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A Voluntary Organization Composed of Persons Interested in the Improvement of the Bankruptcy Code and Its Administration

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September 28, 2016

Honorable Chuck Grassley
Chairman
Committee on the Judiciary
United States Senate
Washington, DC 20510

Honorable Tom Marino
Chairman
Subcommittee on Regulatory Reform,
Commercial and Antitrust Law
House of Representatives
Washington, DC 20515

Honorable Patrick J. Leahy
Ranking Member
Committee on the Judiciary
United States Senate
Washington, DC 20510

Honorable Hank Johnson
Ranking Member,
Subcommittee on Regulatory Reform,
Commercial and Antitrust Law
House of Representatives
Washington, DC 20515

Re: Revisions to Bankruptcy Code exemptions for qualified financial contracts

Dear Sens. Grassley and Leahy and Reps. Marino and Johnson,

The National Bankruptcy Conference (the "**Conference**") is a voluntary, nonpartisan, not-for-profit organization composed of about 60 of the nation's leading bankruptcy judges, professors and practitioners, which has provided advice to Congress on bankruptcy legislation for nearly 80 years. We enclose a Fact Sheet which provides further information about the Conference.

This letter addresses the exemptions (so-called "safe harbors") to several otherwise applicable provisions of the Bankruptcy Code for qualified financial contracts, i.e., swap agreements, securities contracts, repurchase agreements, forward contracts and commodity contracts, with certain non-debtor counterparties. Under the exemptions, the non-debtor counterparties, unlike other creditors, may enforce insolvency-related default clauses and are not bound by the automatic stay of the bankruptcy case in accelerating or terminating their qualified financial contacts or in liquidating their positions. They are also, unlike other creditors, protected from actions brought by a bankruptcy trustee or debtor in possession seeking to avoid preferential and constructive fraudulent transfers to the non-debtor counterparties in connection with the qualified financial contracts.

In this letter we summarize the recommendations of the Conference in two areas to modify Bankruptcy Code exemptions for qualified financial contracts: (1) exemptions for certain fraudulent transfer claims arising from leveraged buy-out transactions and (2) exemptions for futures contracts involving the physical delivery of commodities. Our recommendations on these subjects differ from those in the Report (the "**ABI Report**")

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of the American Bankruptcy Institute's Commission to Study Chapter 11 Reform available at http://commission.abi.org/full-report. With respect to (1), our recommendation differs substantially from the ABI Report's proposal. With respect to (2), the ABI Report recognizes the need for reform but offers no concrete proposal.

I. Fraudulent Transfers in Leveraged Buy-out Transactions

The Conference recommends modifying the exemption in Bankruptcy Code section 546(e) relating to a settlement payment in connection with a leveraged buy-out transaction that would otherwise constitute a constructive fraudulent transfer. A leveraged buy-out transaction typically occurs when a company borrows money for the purpose of making distributions to the beneficial holders of the company's equity securities. The company takes on debt but uses the proceeds to make payments to equity holders instead of using the proceeds to make investments in assets or funding operations. Because the company needs to repay the borrowed funds, but the benefit of the borrowed funds goes to the beneficial holders of the company's equity securities, creditors of the company, which may include holders of debt securities (such as bond holders) as well as trade, tort and tax creditors, are often made worse off by the transaction.

That is where fraudulent transfer law becomes relevant—or at least would be relevant, absent section 546(e). Equity interests in a company are generally junior to creditor claims against the company and are expected to provide a cushion for the senior claims of creditors, whether holders of debt securities or trade, tort or tax claims, to be satisfied. The effect of a leveraged buy-out transaction is to transfer the value of assets of the company to the company's equity security holders, i.e., its shareholders, and risk leaving insufficient asset values available to satisfy the senior claims of the company's creditors. Fraudulent transfer laws provide a remedy for this type of problem. If after the transaction the company was left insolvent or had insufficient capital to conduct its business and the company later becomes a debtor under the Bankruptcy Code, the company's bankruptcy trustee may be able to look to the equity securities holders to recover distributions to these holders. The distributions would be recoverable as so-called "constructive fraudulent transfers" under section 548 of the Bankruptcy Code or applicable state fraudulent transfer law. However, the majority of courts have held that section 546(e) of the Bankruptcy Code prevents the bankruptcy trustee from recovering these constructive fraudulent transfers. According to these decisions, the equity securities holders can claim that the distributions were "settlement payments" and therefore immune from attack as constructive fraudulent transfers.[1]

