FROM FEUDAL LAND CONTRACTS TO FINANCIAL DERIVATIVES: THE TREATMENT OF STATUS THROUGH SPECIFIC RELIEF

JOHN J. CHUNG[*]

I. Introduction

In sorting through the aftermath of the global economic collapse, one conclusion has emerged regarding its cause: Financial derivatives were at the root of the crisis.[1] It is now widely believed, with the obvious benefit of hindsight, that the failure to regulate derivatives was responsible to a large extent for the collapse, and calls for reform are echoing throughout the government.[2] The failure to adequately regulate derivatives is an issue that needs to be addressed.

Derivatives did not grow out of control due to the absence of legislative attention. Such a view would suggest that derivatives were somehow overlooked by Congress in enacting financial legislation. In fact, the exact opposite is true. Congress explicitly addressed derivatives, and enacted legislation to benefit them through special treatment. This treatment is seen in the Bankruptcy Code, among other places. In bankruptcy, the non-debtor party to a derivative is treated differently and better than other parties who have contracted with the debtor. Unlike such other parties, the non-debtor party to a derivative is permitted to exercise its rights under the derivatives contract, notwithstanding the automatic stay and other bankruptcy provisions. In other words, such a party is permitted to exercise the contract exactly as written. Other non-debtor contractual parties are often forced to accept a substitutionary form of relief. This begs the

---

[*] Associate Professor, Roger Williams University School of Law; B.A., Washington University in St. Louis; J.D., Harvard Law School.

[1] As one commentator observed: "The final months of 2008 marked the end of an unprecedented saga of excess. The mania, panic, and crash had many causes. But if you are looking for a single word to use in laying blame for the recent financial catastrophe, there is only one choice. Derivatives." FRANK PARTNOY, F.I.A.S.C.O., BLOOD IN THE WATER ON WALL STREET 248 (W.W. Norton & Co., Inc. 2009) (1997).

[2] *See, e.g.*, Reuters, *Geithner Seeks Clampdown on Derivatives Dealers*, CNBC, July 10, 2009, http://www.cnbc.com/id/31849274 (discussing U.S. Treasury Secretary Tim Geithner's proposals for increased supervision of the over-the-counter derivatives market).

question: If derivatives are so dangerous, why are they afforded this type of special treatment?

The limited right to specific relief on the contract, as opposed to some other type of relief, is a concept introduced to students in the first year of law school. A basic course in contract law teaches that damages are the favored form of relief for breach of contract and that specific performance is an extraordinary remedy. Contracts for the sale of land are presented as the prototypical example of the type of contract that may be enforced through specific performance. So, why do land contracts and financial derivatives share the common benefit of enforcement through specific relief? Is it mere coincidence, or is there a deeper commonality? The commonly accepted understanding of land contracts is that each parcel of land is unique, so money damages are inadequate to remedy a breach.[3] With regard to derivatives, the expressed reason for favorable treatment (according to the legislative history) is that derivatives require such treatment in order to avoid "systemic risk" to the entire financial system.[4] Based on these stated reasons, one could fairly conclude that any similarity in the treatment of the two types of contracts is mere coincidence. This conclusion has intuitive appeal. After all, the remedy of specific performance for land contracts was developed in feudal England, while the treatment of derivatives is a contemporary invention.

This article contends, however, that these expressed reasons (while true up to a point) mask a deeper rationale that is common to both types of contracts. The core reasons underlying the development of specific performance of land contracts in feudal England are essentially the same as the reasons underlying the favored treatment of financial derivatives in the contemporary economy. The thesis of this article is that both types of contracts have been singled out for

---

[3] But to say that specific performance is available when the subject matter of the contract is "unique" is simply a conclusion devoid of analysis. Whether "uniqueness" has any meaning at all is an open question. *See* Anthony T. Kronman, *Specific Performance*, 45 U. CHI. L. REV. 351, 358-59 (1977). If the term "unique" lacks a helpful meaning, then there must be other reasons why some contracts are enforced through specific relief. This is the inquiry of this article.

[4] H.R. REP. NO. 109-648, pt. 1, at 3 (2006) ("[In] the event of insolvency . . . certain types of financial contracts are processed on a net basis to reduce the risk—especially the systemic risk associated with activities in derivatives markets.").

favorable treatment in the form of entitlement to specific relief because each type of contract represents the dominant form of wealth in its respective era, and the law surrounding these contracts developed as a result of, and to protect, the favored status of those who enter into such contracts.[5] This contention suggests that the stated justifications for special treatment are, to a large degree, pretextual, and that a more encompassing analysis is needed to understand why these two types of contracts have been favored with special treatment.[6] It causes discomfort in polite society to discuss

---

[5] Black's Law Dictionary enumerates four (inconsistent) definitions of status:

> 1. A person's legal condition, whether personal or proprietary; the sum total of a person's legal rights, duties, liabilities, and other legal relations, or any particular group of them separately considered <the status of a landowner>. 2. A person's legal condition regarding personal rights but excluding proprietary relations <the status of a father> <the status of a wife>. 3. A person's capacities and incapacities, as opposed to other elements of personal status <the status of minors>. 4. A person's legal condition insofar as it is imposed by the law without the person's consent, as opposed to a condition that the person has acquired by agreement <the status of a slave>.

BLACK'S LAW DICTIONARY 1447 (8th ed. 2004). The meaning of "status" and how this article uses the word will be discussed more fully below.

[6] Professor Laycock exposed the incoherency underlying the stated reasons for choosing between legal and equitable relief:

> These real reasons for denying equitable remedies are not derived from the adequacy of the legal remedy or from any general preference for damages. Some of the reasons are based on the cost of the equitable remedy in particular circumstances; others apply equally to legal remedies in similar cases. Sometimes there are good reasons to deny legal relief and grant equitable relief instead. But there is no general presumption against equitable remedies.
>
> I conclude that the irreparable injury rule is dead. It does not describe what the cases do, and it cannot account for the results. Injunctions are routine, and damages are never adequate unless the court wants them to be. Courts can freely turn to the precedents granting injunctions or the precedents denying injunctions, depending on whether they want to hold the legal remedy adequate or inadequate. Whether they want to hold the

issues like status and wealth, but any discussion of contractual remedies for these types of contracts is incomplete without, at least, recognizing the possibility that reasons relating to status are an inherent element of specific relief.

In order to develop this analysis, Part II begins by examining the doctrinal differences between specific and substitutionary relief. In addition to the basic discussion concerning the showing necessary to obtain specific relief, Part II introduces the key concept that the availability of specific relief is dependent on the existence of a market by which the value of the contract loss may be determined. Part III discusses the reasons underlying the application of specific performance to land contracts, as developed in early English law. Part IV amplifies the subject of land contracts, and explains the relationship between the structure of feudal society in England and the development of specific performance for land contracts. In doing so, it introduces the crucial importance of status, and the role of land in determining social, political and legal status in feudal England. An understanding of the relationship between land and status is necessary to understand why specific relief was deemed necessary for breaches of contracts for land.

Part V brings the discussion forward to the contemporary economy. It discusses the diminished role of land in the modern economy and society as well as the financial sector's replacement of land as the pre-eminent sector of the economy. Part VI examines the role and importance of derivatives within the financial sector and their role in causing the current economic collapse. Part VII focuses on the special treatment of financial derivative contracts under the Bankruptcy Code. In effect, the Code provides that non-debtor parties to derivatives contracts are entitled to performance of their contracts notwithstanding general bankruptcy principles to the contrary, while just about all other non-debtor parties are prohibited from obtaining performance of their contracts absent court approval. Why are derivatives favored with such special treatment? Congress stated such treatment is necessary to prevent "systemic risk," but is that what is really at stake? This paper attempts to address such questions. Part VIII highlights the parallels between specific

---

> legal remedy adequate depends on whether they have some other reason to deny the equitable remedy, and it is these other reasons that drive the decision.

