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Before the
Subcommittee on Commercial and Administrative Law
Committee on the Judiciary
House of Representatives

September 26, 2008

Exemption of Financial Assets From Bankruptcy

Thank you for the opportunity to talk with you about the exemption of large pools of financial assets from the bankruptcy process.[1] These exemptions are often claimed to be necessary to the accomplishment of certain transactions, but as a prominent Wall Street lawyer put it to me: "If the prospect of bankruptcy makes the deal too risky, it's too risky a deal to do." That is especially true for financial institutions and should be doubly true for those "too big to fail."

I want to share with you today the following major points:

1. The 2005 amendments to the Bankruptcy Code greatly expanded the scope of the exemption of financial assets from the control of the bankruptcy laws.
2. The expansion included exempting for the first time mortgages and mortgage securities, the epicenter of the current financial earthquake.
3. The amendments also used ambiguous language that blurred the boundary between financial contracts and other contracts, creating a lack of predictability and an opportunity for abuse.
4. These exemptions considerably reduce the capacity of the bankruptcy laws, both liquidation and reorganization, to do their traditional work of ensuring an orderly, predictable, and fair resolution of financial distress.
5. The 2005 expansion could be undone without substantial difficulty. Prospectively, business could easily adjust.

[1] I appear as a student of bankruptcy law, not as a representative of the University of Texas School of Law.

6. Given the highly unusual circumstances of systemic risk now presented, even a retrospective suspension of those exemptions could be made a condition of government aid where appropriate.

I. Background

A number of recent events, including the bankruptcy of Lehman Brothers last week,[2] have brought into question the broad exemption of financial assets from the control of the bankruptcy laws. I have been asked to address the effects of these exemptions on the efficacy of our bankruptcy system, especially Chapter 11 reorganization. Because the Committee was able to give me only short notice of the need for my testimony, these remarks are necessarily a short summary of a large and complex topic.

The essence of any bankruptcy law is control of the debtor's property by a court or other public body.[3] In our system, the control is exercised by a bankruptcy judge, who is typically a lawyer with a substantial commercial and business background and who is available pretty much any hour of the day or night for a true business emergency. The public control that accompanies a bankruptcy filing has two primary purposes: maximization of the value available for distribution to stakeholders; and the establishment of the rules for sharing in an orderly distribution of the value thus obtained. The most important stakeholders are creditors, although employees and others also have significant interests that bankruptcy laws seek to serve. The bankruptcy rules in any society reflect the policy decisions that legislators have made about the justice and economic efficiency of various possible approaches to maximizing value and the fair distribution of that value.

In all bankruptcy systems, the debtor's property is taken away from its control. Even in the United States, the Debtor in Possession (DIP), exercises control in a transparent atmosphere under the ultimate control of the bankruptcy court. The court in turn takes account of the views of a creditors committee and other interested parties. The automatic stay freezes the debtor's property pending further order of the court and the

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[2] There are very few reliable data so far available from the Lehman bankruptcy and other very recent events, which means my comments are more general and conceptual than they would be under other circumstances.

[3] Jay Lawrence Westbrook, *The Control of Wealth in Bankruptcy*, 82 Tex. L. Rev. 795, 799 (2004)

avoiding powers make sure that improper or unfair transfers prior to bankruptcy are returned for distribution as Congress has commanded. In addition, certain special rules protect asset values. For example, the Bankruptcy Code makes unenforceable "ipso facto" clauses that permit contracts to be terminated upon bankruptcy, ensuring that all stakeholders can share in the benefits of any good bargains the debtor was able to strike before bankruptcy.

It is the natural desire of every creditor to be the one creditor that is not bound by these bankruptcy rules. If every other creditor is bound by legal cables to a public procedure, the one creditor exempted from that constraint will enjoy far better returns than everyone else. Because financial default is always injurious, each creditor has a truly sad story to tell and thus a truly appealing case for being exempted. Those lucky enough to succeed in winning an exemption do very well indeed, while the rest suffer much more than they would have done if every creditor had to share the pain.

