**Tensions Between "Orderly" Wind-Downs and Reduction of Systemic Risk:
A Derivatives Perspective**

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I. Introduction

- Title II ("Orderly Liquidation Authority") under the Dodd-Frank law is explicitly directed towards, and limited to, the resolution of institutions the failure of which would otherwise present "serious adverse effects on financial stability in the United States" (Section 203(b)(2)).
- A prominent feature for derivatives under Dodd-Frank is the ability of the FDIC to transfer, within one business day, derivatives and other "qualified financial contracts" to one or more replacement counterparties or to a "bridge financial company" (Section 210(c)(9)), which will presumptively be required to be in a position to perform those contracts fully. Specifically, the FDIC is authorized to borrow against the assets of a bridge financial company, on a priority basis, for this purpose (Section 210(n)). Original counterparties are prohibited from terminating their derivatives contracts until 5:00 p.m. on the business day following the FDIC's appointment as receiver to enable these transfers (Section 210(c)(10)(B)).
- In relation to the U.S. Bankruptcy Code, the Administrative Office of the United States Courts and the Comptroller General of the United States are mandated to "evaluate. . . the effectiveness of Chapter 7 or chapter 11 of the Bankruptcy Code in facilitating the orderly liquidation or reorganization of financial companies [and] ways to make the orderly liquidation process under the Bankruptcy Code for financial companies more effective" (Section 202(e)). It can be anticipated that elimination or, at the very least, dilution of the "safe harbor" provisions protecting the contractual right of counterparties to liquidate, terminate or accelerate "swap agreements" and other financial instruments will be seriously considered.
- Representatives of the Lehman estate have stated in open court, in Congressional testimony and in the press that disorderly and abusive derivatives terminations have caused up to or more than $75 billion of "asset destruction". Academic commentators have linked the safe harbors to the creation of systemic risk. See, e.g., Roe, The Derivative Market's Payment Priorities as Financial Crisis Accelerator, 63 Stan. L. Rev. 539 (2011) (available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1567075).
- Political and legal debate have accordingly equated the "disorderly" termination of derivatives with the creation or augmentation of "systemic risk." However, the goal of preserving a derivatives portfolio intact after insolvency, while an appealing prospect

from traditional bankruptcy perspectives and goals and for creditors, might be *antithetical* to the goal of reducing systemic risk.

II. Systemic Risk

- "Systemic risk" is commonly defined as the risk that an entire financial system might collapse as the result of the failure of one or a small sub-set of members leading to a cascade of failures across the system. It is worth noting, however, that, with the possible and limited examples of Asia and Russia in the 1997-98 crisis, this has never actually happened in a post-industrial society. It is accordingly debatable whether anyone actually knows, because they have not experienced, what exactly this sort of systemic risk would look like or mean if it were to occur. The logical extreme result might mean an agrarian subsistence economy.
- A more tangible manifestation of systemic risk probably did occur in 2008-09, which is a pervasive loss of confidence and contagious fear that one's financial and, indeed, industrial and consumer, counterparts would be unable to satisfy their obligations leading to a radical reduction in liquidity and credit risk as market participants seek to protect themselves. This of course led to the deepest and most wide-spread economic contraction in modern times whose effects are still keenly felt in the unemployment lines and the sovereign credit risk markets. It is obviously something to be avoided, if possible.

III. The "Dis-Orderliness" of the Lehman Derivatives Portfolio Unwind

- Lack of planning and inability to ensure continuity of experienced and motivated personnel and systems access
- The sudden fragmentation across jurisdictional lines of a previously tightly integrated enterprise made risk management impossible
    - These "jurisdictional lines" include not only cross-border administrations but also also the separate SIPA receivership for the U.S. broker-dealer and asset sales to Barclays and Nomura
    - Each administration, as appears appropriate under current law, sees its primary and fiduciary duty to its own separate body of creditors – no "co-operation protocol" will enable any administration to sacrifice its constituents' interests to a "greater good"
    - No access internationally to systems or knowledgeable personnel
    - Risk positions were hopelessly dis-aggregated (e.g., derivatives versus intercompany hedges in the form of physical assets subject to seprate administration or back-to-back derivatives with insolvent affiliates)

- Counterparty terminations were effected in droves and could not be monitored or reviewed on a real-time basis.
- Exercise of "self-help" remedies by counterparties raises prospect of reduced asset recoveries and inflated claims, which is the source of the $75 billion in asset deterioration. A key function of the Lehman bankruptcy estate, of course, is to utilize analytics and legal action to minimize this deterioration.