Douglas Laycock, *The Death of the Irreparable Injury Rule*, 103 HARV. L. REV. 687, 692 (1990).

performance of land contracts in feudal England and the treatment of financial derivatives under the Bankruptcy Code. This paper asserts that status is the common element in the favored treatment of both types of contracts. Just as land contracts in pre-industrial England determined and embodied status and wealth, derivatives contracts play a comparable (though not entirely similar or forceful) role today. This common feature, as much as anything else, explains why both types of contracts are protected by specific relief. Part IX concludes the article.

II. The Distinction Between Specific and Substitutionary Relief

A standard formulation of the remedy for breach of contract is that the remedy is designed to put the plaintiff in the position she would have been in had the contract been performed.[7] However, the typical contract remedy does not provide this result. If an employer breaches an employment contract, the remedy that would put the employee in the same position she would have been in is a remedy that would require the employer to perform the contract by providing employment on the agreed terms. Instead of this remedy, however, all the employee can hope to recover is money damages. Simply put, money damages are not the same as contractual performance. As Professor Murphy explains:

> A fundamental distinction in the law of remedies is the difference between specific and substitutionary relief. Specific relief gives the plaintiff the original thing to which the plaintiff is or was entitled; substitutionary relief gives the plaintiff something other than its original entitlement. The most common form of substitutionary relief is money.[8]

---

[7] E. ALLAN FARNSWORTH, CONTRACTS § 12.1, at 730 (4th ed. 2004) [hereinafter FARNSWORTH, CONTRACTS].

[8] Colleen P. Murphy, *Money as a "Specific" Remedy*, 58 ALA. L. REV. 119, 119-20 (2006). Professor Farnsworth explains this difference as follows:

> The judicial remedies available for breach of contract can be characterized as "specific" or "substitutional." Relief is said to be specific when it is intended to give the injured party the very performance that was promised, as when the court orders a defaulting seller of goods to deliver them to the buyer. Relief is said to be substitutional when

Thus, when it comes to contract damages, the law generally does not provide relief by ordering performance of the contract. What the law generally provides is something other than performance—namely, damages.[9] The law also does not generally prohibit breaches of contract (through frequently granting injunctions prohibiting breach). Parties are free to breach, but they also become liable for damages.[10] This is another key distinction between substitutionary and specific remedies: The substitutionary remedy is awarded after the loss has occurred, while the specific remedy may sometimes be imposed to prevent the loss from occurring in the first place.[11]

In order to provide a substitutionary remedy, the substitute must be equivalent in value to the loss. This necessarily requires some valuation mechanism. To illustrate, suppose a seller breaches a contract to sell a widget. In the ordinary case, the buyer's remedy will be damages (in this case, the value of the widget minus the price to have been paid). How does the law value the widget? It simply looks to the market for widgets. Thus, the availability of damages as a remedy requires the existence of a market or market-like mechanism to ensure that the substitute remedy is of equivalent value to the failure to perform.[12] Indeed, the availability of a damages

---

> it is intended to give the promisee something in substitution for the promised performance, as when the court awards a buyer of goods money damages instead of the goods.

FARNSWORTH, CONTRACTS, *supra* note 7, § 12.2, at 734-35.

[9] In the law of contracts, courts have a choice of remedy between specific and substitutionary relief. In torts, however, there is usually no such choice. The only remedy available in most tort instances is substitutionary. The extreme example is a wrongful death, for which the only remedy is a substitute for the loss.

[10] Justice Holmes stated it this way: "The duty to keep a contract at common law means a prediction that you must pay damages if you do not keep it, — and nothing else." Oliver Wendell Holmes, Jr., *The Path of the Law*, 10 HARV. L. REV. 457, 462 (1897).

[11] Laycock, *supra* note 6, at 696.

[12] This need for a market mechanism was implicitly recognized in this statement:

> The law, concerning itself more and more with merchandise bought or sold for money, with things having a definite and calculable exchange value, came to conceive that the money compensation, which was an entirely adequate remedy in the common case, and in many cases the only possible one when once the wrong

remedy necessarily assumes the existence of a market economy and market mechanisms in the first place, "since in a market economy money ought to enable an aggrieved promisee to arrange a substitute transaction."[13] Without a market, there is no reliable basis upon which to determine damages. In such a situation, specific relief is the only remedy available.

Scholarly commentators have pondered several reasons why damages are the favored remedy over specific performance for a breach of contract claim. To an extent, the favoring of damages over specific performance is puzzling. After all, specific performance is the most accurate means to remedy a breach of contract because it gives the non-breaching party the precise performance that he contracted for.[14] In fact, specific performance was the generally available remedy for breach of contract in England until approximately 1260, at which time damages became the favored remedy.[15]

> complained of had been committed, was the only remedy available for their use . . . .

CHARLES ANDREWS HUSTON, THE ENFORCEMENT OF DECREES IN EQUITY 74 (1915).

[13] E. Allan Farnsworth, *Legal Remedies for Breach of Contract*, 70 COLUM. L. REV. 1145, 1154 (1970).

[14] Alan Schwartz, *The Case for Specific Performance*, 89 YALE L.J. 271, 274 (1979). So why is specific performance not routinely available? Professor Schwartz cites three not entirely satisfactory (by his own description) reasons:

> First, the law's commitment to the compensation goal may be less than complete; restricting specific performance may reflect an inarticulate reluctance to pursue the compensation goal fully. Second, damages may generally be fully compensatory. In that event, expanding the availability of specific performance would create opportunities for promisees to exploit promisors by threatening to compel, or actually compelling, performance, without furthering the compensation goal. The third explanation is that concerns of efficiency or liberty may justify restricting specific performance, despite its greater accuracy; specific performance might generate higher transaction costs than the damage remedy, or interfere more with the liberty interests of promisors.

Id. at 274.

[15] *Id.* at 274 n.15. Specific performance is now "strictly an ancillary and supplementary remedy, and is confined to those classes of agreements for

One common explanation for the limited availability of specific performance is that courts are reluctant to supervise the performance of contracts.[16] Thus, judicial resources are conserved, and judges are spared from duties beyond their expertise (such as supervising a construction project).[17] It is incorrect to conclude, however, that specific performance always requires more judicial involvement than an award of damages. Specific performance can also be viewed as a means to limit judicial involvement. By ordering performance, a court avoids the task of valuing the loss. There is no need to resolve potentially thorny issues such as whether or not consequential damages are recoverable. The significance of this point, for purposes of this article, is that when the law favors or requires specific relief for a certain type of contract, it is (in some cases) preventing the need for a judicial determination of the value or amount of the loss. To put it more broadly, specific relief avoids or prevents third party (i.e., judicial) interference with the operation of the contract by preventing the third party from substituting something other than performance.

There are numerous reasons why specific performance is a superior remedy to damages. Nevertheless, the law favors damages over specific performance, and courts will only grant specific performance when damages are inadequate compensation for the plaintiff.[18] Again, this is a standard formulation of contract remedies, but it raises the question: inadequate compensation of what? The quick response is that the plaintiff must show damages are inadequate compensation for the loss, but what exactly is the loss? Is it something that can be valued in the market? A related question is why are some losses deemed to be adequately compensable by

---

whose breach the mere payment of pecuniary damages is acknowledged to be either impracticable or inadequate." JOHN NORTON POMEROY & JOHN C. MANN, A TREATISE ON THE SPECIFIC PERFORMANCE OF CONTRACTS § 4, at 5 (3d ed. 1986).

[16] FARNSWORTH, CONTRACTS, *supra* note 7, § 12.4, at 742.