We recommend narrowing section 546(e). Our recommendation has four elements. The first is to remove the section 546(e) protection for a beneficial holder of a *private* equity security who receives a distribution on the security in a leveraged buy-out transaction. The second is to remove the exemption for a beneficial holder of a *public* equity security who receives a distribution on the security in a leveraged buy-out transaction if the value of the distribution is at or *above* a certain threshold. The third is to provide for the section 546(e) protection to continue for the benefit of a beneficial holder of a *public* equity security who receives a distribution on the security in a leveraged buy-out transaction if the value of the distribution is *below* the threshold. The fourth is for the section 546(e) protection to continue *post-bankruptcy* for the beneficial owner of public equity security if the value of the distribution to the equity security holder on the

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[1] A recent decision from the Seventh Circuit Court of Appeals has held that the beneficial holder is not protected by section 546(e). *FTI Consulting Inc. v. Merit Management Group*, LP, ___ F3d __ (7th Cir. July 28, 2016). Nevertheless, decisions from Courts of Appeals in five other circuits have held otherwise. *In re Quebecor World (USA) Inc.*, 719 F.3d 94 (2d Cir. 2013); *Contemporary Indus. Corp. v. Frost*, 564 F.3d 981, 987 (8th Cir. 2009); *In re QSI Holdings, Inc.*, 571 F.3d 545, 551 (6th Cir. 2009); *In re Resorts Int'l, Inc.*, 181 F.3d 505, 516 (3d Cir. 1999); *In re Kaiser Steel Corp.*, 952 F.2d 1230, 1240 (10th Cir. 1991).

security is below the threshold. We explain the first three elements of the recommendation in Part I.A. followed by our explanation of the fourth element in Part I.B.

A. Protection Limits in Bankruptcy

At least as early as 2010, the Conference has been on record as advocating amendments to sections 546 and 550 of the Bankruptcy Code that would permit recourse to the beneficial holder of an equity security who received an otherwise exempt "settlement payment" in connection with a leveraged buy-out transaction if the settlement payment to the beneficial holder constituted a constructive fraudulent transfer. We attach our letter to the Honorable John Conyers, Jr. dated March 15, 2010 (the "**2010 Letter**"), offering several proposed amendments to the Bankruptcy Code exemptions for financial contracts, including our recommendation for amendments to section 546(e).

In contrast, the ABI Report has recommended a narrower exemption from section 546(e) for distributions to beneficial holders of equity securities. The ABI Report would except from the section 546(e) exemption distributions to beneficial holders of *privately issued* equity securities in a leveraged buy-out transaction. In particular, the ABI Report recommends that:

- Section 546(e) of the Bankruptcy Code should be amended to remove protection from avoidance actions for beneficial owners of privately issued securities in connection with prepetition transactions using some or all of the debtor's assets to facilitate the transaction (e.g., leveraged buyouts).
- Section 546(e) should continue the existing protection from avoidance actions for (i) securities industries participants who act as conduits in both public and private securities transactions and (ii) public securities holders.[2]

The stated rationale for this "private/public" distinction is that, after considering "the merits of limiting section 546(e) solely to securities industries participants that act as conduits," the Commission ultimately "determined that allowing fraudulent transfer claims against the beneficial owners of publicly issued securities would have the potential to affect the securities transfer system—a considerable difference from privately issued securities transfers."[3] However, the ABI Report provides no explanation as to how recovery from an end recipient of a transfer—rather than from an intermediary in the securities transfer system—would adversely affect the securities transfer system. Accordingly, a distinction that would exempt all settlement payments to holders of publicly-issued securities seems unjustified and would be unduly prejudicial to creditors (including holders of debt securities) whose claims are senior to the interests of equity security holders.

Nevertheless, we would recommend that consideration be given to a different distinction that is not reflected in the ABI Report or our 2010 Letter: a settlement payment by the issuer of a publicly issued security that is challenged as a constructively fraudulent transfer should continue to be exempt if the aggregate value of the property affected by the transfer to the particular beneficiary is less than some minimum threshold amount. This limitation should be modeled on existing exceptions in sections 547(c)(8) and (9), which provide a safe harbor for otherwise avoidable preferential transfers in which the value

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[2] ABI Report at 95.

[3] *Id.* at 98.

transferred is below a certain threshold amount. The threshold is $600 in the case of an individual debtor with primarily consumer debts; it is $6,200.00 in the case of a debtor whose debts are not primarily consumer debts.. However, we recommend that the section 546(e) exemption provide for a significantly higher minimum threshold than those in sections 547(c)(8) and (9).

The rationale for such a limitation is twofold. First, given the cost of locating and suing thousands of former beneficial owners with small holdings—as well as issues that may arise in attempting to collect individual judgments in relatively small amounts from former beneficial owners, which may include 401(k) plans, retirees, probate estates and the like—the net benefit of pursuing defendants who received relatively small amounts is questionable. Second, leveraged buy-out transaction litigation, particularly in venues far from their residence, imposes a disproportionate burden on "smaller" defendants.

