Bloomberg BNA

Bankruptcy Law Resource Center™

Speakers Recommend Chapter 11 Changes To Effect Safer, More Efficient Proceedings

By Stephen Joyce| May 16, 2013

NEW YORK—Any revisions to the federal Bankruptcy Code's treatment of qualified financial contacts should amend the Code's safe harbors to narrow preferential treatment for counterparties while retaining the Code's push to combat systemic risk to the U.S. financial system, speakers said at a May 15 field hearing of the American Bankruptcy Institute's Commission to Study the Reform of Chapter 11.

Application of the safe harbor provisions, which were expanded in 2005 and 2006, has generated "considerable controversy, not to mention splits in the case law," Bernstein Shur Sawyer & Nelson PA shareholder Robert J. Keach said at the ABI Commission's field hearing.

Effectuation of the safe harbors, especially when large financial institutions deemed "too big to fail" are transaction counterparties, was a primary discussion topic at the field hearing, one of an envisioned eight, or possibly more, scheduled to take place in 2013, Togut Segal & Segal LLP partner and commission co-chair Albert Togut said. The commission held six field hearings in 2012, he said.

The commission's mandate is to contemplate the need for comprehensive Chapter 11 reform, including "reinventing the statute," Togut said.

Dispute Over Safe Harbor Effects

When a bankruptcy petition is filed, the Bankruptcy Code provides for an automatic stay preventing any immediate action by creditors to recover assets from the debtor in possession. Certain qualified financial contracts, however, qualify for preferential treatment provided by the safe harbors.

Critics of the safe harbors as currently utilized claim they go far beyond their original intended purpose of protecting financial markets from systemic failure, plus they possess the unintended consequence of shielding nondebtor counterparties to typical commercial transactions from the otherwise typical effects of the Bankruptcy Code, Keach said.

Supporters, however, assert the safe harbors are necessary to ensure the smooth functioning of financial markets and work to prevent systemic failure to the U.S. financial system in the event a large financial counterparty, including those considered "too big to fail," files for bankruptcy protection, Keach said.

"A number of recent decisions and high-profile cases ... have highlighted perceived problems with the possible over-breadth of these provisions and their potential to exclude from or remove from the estate valuable assets, often without the knowledge or involvement of the court," said Keach, a commission co- chair.

"I do believe there is a balancing act here, which is the reality that safe harbors are required in order to

avoid the systemic risk that would result from the uncertainty the market would have if it could not terminate its positions and close on its positions," Alvarez & Marsal Holdings LLC Managing Director and field hearing speaker Daniel J. Ehrmann said. The safe harbors are a "necessary evil," he said.

Assumptions Challenged

University of Pennsylvania Law School professor David A. Skeel asserted at the hearing that some assumptions practitioners hold about the value of the safe harbors may be flawed.

One assumption is that exemption from the automatic stay removes the risk of so-called "domino effect failures," that unless counterparties can quickly exit from their contracts the losses they would suffer from the debtor's failure to perform might destabilize one or more counterparties. But real-world examples may debunk that notion, Skeel said.

"With AIG in particular we learned that the absence of a stay made it impossible for a large financial institution to halt its own snowballing decline, because there was no way to stop its counterparties from dismembering the firm and forcing fire sales of its assets," Skeel said.

"AIG briefly considered filing for bankruptcy, but concluded that in the absence of a stay, the only alternative for them was to push hard for a massive federal bailout," said Skeel, a field hearing speaker.

The special treatment magnified the contagion rather than reducing it," Skeel said. He recommended to the commission a sharply reduced stay, perhaps lasting only three days, be applied to both cleared and noncleared derivative transactions.

Seeking Certainty

Another issue mentioned by several commissioners and speakers was the need for certainty by counterparties and their counsel concerning how transactions will be treated in a bankruptcy.

For instance, counterparties should be assured that close-out netting—the offsetting of mutual exposures between two financial market counterparties—possesses legal certainty, Allen & Overy LLP consultant and former senior partner Edward Murray said at the hearing.

When material uncertainty exists regarding when affected financial transactions may be closed out, "a severe risk of contagion and consequent market instability" might be created, Murray told the commission.

U.S. Bankruptcy Judge James M. Peck, the judge in the Lehman Brothers Holding Inc. bankruptcy who attended the field hearing, said certainty can be provided concerning any transaction by a bankruptcy judge.

But the notion that judicial discretion provides legal comfort to counterparties and certainty to litigants was challenged by some practitioners at the hearing.

Reporting Requirement

The safe harbors can create an "arduous and expensive" process when a large counterparty files for protection, Hughes Hubbard & Reed LLP partner and hearing speaker Christopher K. Kiplok said.

Kiplok, a lead liquidator in Lehman Brothers Inc. and MF Global Inc., told the commission that in those two proceedings several hundred counterparties availed themselves of safe harbor protections of financial instruments involving tens of billions of dollars.

Based on his experience, Kiplok recommended the Bankruptcy Code impose a reporting requirement on any entity enjoying the safe harbor benefits. Information regarding collateral or other property of the estate being held by the counterparty, valuation statements, the nature and amount of any setoffs or deductions, and any adjustments the counterparty intends to assert should be reported, Kiplok said.

The debtor should be required to provide to financial product counterparties a current mailing address to which counterparties may send termination notice copies, notices of default, correspondence to facilitate counterparties making payments of cash or transfer of securities, and the name and address of the trustee's legal counsel, he said. That information should be posted on the debtor's website and perhaps elsewhere, Kiplok said.

More Efficacious Proceeding

The core reason for the proposed disclosure requirements is to facilitate a quicker, more efficacious bankruptcy proceeding, Kiplok said.

“In Lehman alone, approximately 100,000 hours of professional time went to locating and researching potentially owed amounts, contacting counterparties, convincing them to share necessary information, and negotiating with them for payment of amounts that they themselves knew they owed,” he said “There should be a better more efficient way to go about this,” Kiplok told the commission.

“Within a defined period of time … financial product counterparties should be required to provide the debtor information regarding their terminated transactions, together with summaries setting forth the trade information closeout date and account believed to be owed,” he said.

When questioned by commissioners, Kiplok said the information he deems necessary to share would be the types of “fundamental” data typically flowing between debtors and their counterparties. Confidential data could be kept nonpublic, he said. “The effort here is to strike a balance. It's not to apply anything punitive,” he said.

Peck Comments

Peck said any reform of Chapter 11 proceedings should consider at least two phases of a bankruptcy, particularly when the counterparties are large financial institutions.

The first phase to be considered is the early, immediate shocks associated with the bankruptcy filing—saving the enterprise, avoiding massive financial losses, and preventing systemic shock to the U.S. financial
system. The second phase is everything that happens after that, he said.

“Who is going to be the decider? Who is the person or what group of people actually has the capacity to deal with problems of this sort on an emergency schedule with or without due process of law?” Peck said.

Answers include the judicial system and regulators, he said.

Robert Keach is a shareholder and co-chair of Bernstein Shur’s Business Reorganization and Insolvency Practice Group. He can be reached at rkeach@bernsteinshur.com or 207 228-7334.