All this is background to the subject of the exemption of financial assets from most of the key provisions of the Bankruptcy Code. These exemptions permit certain parties to avoid the effects of the automatic stay, the avoiding powers, and the ipso facto provisions so they can grab the value from what would otherwise be the debtor's property available for sharing according to the Congressional bankruptcy scheme. These exemptions were granted originally in a much narrower form then they now have. They were sought on the theory that certain relatively esoteric markets were so international in nature and so removed from ordinary commerce that they required bankruptcy exemption to function properly and would not interfere in the ordinary functioning of the bankruptcy laws. Without revisiting the rationale in a serious or detailed way, Congress agreed in 2005, in a debate focused overwhelmingly on consumer bankruptcy provisions, to expand dramatically the scope and effect of these exemptions, covering far more types of transactions and products than before under provisions written with a wide and fuzzy pen. The resulting language could be read to include much that was not specifically contemplated by those who voted for the changes. The attached articles by Professor Edward Morrison, Joerg Riege, and Franklin R. Edwards, give background and provide detail as to the provisions. The details of the changes made by the 2005 amendments to

the Bankruptcy Code are described in the attached article by a team of lawyers from Cleary Gottlieb in a Practicing Law Institute (PLI) paper.

II. Nature of Exemptions

The financial assets exempted from bankruptcy control are securities and commodity contracts, repurchase agreements ("repos"), swap agreements ("swaps"), and netting agreements. The exemptions are found in sections 555-556 and 559-561 of the Bankruptcy Code. I will note briefly the nature of each product, but the reader is referred to an attached article by Professor Henry Hu for a more detailed explanation of derivatives. Although the article was written in 1993, the explanation is remarkably clear and will be helpful.

Repos are agreements by which a seller (debtor) agrees to sell (give a security interest in) certain securities or mortgages to a buyer (lender), with the seller obligated to repurchase them in a short time for a somewhat larger amount (interest and fee). In short, repos are secured loans in the form of sale and repurchase contracts. Prior to the 2005 amendments, the exempted repos were United States government or government-backed securities traded primarily in a specialized financial market. The amendments added most types of mortgages and mortgage-related securities to the list without regard to any connection with government. These are the very types of investments that have proved to be toxic in the current crisis. Following the amendments, it appears that many types of private-sector transactions that had been structured as loans secured by mortgages or related securities were instead configured as repo transactions, enabling deals with the same economic function to adopt a form that exempted them from bankruptcy control.

Swaps are agreements governed by ISDA (International Swap Dealer Association) forms in which the parties agree that party A will pay to party B a certain sum at a future date, with the sum to be paid calculated against some external standard, such as a currency fluctuation or an interest rate change. Swaps are often used as a form of financial insurance, with credit default swaps serving a role akin to guarantees wherein A, for a fee, guarantees to pay to B the debt that C owes to B if C does not pay, if C goes into bankruptcy, or if some similar event occurs. It is this sort of credit insurance (notational amount estimated currently at $62 trillion) that has created the greatest concern for the financial system, because companies like Lehman—and many companies

who are not so obviously financial companies—have written huge amounts of this insurance.[4]

Securities and commodities contracts are defined by reference to their respective regulatory statutes. The terms are relatively transparent—they mean what they seem to mean.[5]

Netting agreements are simply a sophisticated form of setoff of mutual debts, a process ordinarily governed by section 553 of the Bankruptcy Code. A master netting agreement permits netting across a number of otherwise unrelated contracts within the exempted categories just described, a form of offset[6] usually prohibited or substantially constrained in various ways by the Bankruptcy Code.

What all these financial assets have in common is that they are exempted from the operation of the automatic stay, the avoiding powers (e.g., concerning preferences and fraudulent conveyances), and the rules governing executory contracts in bankruptcy. As a consequence, the debtor's counterparties are free to sell their collateral or terminate their contracts with the debtor notwithstanding insolvency or the filing of bankruptcy, contrary to the most fundamental principles of bankruptcy law. For that reason, it may be impossible to reorganize a debtor whose assets included a substantial portion of such financial assets. Even in liquidation, the disappearance of the value represented by these assets may ensure that unsecured creditors will get little or nothing.