In theory, the "venue" issue could be dealt with by requiring that a claim against a "smaller" beneficial owner be pursued in the venue of the owner's residence, along the lines of 28 U.S.C. § 1409(b). That section provides that certain types of lawsuits seeking money judgments or property of less than specified amounts must be brought in the District Court for the district in which the defendant resides. It would, however, be quite inefficient to have lawsuits in venues throughout the country, on a parallel track, with respect to what is basically a single, complex leveraged buy-out transaction. In a sense, one could view the proposed minimum threshold requirement for suit against a particular former beneficial owner as the tradeoff for the ability of the plaintiff to sue other former beneficial owners scattered throughout the country who received distributions of a value above the threshold in a leveraged buy-out transaction-based fraudulent transfer suit filed in a single venue.

B. Protection Post-Bankruptcy

While Conference members (and courts[4]) are, as a general matter, split on whether section 546(e) protections should continue to protect transferees post-bankruptcy from State law constructive fraudulent transfer claims of creditors, there is a consensus in the Conference that, if a public beneficial owner has received a distribution in connection with a leveraged buy-out and the value of the distribution is below the threshold described above, it makes little policy sense for the section 546(e) to protect the holder during the bankruptcy but not post-bankruptcy. The protection should continue to protect the public beneficial owner post-bankruptcy. This would be the case whether the relevant fraudulent transfer claim is abandoned by the estate representative or is assigned to a litigation trustee.

II. Futures Contracts Involving the Physical Delivery of Commodities

The Bankruptcy Code's qualified financial contract exemptions encompass virtually every contract traded on organized and over-the-counter (OTC) markets. Their scope is so broad that the exemptions appear to

[4]Courts are split whether section 546(e) is available to a state law constructive fraudulent transfer defendant post-bankruptcy. The Court of Appeals for the Second Circuit has recently held that section 546(e) should continue to provide post-bankruptcy protection. See *In re Tribune Co. Fraudulent Conveyance Litig.*, 818 F.3d 98 (2d Cir. 2016), *cert. filed* Sept. 12, 2016. Other courts have disagreed. *In re Physiotherapy Holdings, Inc.* ___ B.R. ___, 2016 Bankr. LEXIS 2810 (Bankr. D. Del. June 20, 2016).

encompass ordinary commodity supply agreements, such as those calling for delivery of natural gas[5] and diesel fuel.[6] This breadth has worried courts,[7] commentators,[8] and the Conference[9] for years.

This feature of the Bankruptcy Code is widely understood to be a problem, as evidenced by the ABI Report, which recognizes the problem (but offers no solution).[10] The challenge is implementation. We set out two options below. We recommend the first option ("Option A"): It is simple to implement and apply, offers certainty to financial markets, and would not have a large impact on the ability of financial institutions to hedge risk. We offer the second option ("Option B") as a second-best alternative. Like the Option A, it prevents the Code's safe harbors from shielding ordinary supply agreements from ordinary bankruptcy obligations, but the solution is more complex and requires decision-making by a bankruptcy judge. Because judicial decision-making is a source of uncertainty to financial markets, we favor Option A.

Option A

Any solution to this problem should achieve three well-accepted goals. First, the Code's safe harbors should offer no protection to contracts for the physical delivery of goods that are produced or used by a non-financial institution in the ordinary course of its operations. These contracts are supply agreements. Special protection for these contracts does not enhance stability of financial markets, which is the principal goal of the Code's safe harbors. The ABI Report agrees.[11] On the other hand, *contracts between financial institutions* should be safe harbored regardless of whether the contracts call for physical delivery of commodities. Financial market stability depends critically on the ability of financial institutions to close-out contracts with defaulting counterparties, net termination payments, and liquidate underlying collateral without delay or interference from the Bankruptcy Code. For similar reasons, *contracts traded on financial markets*—even contracts between non-financial institutions—should be protected by the Code's safe harbors. Market stability depends critically on the ability to rapidly close-out, net, and liquidate contracts with defaulting counterparties.

These goals can be achieved by adding the following new section to the Bankruptcy Code, which draws simple, bright-line rules for excluding contracts that are highly likely to be supply agreements:

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[5] *In re National Gas Distributors*, 556 F.3d 247 (4th Cir. 2007).

[6] *In re Laurel Valley Oil Co*., 2013 WL 832407 (N.D. Ohio 2013).

[7] *In re National Gas Distributors*, 369 B.R. 884 (E.D. N.C. 2007) (Small, J.), rev'd, *In re National Gas Distributors*, 556 F.3d 247 (4th Cir. 2007)

[8] *See, e.g.,* ABI Report at 107-110.

[9] *See* the 2010 Letter.

[10] ABI Report at 110 ("The Commission voted to exclude ordinary supply agreements from the safe harbors. In reaching this conclusion, the Commissioners emphasized that the exclusion from the safe harbors should be limited to nondealer counterparties' physical supply contracts, including contracts for the supply of natural gas and electricity.").