[17] *See* POMEROY & MANN, *supra* note 15, § 23, at 61.

[18] Schwartz, *supra* note 14, at 272. Saying that damages are inadequate compensation is another way of saying that there is no market to determine the adequate amount of damages. In such a situation, the risk is too great that damages will not address the totality of the loss. When the subject of the contract is deemed "unique," "the risk is greater that the promisee's money damage remedy will be under-compensatory" because "there is no developed market generating information about the value of the subject matter of their contract." Kronman, *supra* note 3, at 366.

money, while others are not? Such questions may seem simple and basic. However, the analysis requires consideration of factors that may not even be expressed or acknowledged by policymakers when choosing between the two forms of remedy.[19]

III. Specific Performance and Land

In the development of early English law, real property was accorded a greater importance and value than personal property.[20] Professor Farnsworth observed:

> Land was viewed by English courts with particular esteem and was therefore singled out for special treatment. Each parcel, however ordinary, was considered "unique," and its value was regarded as to some extent speculative. From this it followed that, if a vendor broke a promise to convey an interest in land, money would not enable the injured purchaser to buy a substitute, and specific performance would generally be granted.[21]

Even after the English courts came to regard money damages as the norm and specific relief as a deviation from this norm, specific performance remained the favored remedy for land contracts.[22] For centuries now, courts have regarded money damages as an inadequate remedy for a breached contract for the sale of land. Thus, equitable jurisdiction is firmly established where land is the subject

---

[19] In this vein, one commentator observed:

> Unfortunately, the legal conclusion that the legal remedy is inadequate masks the intellectual process of identifying and evaluating interests. Moreover, though the inadequacy prerequisite has proved flexible enough to adopt [sic] to changed conditions, it grants excessive discretion and is too imprecise to ensure predictability. To expose that intellectual process and to constrain discretion with a rude set of standards are the modest goals of the present effort.

Doug Rendelman, *The Inadequate Remedy at Law Prerequisite for an Injunction*, 33 U. FLA. L. REV. 346, 358 (1980).

[20] POMEROY & MANN, *supra* note 15, § 9, at 22-23 n.(e).

[21] FARNSWORTH, CONTRACTS, *supra* note 7, § 12.6, at 749.

[22] *Id.* § 12.4, at 741 ("Only for land, which English courts regarded with particular esteem, was a general exception made, on the ground that each parcel of land was 'unique' so money damages were inadequate.").

matter of a breached contract, and specific performance is the favored remedy.[23]

One explanation for why specific performance remained the favored remedy is that there was no adequate market mechanism in pre-industrial England to value the loss caused by a breach of a land contract:

> [There are many cases where] the ability of money to purchase an exact equivalent does not exist. One landed estate, though of precisely the same market value as another, may be entirely different in every other circumstance that makes it an object of desire. The vendee in a land contract may recover back the purchase money which he has paid, and with the damages which he thus receives he may purchase another estate of equal market value, but then there may be numerous features and incidents connected with the former tract which induced him to purchase, which made it to him peculiarly desirable, but which were not taken into account in the estimate of his damages, and which cannot be found in any other land which he may buy with the money. It is evident that in this and similar cases there would be a failure of justice unless some other jurisdiction supplemented that of the common law, by compelling the defaulting party to do that which in conscience he is bound to do, namely, actually and specifically to perform his agreement.[24]

As discussed further in Section IV, a contract for land in pre-industrial England embodied numerous rights, obligations, and benefits for which there was no market. This is the essence of why money was an inadequate remedy. Any assertion that land was viewed as unique (and thus in need of specific performance) because of a parcel's unique topographical and geographical features is incomplete and simplistic. It evokes a misty view of a distant era

---

[23] POMEROY & MANN, *supra* note 15, §10, at 23. Equity adopted this principle, "not because [the land] was fertile or rich in minerals . . . but because it was *land*—a favorite and favored subject in England, and every country of Anglo Saxon origin." Kitchen v. Herring, 42 N.C. 190, 190 (1851).

[24] POMEROY & MANN, *supra* note 15, § 9, at 21-22.

when dukes required specific performance so that they could enjoy a particular view. Thus, first year law students are led to believe in their Contracts and Property classes that an entire legal doctrine was developed to protect the aesthetic and sentimental sensibilities of the noble classes. While this view may have its quaint charm, land was accorded special treatment and deference, not because of the land itself, but because of the incalculable rights and benefits tied to ownership of the land—the status conferred by land.[25]

IV. The Role of Land in Feudal England as an Explanation for the Development of Specific Performance of Land Contracts

So, what explains the importance and reverence for land in the development of the law in England (and later, as received by American jurisprudence)? The answer is found by tracing the law's development to feudal England. In feudal England, land was paramount because it was the basis of the social and political order in the feudal hierarchy.

The feudal system existed throughout Europe and developed in England after the conquest by William the Conqueror in 1066.[26] The basis and origin of the feudal system arose out of military conquest.[27] A conquering general would reward his senior officers by allotting to them large parcels of the conquered land, and the senior officers would, after retaining a large parcel for themselves, allot smaller parcels to their inferior officers.[28] These allotments were called "feuds, fiefs, or fees."[29] The allotment of conquered land also imposed a reciprocal system of duty and service on the recipients of land, the feudatories. Every feudatory was under the command of and bound to defend his grantor.[30] The feudal system ensured that the monarch had a ready military force of feudatories prepared to defend him, each other, and the territory as a whole.[31] In addition to military

---

[25] Nancy Perkins Spyke, *What's Land Got to Do with It?: Rhetoric and Indeterminacy in Land's Favored Legal Status*, 52 BUFF. L. REV. 387, 391 (2004).
[26] *See* 2 WILLIAM BLACKSTONE, COMMENTARIES 48 (1766).
[27] *Id.* at 45.
[28] *Id.*
[29] *Id.*
[30] *Id.* at 46.
[31] *Id.*

duties, the feudatories also acquired with the land a set of duties to provide civic services. Each had the duty to assist the monarch in the administration of justice within his territory. Such duties included the duty to resolve disputes involving tenants of the land and the duty to sit as a jury member in the trial of a peer.[32] The rewards of conquest, and the corresponding duties, were all tied to the allotted land. Thus, land defined the role and status of these elite members of their society. Their relationship to one another and the monarch depended on their landholding.

In addition to defining status in medieval England, ownership of land defined wealth.[33] The feudatory enjoyed the fruits of the land and the labor of the landless peasants who worked the land. Not surprisingly, land was the predominant form of economic wealth in pre-industrial England.[34] Given the nature and role of land during the development of law in pre-industrial England, the law's special view of land is not surprising:

> Land, partly because of its scarcity, perhaps, but generally because of its power to determine the

---

[32] *Id.* at 54.

[33] Spyke, *supra* note 25, at 394; Laycock, *supra* note 6, at 703.

[34] David Cohen, *The Relationship of Contractual Remedies to Political and Social Status: A Preliminary Inquiry*, 32 U. TORONTO L.J. 31, 37 (1982); Spyke, *supra* note 25, at 420. Indeed, forms of wealth other than land appear to have discouraged in such times:

> Entailment made the income of the nobility dependent on agriculture: Because they were unable to sell their land and invest the funds in other assets, the nobility could generate wealth only from rent. And except for the few whose lands were located at the site of a mineral deposit or a growing urban area, rent could be received only from farmers who used the land for agricultural purposes. Consequently, although the nobility were assured of a steady source of income, they were discouraged from entrepreneurial wealth-seeking in favor of playing their family's role as the symbol of law and order.