It is important to emphasize that the exemptions were substantially expanded by the 2005 amendments to the Bankruptcy Code. The amendments not only included specific additions, but employed very broad language that could include a number of contracts that fall outside the usual and customary boundaries of the financial assets concerned. The simplest example of explicit expansion is the repurchase (repo) agreement. As noted above, this exemption was originally limited to government and government-backed securities, but was expanded to include mortgages and mortgage-related securities and interests in the securitization of the same.[7] But the expansion also employed sweeping language. For example, the amendments added to the swap

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[4] Note that, unlike conventional insurance, this sort of business is entirely unregulated.
[5] Nonetheless, there has been some unfortunate blurring of these provisions as well and it should be corrected. See the PLI article attached.
[6] Setoff and offset mean essentially the same thing.
[7] Bankruptcy Code §101(47) (definition of repurchase agreement).

exemption provisions that defined swap agreements as including agreements that are *like* swap agreements. I have been told by a number of lawyers that the bar is busily revising ordinary commercial contracts into the form of swap agreements so the contracts may enjoy immunity from assumption or rejection under the Bankruptcy Code and the counterparties may use master netting agreements to offset the profitable contracts against the unprofitable ones, something that would not be permitted in a normal bankruptcy[8] because of the sharing principle.

It is very difficult to analyze the financial condition of Lehman Brothers at the time of its Chapter 11 filing because of a lack of financial data in readily available and manipulable form. It reported overall assets of $639 billion and debts of $613 billion.[9] It is said to have as much as $160 billion in unsecured debts.[10] Much of its asset base no doubt consisted of financial assets exempt from the automatic stay and the bankruptcy avoiding powers. Thus it is highly likely that many of its assets, probably overvalued to start, walked out the door just before or shortly after its bankruptcy filing, leaving only the dregs, relatively speaking, for the other creditors and stakeholders.[11] It was reported that creditors expected an orderly liquidation, but it has also been reported that some counterparties have not exercised their rights because of various uncertainties. Anecdotally, in a number of recent defaults parties have been hesitant to liquidate repos and other exempted positions because of the very low asset values available in the market. On the other hand, the Wall Street Journal reported that a "private" trading session was held for traders to settle or unwind their contracts with Lehman on the afternoon before it filed, in circumstances described as "chaos."[12] The bankruptcy law is designed to solve such difficulties, by taking a global and orderly approach to liquidation or reorganization, but the law cannot help where it has no power. The 2005 amendments greatly reduced the power of the bankruptcy laws for a large sector of the economy.

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[8] For extended discussion of the changes, see the PLI article attached.

[9] Lehman Brothers Bankruptcy Petition at p. 17.

[10] Its 30 largest unsecured creditors were owed in excess of $155 billion, including at least $150 billion in bond debt. *Id.* at Schedule 1.

[11] It appears the estate will get less than $5 billion for all of Lehman's broker-dealer business, one of the largest in the world. It's not clear what else has been left behind as the favored creditors exited.

[12] Crisis on Wall Street as Lehman Totters, Merrill Is Sold, AIG Seeks to Raise Cash --- Fed Will Expand Its Lending Arsenal in a Bid to Calm Markets; Moves Cap a Momentous Weekend for American Finance, Wall S. J. September 15, 2008, p. A1.

For these reasons, Congress should consider rolling back the 2005 amendments. We have no hard data on their effects, because the current crisis is the first since their adoption. For that reason, I am unable to point to specific examples of the adverse effects of the financial-asset exemptions. But I do not think Congress should await data while a natural experiment is conducted on the futures of American businesses and their creditors. The markets affected by these exemptions were vigorous and growing before these amendments were adopted. Their repeal is unlikely in my judgment to slow those markets except insofar as it might deter too-risky transactions, a positive development. Ideally, that repeal would be combined with appropriate steps to regulate those aspects of the markets that have helped to produce the current turmoil.

I do not suggest that Congress should immediately repeal all of these exemptions. There may be good reason for some of them under some circumstances, especially with respect to major financial institutions subject to regulation. However, the 2005 amendments have been in effect less than three years. It is unlikely that any seriously adverse consequences would arise from repealing those over-broad and ambiguous changes and then studying carefully the pluses and minuses of the remaining provisions. Business can and will adjust to a return to the prior rules. While prior transactions may have been structured to take advantage of legal loopholes, it is almost always the case that these same deals can be done through other structures to conform to the legal changes Congress finds to be necessary and fair.