[11] *Id*., at 109 ("The Commissioners discussed the potential inclusion of ordinary supply contracts in the Bankruptcy Code safe harbors. The safe harbors were designed to promote liquidity and stability in financial markets. Market liquidity and stability are not furthered in a meaningful way when ordinary supply agreements are safe harbored.").

Section 563

(a) Notwithstanding any other provision of this title, a contract calling for physical delivery of a good shall not be treated as a contract of the kind specified in section 561(a) for any purpose under this title, despite any option for cash settlement in the contract, unless the contract is executed on an organized exchange or is a contract solely between or among dealers, securities clearing agencies, or clearing organizations (as defined in section 761(2)).

(b) For the purposes of this section—

(1) An organized exchange is a derivatives clearing organization (as defined in the Commodity Exchange Act), a multilateral clearing organization (as defined in the Federal Deposit Insurance Corporation Improvement Act of 1991), a national securities exchange, a national securities association, a securities clearing agency, a contract market designated under the Commodity Exchange Act, a derivatives transaction execution facility registered under the Commodity Exchange Act, or a board of trade (as defined in the Commodity Exchange Act);

(2) a dealer is a person that as a regular and significant part of its business holds itself out to the market as prepared to enter into either side of a contract of the kind specified in subsection (a);

(3) electricity is a good; and

(4) the determination of whether a contract referred in subsection (a) is a contract with a dealer, securities clearing agency, or clearing organization shall be made as of the date of the filing of the petition.

Under this approach, *on-exchange contracts are always exempt*, regardless of counterparty or subject matter. Similarly, *contracts between financial institutions are always exempt*. On the other hand, over-the-counter (OTC) contracts are *never exempt* if at least one of the counterparties is a non-dealer.

This bright-line approach has the advantages of clarity and simplicity, but also has some downsides. It would (i) increase off-exchange hedging costs for non-financial institutions, and it would (ii) potentially expose financial institutions to higher costs of default from contracts with non-financial institutions. With respect to (i), we are unaware of data indicating that these costs will be large. With respect to (ii), our understanding is that financial institutions rarely (if ever) have large exposures to non-financial counterparties. Large exposures exist between financial institutions, not between financial and non-financial entities. The ABI Report reached largely the same conclusion, acknowledging that narrowing the safe harbors to exclude supply agreements would increase costs for non-debtor trading partners, but concluding that these costs would not be large.[12]

[12] ABI Report at 109 ("The legislative history of the safe harbors clearly establishes a desire to protect the securities transfer system and promote market stability. Although the Commissioners could hypothesize scenarios in which subjecting the nondebtor party to an ordinary supply contract to the Bankruptcy Code's automatic stay and other provisions could possibly affect others in the market, the Commissioners found those scenarios highly unlikely and, even if possible, very limited in scope. Most ordinary supply contracts are bilateral agreements that impact only the rights of the parties bound by the contract. The Commissioners acknowledged the hardship that may be imposed on the nondebtor party by the chapter 11 filing, but they did not find such hardship significantly different from that experienced by most of the debtor's stakeholders.").

Option B

In the 2010 Letter, the Conference recommended modifying the exemptions to give the debtor a short period to "elect that all forward and commodity contracts between the debtor and a single counterparty not have the benefit of the exemptions otherwise applicable to the contracts." The debtor would have the right to notify the court, within 48 hours after an order for relief, that it was considering whether to assume or reject all forward or commodity contracts ("excluded commodity contracts") with a single counterparty. Once that announcement was made, the counterparty's close-out rights would be suspended for a short period (perhaps 30 days) while the debtor decided whether to assume or reject the excluded commodity contracts. During the pendency of that decision-making period, the debtor would be required to post cash collateral equal to 105 percent of its net obligation (if any) to the counterparty under all contracts.[13] The net obligation would be an administrative expense claim, and the cash collateral on deposit would be adjusted on a daily basis to reflect the debtor's net exposure to the counterparty. If the debtor ultimately assumed the excluded commodity contracts, it would continue posting cash collateral. If it rejected the contracts, the counterparty would enjoy the usual exemptions and have a short window (perhaps 30 days) to exercise close-out rights. Aside from these rules, the excluded commodity contracts would be subject to ordinary rules of bankruptcy law.

Although we still support this option, it is more complicated than Option A and requires a judge to decide whether the debtor has posted adequate cash collateral. This could be a source of uncertainty to financial markets. We therefore view Option B as a "second best" alternative.

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We would be pleased to discuss these recommendations further and to respond to any questions or concerns that any of you might have.

Sincerely,

/s/ Jane Lee Vris

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[13] The cash collateral must equal 105 percent of the amount by which the net obligation on that date exceeds the net obligation (if any) on the date of the order for relief. This ensures that pre-petition obligations do not receive administrative expense priority.