IV. How the Lehman Derivatives Portfolio Unwind Might Have Been More "Orderly"

A. **Planning.** Obviously, a greater degree of planning and execution (whether or not preceding an actual bankruptcy) would have been critical to any "rescue" of Lehman's derivatives portfolio. Elements of this planning effort might have included the following.
  - Securing access to requisite systems and personnel
  - Identification of the "mission critical" portions of the portfolio and execution of a communications strategy, backed up with adequate funding to provide "adequate assurances of performance" to the relevant counterparties, to avoid terminations
  - Development of a disposition strategy, including potentially a "step-out" mechanism under which counterparties with off-setting risks would be paired together
  - Day-to-day administration of the portfolio (e.g., exercise of options)
  - A detailed understanding of the precise funding needs and sources and uses of cash over varying periods of time and a plan to fund any shortfalls
  - Monitoring and reviewing termination notices on a real-time basis so that "live" trades could be risk-managed
  - The Dodd-Frank law is to be commended for its "living will" requirement, which ought to provide for much of the foregoing. In the ideal scenario, a "living will" could be activated long before the onset of an insolvency panic, thereby materially reducing, and potentially eliminating, systemic risk.

B. **Time.** One of the fundamental protections afforded bankruptcy estates under the Bankruptcy Code is the "automatic stay" on the exercise of creditor remedies under Section 362 of the Bankruptcy Code. This stay, bolstered by the "*ipso facto*" prohibition in Section 365, generally prevents solvent contracting parties from, among other things, terminating contracts with the bankruptcy estate on the basis of its bankruptcy or financial condition. The safe harbor provisions represent one of the rare exceptions to this rule. Because the concept of an "orderly" liquidation of a derivatives portfolio has become bound up in the minds of policy-makers and academics with eliminating or diluting the safe harbors, a "thought experiment" might be in order on the impact on counterparties if derivatives contracts were to be treated similarly to all other contracts in bankruptcy.

- Counterparties would, as mentioned, be prohibited from terminating their derivatives contracts and the impact of disorderly or abusive terminations would in principle be eliminated.
- Instead, the Lehman bankruptcy estate would have a "breathing space" within which to execute its "living will." After conducting its analysis, the Lehman estate would be able to determine the disposition of each contract via "assumption", "assumption and assignment" or "rejection" under Section 365. The Lehman estate has hundreds of "live" contracts today in this position, in part because Judge Peck has ruled in *Metavante* that counterparties who do not "promptly" exercise their safe-harbored termination rights have waived them.
- "Assumption" (or "assumption and assignment") of a contract typically means that the estate has adopted the contract as sufficiently valuable or important that it is prepared to perform its obligations under the contract in full in order to obtain the benefits of the contract. "Rejection", on the other hand, typically denotes a contract that represents a liability for the bankruptcy estate that will be paid in bankruptcy dollars. The standard for whether to assume or reject is generally speaking a "business judgment" standard.
- In principle under current law, a Chapter 11 estate has the entire duration of the case to make this decision. Moreover, under *Metavante* and a very large body of case law outside the derivatives context, the bankruptcy estate can require the solvent party to perform its part of the bargain pending a decision to assume or reject.
- The Bankruptcy Code is thus structured to provide maximum flexibility to the bankruptcy estate at the cost of great uncertainty on the part of the solvent counterparty. Moreover, the bankruptcy estate's ultimate decision whether to assume or reject is almost guaranteed to operate against the interests of the solvent counterparty. In the context of "zero-sum" financial contracts, the solvent counterparty will be required to perform unprofitable contracts, yet be forced to accept "bankruptcy dollar" damages for profitable contracts.
- Eliminating the Bankruptcy Code safe harbors would accordingly permit the bankruptcy estate to liquidate its derivatives portfolio in an "orderly" fashion for the benefit of its "ordinary" creditors, but would impose significant delay, uncertainty and losses on its derivatives counterparties.

