced the formation of the Commission noted a general consensus that "derivative safe harbors [are] far too broad and need[] to be at least curtailed." In light of that backdrop, trading firms should be wary and proactive.

A Bigger, But Perhaps Less Plausible, Risk

In addition to the threat posed by the Commission, Congress appears to be considering radical changes to the safe harbors as well. Senate Bill 1282, the "21st Century Glass-Steagall Act of 2013," was introduced on July 11, 2013, by Senator Warren (D-MA). Currently, Senators Tammy Baldwin (D-WI), Barbara Boxer (D-CA), Maria Cantwell (D-WA), Angus King (I-ME), Edward Markey (D-MA), John McCain (R-AZ), Barbara Mikulski (D-MD), and Sheldon Whitehouse (D-RI) have signed on as co-sponsors.

The bill is aimed primarily at recreating the wall that existed among banks, investment banks and insurance companies until 1999. Separate from those goals, however, is Section 5 of the legislation, which states simply: "Title 11, United States Code, is amended by striking sections 555, 559, 560, 561 and 562." Those statutes of the Bankruptcy Code provide much of the substantive protections of the safe harbor.

More specifically, sections 555, 559, 560 and 561 guarantee the enforceability of contractual rights to terminate, liquidate and accelerate under securities contracts, repurchase agreements, swap agreements and master netting agreements. They also allow for setoff and netting rights. Section 562 provides for certain damages calculations under terminated or rejected safe harbor contracts. Oddly, the legislation would leave section 556 – which provides analogous rights to parties under a forward contract – untouched.

As a general matter, the bankruptcy system is about collective risk, and which parties should bear that risk. In a generic bankruptcy, policy favors treating parties equitably by spreading the risk evenly among various parties. In a bankruptcy featuring a major trader of derivatives, however, there is a policy choice to be made: should the risk be borne by the entire market, or solely by the parties-in-interest to the bankruptcy case? To date, Congress has favored the latter, preferring to avoid major market disruptions. In other words, the current version of the Bankruptcy Code provides more protections to derivatives traders than to generic creditors, because doing so prevents a domino effect of multiple defaults. The

© 2013 Sutherland Asbill & Brennan LLP. All Rights Reserved.
This article is for informational purposes and is not intended to constitute legal advice.

SUTHERLAND

positions favored by Professor Lubben and Senator Warren, on the other hand, would seem to favor accepting the risk of a market disruption rather than spreading risk more widely.

Either choice might represent reasonable policy, but at minimum, one would clearly mark a major departure from existing law. Traders in derivatives markets may need to stay vigilant in coming months, because their protections in bankruptcy law appear to be somewhat endangered.

If you have any questions about this Legal Alert, please feel free to contact any of the attorneys listed below or the Sutherland attorney with whom you regularly work.

James M. Cain	202.383.0180	james.cain@sutherland.com
Jacob Dweck	202.383.0775	jacob.dweck@sutherland.com
Daphne G. Frydman	202.383.0656	daphne.frydman@sutherland.com
Catherine M. Krupka	202.383.0248	catherine.krupka@sutherland.com
David T. McIndoe	202.383.0920	david.mcindoe@sutherland.com
R. Michael Sweeney, Jr.	202.383.0921	michael.sweeney@sutherland.com
Warren N. Davis	202.383.0133	warren.davis@sutherland.com
Meltem F. Kodaman	202.383.0674	meltem.kodaman@sutherland.com
Mark D. Sherrill	202.383.0360	mark.sherrill@sutherland.com
Cheryl I. Aaron	202.383.0917	cheryl.aaron@sutherland.com
Doyle Campbell	212.389.5073	doyle.campbell@sutherland.com
Kalaundra Y. Carreathers	202.383.0830	kally.carreathers@sutherland.com
Meghan R. Gruebner	202.383.0933	meghan.gruebner@sutherland.com
Alexander S. Holtan	202.383.0926	alexander.holtan@sutherland.com
Raymond A. Ramirez	202.383.0868	ray.ramirez@sutherland.com

© 2013 Sutherland Asbill & Brennan LLP. All Rights Reserved.
This article is for informational purposes and is not intended to constitute legal advice.