Fred Bosselman, *Four Land Ethics: Order, Reform, Responsibility, Opportunity*, 24 ENVTL. L. 1439, 1452 (1994). As expected, social status was also tied to land and its attendant wealth. Jason S. Kirwan, *Appraising a Presumption: A Modern Look at the Doctrine of Specific Performance in Real Estate Contracts*, 47 WM. & MARY L. REV. 697, 703 (2005). When the industrial class emerged, land provided the distinction between the nobility and the "nouveaux riches" merchants. Cohen, *supra*, at 53.

> financial, social and political status of every British subject, was naturally a highly favored subject in the courts of Britain. The courts of that country it seems, were fully justified in assuming, under the existing circumstances, that all land did have a special and particular value. Land was power and influence and those were things much desired.[35]

The history and role of land in medieval England makes it plain why contracts for land were enforceable by specific performance. Money was simply not a substitute for land. How would a court determine the amount of loss represented by the loss of status that only comes with the land? What is the amount of loss represented by the loss of one's place in society, of one's place among other landholders? What is the amount of loss represented by the loss of the ability to expropriate the labor value of tenants? These are the considerations that led to the development of specific performance of land contracts. Moreover, in a society based on status, there was no market to determine the value of that status (as discussed below, status is the antithesis of the market). Thus, any suggestion that specific performance developed solely because land *qua* land is difficult to value is incorrect. A breached contract for land was difficult to value, but the difficulty was due to the impracticability of putting a value on the status conferred by land. Thus, contrary to popular misconception, specific performance did not develop to soothe the aesthetic sensibilities of an aristocrat who wanted a particular view of the sunset.

V. The Role of Finance in Determining Status and Wealth in Contemporary America

While land remains an important source of wealth, it obviously is not the only, or predominant, source of wealth in contemporary America. The role of land as the predominant determinant of wealth was undoubtedly weakened by the Industrial Revolution of the nineteenth century. By the early twentieth century, observers were commenting on the weakening of land's link to wealth:

> "To the common law title to real estate was as sacred as was a prerogative of the King. Under modern

[35] Robert Bird & William E. Fanning, *Specific Performance of Contracts to Convey Real Estate*, 23 KY. L.J. 380, 380-81 (1934).

> conditions, title to real estate is but a property right, little, if any, superior in the eyes of the law to any other property right." And, in this country where money "does the talking" rather than land, why shouldn't money satisfy in all cases where there is no special or peculiar value attached to the land by the party complaining?[36]

More pointedly, these commentators added: "We cannot in general see the uniqueness of land in this country. It is not the basis of our social, political, or governmental system, nor does it, just because it is land, bring any power to the owner."[37] Thus, the era when land was the determinant of wealth and status was already over by the 1930's (and undoubtedly earlier). Instead, "[o]ther contracts which have nothing at all to do with real property may have replaced, or at least joined, land contracts as the focal point of social expectations and obligations."[38] This last statement (as read today) is mostly, but not entirely, correct. It is only incorrect today in stating that other contracts "may have" replaced land contracts as a socially dominant force. Other contracts have, in fact, taken the pre-eminent position.

So what has replaced land? In one word—finance. Back in 1950, when the American economy had a more vibrant manufacturing base, manufacturing's share of the gross domestic product was 29.3% compared to 10.9% for financial services.[39] By 2005, manufacturing's share had dropped to 12%, and financial services had grown to 20.4%.[40] In this decade, profits from the financial services sector reached 41% of all corporate profits in America.[41]

---

[36] *Id.* at 384 (quoting Duckworth v. Michael, 19 Pac. (2d) 914 (1933)).
[37] *Id*. at 383-84.
[38] Cohen, *supra* note 34, at 36.
[39] KEVIN PHILLIPS, BAD MONEY: RECKLESS FINANCE, FAILED POLITICS, AND THE GLOBAL CRISIS OF AMERICAN CAPITALISM 31 (2008).
[40] *Id.*
[41] Professor Johnson, the former chief economist at the International Monetary Fund and a professor at the Sloan School of Management at the Massachusetts Institute of Technology, wrote:

> From 1973 to 1985, the financial sector never earned more than 16 percent of domestic corporate profits. In 1986, that figure reached 19 percent. In the 1990s, it oscillated between 21 percent and 30 percent, higher than it had ever been in the postwar period. This decade, it reached 41 percent.

"Not long ago, the sum of all financial assets—stocks, bonds, loans, mortgages, and the like, which are claims on real things—were about equal to global GDP. Now they are approaching four times global GDP."[42] Given these types of numbers, it is not surprising that informed observers would make comments such as: "Over the past generation—ever since the banking deregulation of the Reagan years—the U.S. economy has been 'financialized.' The business of moving money around, of slicing, dicing and repackaging financial claims, has soared in importance compared with the actual production of useful stuff."[43] To the extent anyone wonders why the financial industry deserves such scrutiny, is there any question that it created and caused the global economic collapse? The important inquiry now is to determine how it was allowed to grow to the point where it could cause this type of damage.

The growth of the financial industry is significant, but the breathtaking rise in its significance is only understood when examining what this growth has meant for individual wealth. From 1948 to 1982, the average compensation for financial center workers was about the same as the average for all domestic private industries.[44] By 2007, financial sector compensation grew dramatically to 181 percent of other private sector compensation.[45] Any reference to average compensation is misleading, however, because of the explosive growth in compensation at the top slice of the hierarchical pyramid:

> One of the most striking developments over the past quarter-century is the dramatic shift of taxable incomes toward the wealthiest people. Between 1980 and 2005, the top tenth of the population's share of all taxable income went from 34 percent to 46 percent, an increase of about a third. The changing distribution *within* the top 10 percent, however, is what's truly remarkable. The unlucky folks in the 90th to the 95th percentiles actually lost a little

---

Simon Johnson, *The Quiet Coup*, ATLANTIC, May 2009, http://www.theatlantic.com/doc/200905/imf-advice.

[42] CHARLES R. MORRIS, THE TRILLION DOLLAR MELTDOWN: EASY MONEY, HIGH ROLLERS, AND THE GREAT CREDIT CRASH xii (2008).

[43] Paul Krugman, Op-Ed., *The Joy of Sachs*, N.Y. TIMES, July 17, 2009, at A23.

[44] Johnson, *supra* note 41.

[45] *Id.*

> ground, while those in the 95th to 99th gained a little. Overall, however, income shares in the 90th to 99th percentile population were basically flat (24 percent in 1980 and 26 percent in 2005).
>
> Almost *all* the top one-tenth's share gains, in other words, went to the top 1 percent, or the top "centile," who doubled their share of national cash income from 9 percent to 19 percent. Even within the top centile, however, the distribution of gains was radically skewed. Nearly 60 percent of it went to the top *tenth* of 1 percent of the population, and more than a fourth of it to the top *one-hundredth* of 1 percent of the population. Overall, the top tenth of 1 percent more than tripled their share of cash income to about 9 percent, while the top one-hundredth of 1 percent, or fewer than 15,000 taxpayers, quadrupled their share to 3.6 percent of all taxable income. Among those 15,000, the average tax return reported $26 million of income in 2005, while the take for the entire group was $384 billion.[46]

The numbers are more astounding when considered in terms of individual compensation. In 2007, one hedge fund manager made $3.7 billion by shorting subprime mortgage securities and collateralized debt obligations.[47] In 2007, the average annual compensation for the top twenty-five highest paid hedge fund managers was $892 million.[48] The head of the AIG unit that was involved in credit default swaps was paid approximately $280 million in this decade.[49] Such figures led one prominent political commentator to state: "The flight of the economy from tangibles to money manipulation is

---

[46] MORRIS, *supra* note 42, at 139-40.

[47] Heidi N. Moore, *How the 10 Richest Hedge Fund Managers Got That Way*, DEAL JOURNAL, Apr. 16, 2008, http://blogs.wsj.com/deals/2008/04/16/how-filthy-rich-hedge-fund-managers-got-that-way/?mod=WSJBlog.