If it is claimed that certain transactions could not be done without these exemptions, the first response, as my Wall Street friend noted, is that a transaction too risky to face equitable treatment in bankruptcy is too risky period, especially for a bank or quasi-bank. If the claim is made that the result will be increased costs, I think that close examination will often show that the savings permitted by these structures are simply the result of the illegitimate advantages they give over the other creditors and stakeholders in a bankruptcy case. In other words, if I favor Jones over Smith in bankruptcy, Jones will undoubtedly have lower costs but it is nearly certain those costs will be offset or more than offset by Smith's increased costs. Given that centuries of experience have shown that the orderly resolution of financial distress is preferable to post-default chaos and purely private maneuvering, the burden of showing a net increase

in efficiency would seem to be on those seeking to obtain or retain exemptions from that process.

Some will argue that bankruptcy has nothing to contribute to the resolution of the financial distress of a business with financial assets of the sort discussed in these remarks. They may say that financial institutions must have their own liquidation or reorganization process, as do banks and insurance companies. But it is evident that those specialized bankruptcy procedures always involve government money and therefore require government regulation of the covered firms. It is unlikely that most policymakers would want to extend both compulsory insurance and regulatory oversight to every hedge fund and other hybrid business that has some significant percentage of financial assets. Thus it is crucial that those businesses have some effective forum for orderly, predictable, and fair resolution of financial distress. Chapter 11, which is admired and often copied all over the world, has for many years been the favored method in American law. Yet Chapter 11 cannot work successfully if the bankruptcy process has no control over substantial financial assets of the distressed debtor. Congress should exempt regulated financial institutions from ordinary bankruptcy proceedings, rather than exempting financial assets.

With regard to the current crisis, it seems likely to me that counterparties faced with inadequate and chaotic results without government intervention would likely be open to waiving their exemption rights where waiver was made a condition of government funding of their debtor. A waiver condition may therefore be a useful tool in the government's crash-prevention toolbox. As in the 1930's, a systemic crisis requires and permits steps that would not be desirable in ordinary times. I wrote an article concerning the special circumstances of systemic crisis some years ago for a World Bank symposium, copy in the appendix. I have argued that we should consider adopting special legal rules to be applied when a systemic crisis arises. I also recommend Robert Shiller's recent column discussing that point in the New York Times.[13]

After the debacle of the Great Depression, lawmakers erected a number of levies to contain troubled financial waters. Perhaps understandably, later generations who

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[13] Robert Shiller, Crisis Averted. What of the Next One? New York Times August 10, 2008. Professor Shiller discusses the need for an overall strategy for resolving systemic crisis. He cites my article concerning the need for special bankruptcy rules when a systemic crisis arises.

viewed history through the lenses of happier times found the restrictions confining as well as inconsistent with the new creed of market autonomy. They deconstructed the history and tore down many of the levies and flood gates that seemed merely quaint in light of broader and calmer waters. Many of them now regret it. Repeal of the 2005 amendments concerning the exemption of financial assets represents a simple and relatively clean preparation for whatever new structures Congress adopts going forward.

Citations for Professor Westbrook's Testimony Appendix

Jay L. Westbrook, *The Control of Wealth in Bankruptcy*, 82 TEX. L. REV. 795 (2004).

Edward R. Morrison and Joerg Riegel, *Financial Contracts and the New Bankruptcy Code: Insulating Markets from Bankrupt Debtors and Bankruptcy Judges*, 13 AM. BANKR. INST. L. REV. 641 (2005).

Franklin R. Edwards and Edward R. Morrison, *Derivatives and the Bankruptcy Code: Why the Special Treatment?*, 22 YALE J. ON REG. 92 (2005).

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Henry T.C. Hu, *Misunderstood Derivatives: The Causes of Informational Failure and the Promise of Regulatory Incrementalism*, 102 YALE L.J. 1457 (1993).

Jay L. Westbrook, *Systemic Corporate Distress: A Legal Perspective, in* RESOLUTION OF FINANCIAL STRESS (Stijn Claessens, Simeon Djankov & Ashoka Mody eds., 2001).