V. Implications for Systemic Risk

- The delay, uncertainty and losses the standard Bankruptcy Code model for executory contracts implies for derivatives counterparties would likely be disastrous from a systemic risk perspective. It is difficult to see how these side-effects from the Bankruptcy Code could do anything other than *increase* systemic risk, as the "system" watches the near inevitable train wreck in slow motion. The process might

take days, weeks, months or years in a market where even an intra-day rumor can threaten a firm's survival.

- In this way, an "orderly" liquidation, while of obvious benefit to the bankruptcy estate, does so at the expense of systemic risk. The interests of "ordinary" creditors and the "system" are antithetically opposed, as are the policy goals of bankruptcy and financial market stability regulation.
- It would seem that the only means in which a stay on termination might *not* increase systemic risk is to eliminate the risk that the insolvent institution will fail to meet its obligations to its systemically important counterparties. But this is a political and practical impossibility.
- First, of course, it is not politically possible in today's environment or probably any environment for the federal government, *ex ante*, to declare it will stand behind any and all obligations of each and every financial institution. Second, the recent ratings warning from S&P and the on-going disruption in the European sovereign debt markets remind us that the governmental purse is not in any event inexhaustible.
- Although it *might* be an acceptable political solution to declare that every last penny of an insolvent financial institution should be devoted to avoiding systemic risk, in and of itself this cannot eliminate the risk of a failed financial institution's inability to satisfy its obligations to its systemically important counterparties, for the following simple reasons:
    - A failed institution of course has finite assets and, even if projections at any given point in time are supernaturally accurate, these are bound to go awry as the result of the asset/hedge dis-aggregation described above for any internationally important financial institution and the fact that the bankruptcy estate or, indeed, a bridge financial company under the Orderly Liquidation Authority will face its own credit-challenged counterparties in the "zone of systemic risk."
    - The "orderly" wind-down will almost certainly require a disposition of the derivatives portfolio at some point. For example, the Orderly Liquidation Authority sets a time limit of between two and five years for a bridge financial company to hold its status as such (Section 210(h)(12)). There can be no assurance there will be a market in which to dispose of the portfolio within this timeframe. It is also conceivable that the overhang of this near-certain disposition of massive risk positions will itself contribute to systemic risk.
- Finally, even if systemically important counterparties are certain to receive performance in full of their derivatives contracts with a failed financial institution, does this not introduce an unacceptable level of moral hazard ?

VI. Conclusions

- It is fairly obvious that the "orderly" liquidation of a derivatives portfolio presents significant opportunities for preserving and enhancing the insolvency estate for the benefit of its creditors generally
- On the other hand, it is far from obvious that such an "orderly" liquidation would prevent or ameliorate systemic risk in the form of fear contagion or otherwise as to the impact of a failed financial institution on its counterparties as they and other market participants await the outcome of the assumption/rejection/performance process, no matter how short, unless *all* risk of the failed institution's non-performance of its obligations is removed.
- In contrast, there continues to be great uncertainty, on the order of tens of billions of dollars, as to the amount of claims of systemically important financial institutions that will be recognized by the Lehman estate and the rate of recovery that will be realized on those claims. These questions do not appear, however, to be the source of systemic risk. The probable reason for this is that the underlying basis for determining those claims has been fixed by terminating the related market risk and is accordingly quantifiable.
- The purpose of this paper is not to advocate for or against modification of the safe harbors. However, it does conclude that modification of the safe harbors may well have an adverse impact on the containment of systemic risk absent:
    - A probably ill-suited duty on the part of private-sector insolvency practitioners to attend to the needs of the "system" as opposed to the interests of creditors generally
    - An explicit policy decision that those creditors must subsidize future obligations of the failed financial institution to its systemically important counterparties.