[48] Rex Nutting, *Hedge-Fund Managers Have Biggest Payday in History*, MARKETWATCH, Apr. 16, 2008, http://www.marketwatch.com/story/hedge-fund-managers-tally-up-biggest-payday-alpha-magazine.

[49] Peter Koeing, *AIG Trail Leads to London 'Casino'*, DAILY TELEGRAPH, Oct. 18, 2008, http://www.telegraph.co.uk/finance/financetopics/financialcrisis/3225213/AIG-trail-leads-to-London-casino.html.

enriching a broad cross section of the upper-echelon institutions and practitioners of U.S. finance . . . ."[50]

Obviously, this level of compensation was attained by only an infinitesimal number of the world's six or seven billion people. However, the present inquiry is whether the law enabled such paydays, and how did it happen? This inquiry is also the reason why this paper draws parallels to another era when a group of an infinitesimal few enjoyed vast wealth beyond the grasp of almost everyone else—the feudal era when lords presided over their landholdings, living off of the natural resources and the labor of their tenants. At first, the comparison may seem crude and superficial. In one era, there lived a small number of people whose wealth was unimaginable and grossly disproportionate to that of everyone else, and they were called the landed nobility. In another era, there lived a small number of people whose wealth was equally unimaginable and grossly disproportionate to everyone else, and they were called investment bankers, derivatives traders, hedge fund managers and the like. But the comparison holds lessons in how law develops and what law protects. In both eras, the law developed mechanisms to protect and preserve these elites and did so (in one small measure) by favoring specific relief in the enforcement of their contracts. The conclusion to be drawn, then, is that the law resorts to specific relief in some instances in order to protect and preserve elite interests. But what exactly is being protected or preserved? This article proposes the possibility that the law provides specific relief to protect status (including the status that is the source of the ability to realize the wealth).[51]

The next question would then be: How are the elite interests able to develop and apply the doctrine to benefit their status and wealth? To some extent, it is like the chicken or egg question: Which came first, status or wealth? The answer may be unknowable, but there is no question that a virtuous circle (for its beneficiaries) exists where wealth is used to influence law in order to protect status, and status is used to protect wealth. One prominent economist made the following observation regarding the current situation:

---

[50] PHILLIPS, *supra* note 39, at 63.

[51] In the larger picture, specific relief plays, of course, a small role in the protection and preservation of status, and this article does not suggest any role larger than it actually is. The modest purpose is to bring attention to an often overlooked doctrine and its involvement in policy choices.

> [E]lite business interests—financiers, in the case of the U.S.—played a central role in creating the crisis, making ever-larger gambles, with the implicit backing of the government, until the inevitable collapse. More alarming, they are now using their influence to prevent precisely the sorts of reforms that are needed, and fast, to pull the economy out of its nosedive. The government seems helpless, or unwilling, to act against them. . . . The great wealth that the financial sector created and concentrated gave bankers enormous political weight—a weight not seen in the U.S. since the era of J.P. Morgan (the man).[52]

This political clout is evident in the way derivatives have been singled out for special treatment.

VI. The Role of Financial Derivatives in the Modern Economy

As recently as the 1980's, the total amount of global financial assets was roughly equal to the total amount of the world's gross domestic product.[53] By the end of 2005, global financial assets were about 3.7 times larger than global GDP.[54] The growth in derivatives fueled a large part of this expansion.[55] Derivatives provide their holders with the ability to profit from assets that they do not actually own:

> Derivatives are financial instruments or contracts with values that are linked to, or derived from, the performance of underlying financial instruments, interest rates, currency exchange rates, or indexes. In a simplified sense, a derivative links its holder to the risks and rewards of owning an underlying financial instrument without actually owning the financial instrument.[56]

---

[52] Johnson, *supra* note 41.
[53] MORRIS, *supra* note 42, at 134.
[54] *Id*.
[55] *See id.* at 134-35.
[56] Allan C. Pulwalski, Fed. Deposit Ins. Corp., *Derivatives Risk in Commercial Banking*, Mar. 26, 2003, http://www.fdic.gov/bank/analytical/fyi/2003/032603fyi.html.

Derivatives today are within the domain of the most sophisticated financial institutions, and are developed by mathematicians with PhD's.[57] Indeed, the mechanics of many derivatives are beyond the comprehension of even those with formal, advanced training and a sophisticated financial background.[58] However, the origins of derivatives are more humble.

Derivatives originally developed to serve basic and simple market needs. For example, a forward contract is a form of a derivative, and its origins are plain and understandable. A farmer who plants crops in the spring does not know what the market price of the crop will be in the fall. However, he can lock in a guaranteed price when he plants his crops in the spring by selling a crop forward contract to a buyer who agrees to pay the guaranteed price in the fall. By virtue of this contract, the farmer is protected against a drop in the market price between the fall and spring, and the buyer is protected against a rise in the price during that same period. Thus, derivatives, as originally developed, can provide a useful market function.[59]

---

[57] Nelson D. Schwartz & Julie Creswell, *What Created this Monster?*, N.Y. TIMES, Mar. 23, 2008, § BU, at 1.

[58] Even someone like Alan Blinder, the former vice-chairman of the Board of Governors of the Federal Reserve and current Gordon S. Rentschler Memorial Professor of Economics at Princeton University, reportedly admitted to only "a modest understanding of derivatives" and an inability to place a value on any particular derivative. *Id*.

[59] The Federal Deposit Insurance Corporation describes the benefits of derivatives in this way:

> Derivatives are important to the financial markets and the world economy because they provide a means for companies to separate and trade various kinds of risks. The ability of participants in the financial markets to adjust specific risk exposures enhances the efficiency of capital flows by allowing companies to conduct business activities without amassing certain risks that would otherwise attend that business. For instance, mortgage lenders that are comfortable with the credit risk of mortgage lending may be less comfortable with the amount of exposure to interest rate movements that accompany a large mortgage portfolio. A mortgage company can use derivatives to lessen their exposure to the effect that interest rate movements might have on the value of their business and continue to make mortgage loans. Mortgage borrowers benefit from these

The size of the derivatives market is staggering. In 2008, the size of the worldwide derivatives market exceeded $530 trillion.[60] By contrast, the world's gross domestic product in 2008 was $62 trillion.[61] The market is also concentrated in that it is dominated by a few, elite international banks and securities firms. In 2002, the ten largest derivatives dealers were counterparties to most of the derivatives transactions that took place, and just seven U.S. banks held over 95% of the U.S. banking system's notional derivatives exposure.[62] In the first quarter of 2009, just five banks represented 96% of the total industry notional amount of derivatives activity in the U.S. banking system.[63] The derivatives activities also returned to profitability for American commercial banks after the collapse in 2008. The banks generated $9.8 billion from derivatives in the first quarter of 2009, compared to a loss of $9.2 billion in the fourth quarter of 2008.[64]

The market for derivatives has moved far beyond its simple roots. Its scale now dwarfs the "real economy" and it has turned into something that threatens the global economy.[65] Paul Krugman, the 2008 Nobel Prize recipient for his work in economics, describes the roots of the economic crisis:

> arrangements because mortgages are cheaper when lenders have choices about the risks that they retain.

Pulwalski, *supra* note 56.

[60] Sarah N. Lynch, *Harkin Seeks to Force All Derivatives onto Exchanges*, WALL ST. J., Nov. 20, 2008, http://online.wsj.com/article/SB122721812727545583.html.

[61] *Id*.

[62] Franklin R. Edwards & Edward R. Morrison, *Derivatives and the Bankruptcy Code: Why the Special Treatment?*, 22 YALE J. ON REG. 91, 98 (2005).

[63] OFFICE OF THE COMPTROLLER OF THE CURRENCY, ADM'R OF NAT'L BANKS, OCC'S QUARTERLY REPORT ON BANK TRADING AND DERIVATIVES ACTIVITIES FIRST QUARTER 2009 1 (2009), *available at* http://www.occ.treas.gov/ftp/release/2009-72a.pdf.

[64] *Id*.

[65] Much of this growth is due to the rise of the "shadow banking system." A paper issued through the Federal Reserve Bank of St. Louis defines the "shadow banking system" as the system of credit instruments "that exist outside of the traditional commercial banking system, especially those related to consumer credit." Julie Stackhouse & Bill Emmons, Fed. Reserve Bank of St. Louis, *The Credit Crunch Reflects Collapse of a "Shadow Banking System*," CENTRAL BANKER, Spring 2009, *available at* http://www.stlouisfed.org/publications/cb/2009/a/pages/in-depth.cfm.

> To understand the problem, you need to know that the old world of banking, in which institutions housed in big marble buildings accepted deposits and lent the money out to long-term clients, has largely vanished, replaced by what is widely called the "shadow banking system." Depository banks, the guys in the marble buildings, now play only a minor role in channeling funds from savers to borrowers; most of the business of finance is carried out through complex deals arranged by "nondepository" institutions, institutions like the late lamented Bear Stearns—and Lehman.[66]

The shadow banking system's use of derivatives lies at the heart of the crisis. The shadow banking system has been described as a "chain letter," and a "pyramid scheme of leverage."[67] Of all the derivatives in play in this system, experts have pointed to credit default swaps ("CDS")[68] as the most egregious offenders in creating risk and

---

[66] Paul Krugman, Op-Ed., *Financial Russian Roulette*, N.Y. TIMES, Sept. 15, 2008, at A25.

> For example, in the old [pre-shadow banking] system, savers had federally insured deposits in tightly regulated savings banks, and banks used that money to make home loans. Over time, however, this was partly replaced by a [shadow banking] system in which savers put their money in funds that bought asset-backed commercial paper from special investment vehicles that bought collateralized debt obligations created from securitized mortgages — with nary a regulator in sight.

Paul Krugman, Op-Ed., *Partying Like It's 1929*, N.Y. TIMES, Mar. 21, 2008, http://www.nytimes.com/2008/03/21/opinion/21krugman.html.

[67] Caroline Salas, *Credit Derivatives May Lose $250 Billion, Gross Says*, BLOOMBERG, Jan. 8, 2008, http://www.bloomberg.com/apps/news?pid=20601087&sid=a0bPUzHR3dJs&refer=home.

[68] In simple terms, a "credit default swap is a private contract in which private parties bet on a debt issuer's bankruptcy, default, or restructuring." Frank Partnoy & David A. Skeel, Jr., *The Promise and Perils of Credit Derivatives*, 75 U. CIN. L. REV. 1019, 1021 (2007). It is a contract between two parties in which one party buys, and the other party sells, protection against a specified financial event (typically an event involving a default on an obligation issued by a third party). The Second Circuit has described a CDS as "a contract which transfers credit risk from a protection buyer to a credit protection seller." *See* Aon Fin. Prods., Inc. v. Société Générale, 476

F.3d 90, 92 (2d Cir. 2007) (quoting Eternity Global Master Fund Ltd. v. Morgan Guar. Trust Co. of N.Y., 375 F.3d 168, 171-72 (2d Cir. 2004)).

A (simplified) credit default swap may look like this: Big State Pension Fund ("BSPF") buys $10,000,000 of bonds issued by Steady Reliable Corp. ("SRC"). BSPF wants to protect itself against the unlikely (but not impossible) event of SRC going out of business and the inability of SRC to meet its obligations under its bonds. Global International Bank ("GIB") is in the business of selling credit protection. BSPF and GIB enter into a credit default swap under which BSPF makes periodic payments to GIB in return for GIB's commitment that it will pay BSPF $10,000,000 if SRC files a bankruptcy petition. If SRC does not trigger a "credit event" as defined in the CDS, then GIB keeps the money from BSPF. If SRC goes under, GIB pays out on the CDS.

In the language of the CDS market, BSPF is the "protection buyer" and GIB is the "protection seller." The protection buyer pays for protection with "reference" to a specific credit obligation (in this case, the bonds issued by Steady Reliable Corp.). The credit obligation is referred to as the "reference obligation," and the issuer of that obligation (in this case, SRC) is referred to as the "reference entity." The amount of protection purchased by the protection buyer is called the "notional amount," which in this example would be $10,000,000.

This plain vanilla type of CDS serves a useful market function. But Wall Street took this basic CDS and turned it into something that barely resembles the basic structure. This is what Professor Partnoy concluded with regard to such credit default swaps:

> Wall Street saw they could use credit default swaps to create an infinite amount of crap. They quickly engineered new repackaging transactions, using credit default swaps to clone risky subprime-mortgaged-backed investments that, when pooled, generated more sky-high ratings. These new deals were known as "synthetic" CDOs, because they had been created artificially, through derivatives side bets. Instead of basing payoffs on subprime mortgage loans that actually existed in the real world, the banks created an Alice in Wonderland world and based payoffs on the multiple virtual realities that were down the rabbit hole.

PARTNOY, *supra* note 1, at 264. Professor Partnoy and Skeel provide a description of a collateralized debt obligation ("CDO"):

> [A] collateralized debt obligation (CDO) is a pool of debt contracts housed within a special purpose entity (SPE) whose capital structure is sliced and resold based on differences in credit quality. In a "cash flow" CDO, the SPE purchases a portfolio of outstanding debt issued by a range of companies, and finances its purchase by issuing its own financial instruments, including primarily debt but

imbalances.[69] So what harm did derivatives do? As Professor Partnoy explains:

> Without derivatives, the total losses from the spike in subprime mortgage defaults would have been relatively small and easily contained. . . . Instead, derivatives multiplied the losses from subprime mortgage loans, through side bets based on credit default swaps. Still more credit default swaps, based on defaults by banks and insurance companies themselves, magnified losses on the subprime side bets. As investors learned about all of this side betting, they began to lose confidence in the system.[70]

The crisis reached a peak in September 2008. One market observer described it this way:

> Around the world, stock markets collapsed, wiping $600 billion off global equity prices in just thirty-six

---

> also equity. In a "synthetic" CDO, the SPE does not purchase actual bonds, but instead enters into several credit default swaps with a third party, to create synthetic exposure to the outstanding debt issued by a range of companies. The SPE finances its purchase by issuing financial instruments to investors, but these instruments are backed by credit default swaps rather than any actual bonds.

Partnoy & Skeel, *supra* note 68, at 1019. This relationship between CDS's and CDO's is also explained as follows:

> With powerful computers and a lot of brainpower, a CDO manager can create a synthetic CDO, that is, an array of swaps with a risk structure just like a normal "cash-flow" CDO that is built from real securities. The manager must carefully build a reference CDO portfolio, mirroring thousands of real market instruments, and then model its performance under stress. When he is satisfied with the structure, he creates the family of credit default swaps that will return the same profits and losses as the bonds on an identical cash-flow CDO.

MORRIS, *supra* note 42, at 75. In plain English, derivatives were created out of thin air, existing only as computer entries and contracts (which enjoy special treatment under federal legislation).

[69] Salas, *supra* note 67. The deliberate failure to regulate credit default swaps is discussed later in this article.

[70] PARTNOY, *supra* note 1, at 267-68.

> hours. More devastating still was the pattern unfolding deep inside the debt markets. As investors around the world confronted these triple shocks, many panicked to such an extent that they completely withdrew from the market. Almost overnight, liquidity dried up in a host of different debt markets. Merrill Lynch, Goldman Sachs, and Morgan Stanley suddenly found it impossible to raise funds in the capital markets. . . . The implication was brutal: across the Western world, the senior managers of a host of the world's largest banks and brokers quietly told their central banks that they could collapse within days. . . . The issue was no longer a run on one bank or hedge funds, as in the summer of 2007, or a run on "just" the shadow banking world. A run on the entire system had started.[71]

With the benefit of hindsight, it is now clear that derivatives did in fact unleash the feared destruction. "Without derivatives, leveraged bets on subprime mortgage loans could not have spread so far or so fast. Without derivatives, the complex risks that destroyed Bear Stearns, Lehman Brothers, and Merrill Lynch, and decimated dozens of banks and insurance companies, including AIG, could not have been hidden from view."[72]

The economic collapse cannot be understood without understanding the role of derivatives. It is a universally shared view that the scale of the collapse was magnified by derivatives. So what did Congress have to say about derivatives?

VII. The Treatment of Financial Derivative Contracts under the Bankruptcy Code

A debtor in bankruptcy enjoys a wide array of powerful protections against contractual counter-parties. For example, the automatic stay prohibits non-debtor parties from taking any action to enforce their contractual rights or claims against the debtor or property of the debtor's estate.[73] Non-debtor parties are prohibited

---

[71] GILLIAN TETT, FOOL'S GOLD 238 (2009).
[72] PARTNOY, *supra* note 1, at 248.
[73] 11 U.S.C. § 362(a) (2006). An automatic stay works like this:

from exercising *ipso facto* clauses in their contracts with the debtor.[74] The debtor also has the right to choose whether to assume or reject executory contracts.[75]

To illustrate, a local bank that makes a loan to a small business secured by its forklifts as collateral is prohibited by the automatic stay from seizing the collateral once the debtor files a bankruptcy petition.[76] An insurance company that insures the small

---

> When a firm files a bankruptcy petition, it immediately enjoys the benefit of the Bankruptcy Code's "automatic stay," which forbids any creditor from taking steps to collect debts, seize assets, or otherwise "exercise control over property" of the debtor firm. The automatic stay is a core element of any attempt to reorganize under the Code. By shielding the debtor's assets and preventing a race that rewards the first creditor to the courthouse, it avoids dismemberment of a firm with going-concern value and facilitates a collective proceeding in which the parties (debtor and creditors) can negotiate the terms under which the firm will continue as a going concern.

Edwards & Morrison, *supra* note 62, at 95.

[74] 11 U.S.C. § 365(e)(1) (2006). An *ipso facto* clause is a clause in a contract that provides that the contract may be terminated in the event of a party's insolvency or bankruptcy filing.

[75] 11 U.S.C. § 365(a) (2006). Automatic stay permits nonperformance of executory contracts as follows:

> Generally, when a debtor firm enters bankruptcy, it is party to many ongoing ("executory") contracts, in which the debtor and its counterparties have continuing obligations to each other. Some of these contracts will be profitable to the debtor (they are "in the money"); others will not be (they are "out of the money"). The automatic stay prevents counterparties from taking any step to terminate these ongoing contracts. Instead the debtor has an exclusive right to "assume" profitable contracts and "reject" (i.e., breach) unprofitable ones, the consequence being that the counterparty to the "rejected" contract will receive an unsecured claim for damages, which will usually be paid a few cents on the dollar. In other words, the Bankruptcy Code generally allows debtors to "cherry pick" profitable from unprofitable contracts.

Edwards & Morrison, *supra* note 62, at 95-96.

[76] If the bank wants to move against the collateral, it may seek court approval to do so pursuant to a motion for relief from stay. 11 U.S.C. § 362(d).

business is prohibited from canceling the insurance policy on the grounds that the policy contains an *ipso facto* clause. If the debtor has a long-term contract with a supplier, the debtor has the choice of assuming the contract or rejecting it (which is treated as a pre-petition breach under the Bankruptcy Code).[77] These are fundamental and foundational principles of the Bankruptcy Code. Their purpose is to impose a collective mechanism on creditors for the recovery of their debts in order to avoid a piecemeal and destructive tearing apart of the debtor.[78] A fundamental premise of bankruptcy law is that individual creditors should not be left to their own pursuits in dealing with the debtor.

These provisions of the Bankruptcy Code apply to and govern every kind of contract and every non-debtor party, *except* financial derivatives and the non-debtors on the other side of the derivatives. Simply put, the normal and fundamental principles of bankruptcy law do not apply when derivatives are involved.

> The non-debtor counter-party to a derivative or related financial instrument enjoys extraordinary

---

[77] 11 U.S.C. § 365(g) (2006).

[78] DOUGLAS G. BAIRD, THOMAS H. JACKSON & BARRY E. ADLER, BANKRUPTCY: CASES, PROBLEMS, AND MATERIALS 20-30 (3d ed. rev. 2001).

> When a debtor is insolvent and there are not enough assets to satisfy everyone, the creditors are like fishers in a small lake: Their actions collectively can deplete and endanger the common pool. Each creditor has an incentive to act precipitously because if it waits it may not be repaid. . . .
>
> The situation in which the creditors find themselves is much like an arms race among nations. Money spent on weapons, of debt collection or war, is better spent elsewhere if conflict can be avoided. Bankruptcy law, like a peace treaty, can preempt conflict and prevent waste. Under bankruptcy law, each creditor receives what it could expect to receive outside of bankruptcy, taking account of the possibility that it might have won the race and the possibility that it might have lost. As a group, creditors are better off because they do not have to incur the costs associated with pursuing their individual remedies. Their payoffs are also more certain, something that has value in itself if the creditors are risk averse.

Id. at 23.

> privileges if its counter-party files for bankruptcy. Absent special protection, the derivative would be subject to bankruptcy's automatic stay, which prohibits non-debtors from taking any action to enforce an obligation against the debtor without court approval. Bankruptcy also prevents most non-debtors from invoking ipso facto clauses—provisions that make bankruptcy a condition of default under the parties' contracts. Derivatives are given special treatment in both of these areas. Unlike other non-debtors, the non-debtor participants in derivatives contracts are permitted to enforce their rights without interference from the bankruptcy process, due to a perception that if enforcement were delayed, the collapse of an important player in the derivatives markets could have a contagious effect throughout the financial markets.[79]

Commentators noted that the special treatment of derivatives was greatly expanded when the Bankruptcy Code was amended by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA" or the "Act"):[80]

> [BAPCPA] amends the Bankruptcy Code to clarify and expand the existing policy of providing special treatment for parties to financial markets contracts, including securities contracts, futures contracts,

[79] Partnoy & Skeel, *supra* note 68, at 1048-49. The special treatment of derivatives with regard to the automatic stay is set forth in 11 U.S.C. §§ 362(b)(6), (7), (17), (27) (2006). The special treatment of derivatives with respect to *ipso facto* clauses is set forth in 11 U.S.C. §§ 555-556, 559-561 (2006). An example of the pertinent language is found in § 556:

> The contractual right of a commodity broker, financial participant, or forward contract merchant to cause the liquidation, termination, or acceleration of a commodity contract . . . or forward contract because of a condition of the kind specified in section 365(e)(1) of this title . . . shall not be stayed, avoided, or otherwise limited by operation of any provision of this title or by the order of a court in any proceeding under this title.

11 U.S.C. § 556.

[80] Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, 119 Stat. 23.

> forward contracts, repurchase agreements, swaps and related derivatives. That special treatment includes exceptions from the automatic stay to permit setoff and liquidation and exceptions from the avoiding powers for certain kinds of prepetition payments. The principal effect of the BAPCPA amendments is to extend these "safe harbor" provisions to additional parties and additional kinds of financial markets contracts by expanding on the Code's definitions to include new kinds of derivatives and new kinds of transactions in them.[81]

The broad and sweeping reach of the Act and its effect on derivatives generated other scholarly commentary:

> The reforms of 2005 yield important but subtle changes in the Bankruptcy Code's treatment of financial contracts. They might appear only to eliminate longstanding uncertainty surrounding the protections available to financial contract counterparties, especially counterparties to repurchase transactions and other derivatives contracts. But the ambit of the reforms is much broader. The expanded definitions—especially the definition of "swap agreement"—are now so broad that nearly *every* derivative contract is subject to the Code's protection. Instead of protecting particular counterparties to particular transactions, the Code now protects any counterparty to any derivatives contract. Entire markets have been insulated from the costs of a bankruptcy filing by a financial contract counterparty.[82]

---

[81] Rhett G. Campbell, *Financial Markets Contracts and BAPCPA*, 79 AM. BANKR. L.J. 696, 697 (2005).

[82] Edward R. Morrison & 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). The commentators further highlighted how the definition of "swaps" in the Act exempted the entire derivatives market from the automatic stay requirement:

> Prior to 2005, the Code's protections were broad for swaps (any counterparty received protection) and narrow for other derivatives contracts (only some counterparties

The overwhelming intent and effect of the Act was to carve out a wide swathe of protection for derivatives, and to render them immune from the normal operation of bankruptcy law. The protections extended to immunize the entire derivatives market:

> A principal goal of the Act, then, is to expand dramatically the range of protected financial contracts. Entire derivatives markets are now protected. The Act achieves this goal primarily through definitions that are simply long lists of financial products observed (now or in the future) in financial markets. The virtue of this formalistic approach is that it leaves little doubt about the Code's boundaries: any transaction that bears the formal markings of a swap, repo, forward, commodity contract, or securities contract is protected. It is largely unnecessary for judges to analyze the economics of particular transactions.[83]

> were protected). The Act obliterates this asymmetry, principally by redefining "swap" to include, effectively, all derivatives contracts. In so doing, the Code has moved from protecting particular parties to protecting entire *markets*.

Id. at 643.

> The Reform Act radically reworks the Code's definitions, expanding them to cover a broad range of transactions that are or become common in financial markets. One of the more important changes . . . is contained in the definition of "swap agreement." In its new form, essentially all derivatives have become "swap agreements;" all parties to them, and all transfers under or in connection with them, enjoy the Code's protections. For derivatives, at least, the Act now offers *financial market protection*, a significant departure from the old paradigm of protection for particular parties.

Id. at 648.

[83] *Id*. at 652-53.

> These amendments do much more than simply expand the list of protected swaps. They expand it to include virtually *every contract traded* in derivatives markets, including particular contracts—options, forwards, and certain futures—that are given more limited protection elsewhere in the Code. It is difficult to imagine a derivative that would not be encompassed by section 101(53B). Equally

The Act treats derivatives differently—and better—than almost all other types of contracts. Parties that deal in derivatives were singled out by Congress for special treatment unavailable to other parties with contracts with bankrupt debtors:

> Derivatives are essentially outside of this system. Termination of a derivative is exempt from the automatic stay. *Ipso facto* clauses are enforceable in the derivative context. And termination of derivative contracts is expressly exempt from latter [sic] attack as either a constructive fraudulent transfer or preference. Likewise, collateral provided as part of a derivative transaction may be foreclosed upon without concern that doing so violates the Bankruptcy Code.[84]

Derivatives have, to a large extent, been placed beyond the reach of a bankruptcy judge's scrutiny. While other contracting parties must seek judicial approval for their actions, the non-debtor parties to derivative contracts may act without regard to the court. By exempting any transaction that is a "swap agreement" from the reach of normal Bankruptcy operations, the Act exempts the entire derivatives market:

> The 2005 amendments to the Bankruptcy Code enhanced this special treatment by adding new section 561 that specifically preserves the contractual right to terminate, liquidate, accelerate or offset under a "master netting agreement" and across a broad range of derivative contracts. . . . Indeed, it seems that

---

> important, these amendments also extend the Code's protections *to every counterparty* to a derivatives contract because the definition of "swap participant" remains unchanged. It continues to encompass *any* entity that "at any time before the filing of the petition, has an outstanding swap agreement with the debtor." As a result, the amendments to "swap agreement," move the Code from protecting particular parties (to forwards and commodity contracts) to protecting entire derivatives markets.

Id. at 651.

[84] Stephen J. Lubben, *Derivatives and Bankruptcy: The Flawed Case for Special Treatment*, SSRN, at 10 (2009).

> every derivative instrument qualifies as a "swap agreement" under the new amendments. Given that virtually every conceivable derivative transaction is now exempt from the automatic stay and the debtor's power to assume and reject, this seems like overkill, but plainly the industry wanted to make it very clear that the bankruptcy court could not interfere with the normal, non-bankruptcy operations of the derivatives markets.[85]

So how does this benefit derivatives contracts, and how does this relate to the discussion of specific relief? As a general matter, the bankrupt debtor enjoys the powerful right to reject or assume contracts. If a contract is rejected, under section 365 of the Bankruptcy Code, the non-bankrupt party is generally left with an unsecured claim for damages resulting from the rejection.[86] In other words, the debtor has the option of rejecting a contract and leaving the counter-party with a claim for damages. This gives the debtor party the ability to maximize the net present value of all of its contractual obligations:

> Section 365 of the Bankruptcy Code can be then seen as an extension of the classic concept of expectation damages and the more recent understandings of the option to breach. Upon entering bankruptcy a debtor-firm examines its contracts and decides which ones have a negative net present value. The debtor breaches these contracts, by rejecting them under section 365, and assumes contracts that are valuable.[87]

This is generally true for contracts with a bankrupt debtor, with the exception of derivatives contracts. The non-debtor counter-party to a derivatives contract is protected from being left with a relatively worthless claim for damages. Under the Bankruptcy Code, such parties enjoy the right to specific relief:

---

[85] *Id.* at 10-11.
[86] *See* 11 U.S.C. § 365(g).
[87] Lubben, *supra* note 84, at 15. This claim for damages is, of course, paid with bankruptcy dollars, which will typically result in a distribution of a small fraction of the total, allowed amount of the claim.

> This cherrypicking power comes to an end, however, when the underlying contracts are derivatives contracts. Thanks to an exception from the automatic stay, derivatives counterparties typically may terminate ongoing contracts when a debtor enters bankruptcy. Moreover, if a counterparty has entered multiple derivatives contracts with the debtor, the counterparty can set-off in-the-money contracts against out-of-the-money contracts. (The process of terminating and setting-off contracts is often termed "close-out netting.") Finally, if a debtor posted margin or other collateral to support its obligations under these contracts, the counterparty is free to seize it to the extent that the debtor is a net obligor to the counterparty. In other words, thanks to an exemption from the automatic stay, derivatives counterparties can *minimize* their exposure to losses arising from the insolvency of a debtor. If the debtor has posted collateral sufficient to cover its obligations, the exemptions from the automatic stay effectively *eliminate* a counterparty's exposure to loss.[88]

Because of the exemptions of derivative contracts from the Bankruptcy Code provisions that apply to contracts generally, parties to derivatives contracts are able to reduce or even eliminate virtually all exposure to losses.

A. The Stated Justifications for the Special Treatment of Derivatives

Why do derivatives and the parties who deal in them enjoy such special treatment? What is so special about derivatives that such broad exemptions from the Bankruptcy Code were deemed necessary? The derivatives dealers pushed for the special treatment of derivatives due to the asserted need to protect markets sensitive to the delay and dislocation of bankruptcy.[89] And Congress accepted this position:

> If legislative history is to be credited, Congress reasoned that special treatment of derivatives was

[88] Edwards & Morrison, *supra* note 62, at 95-96.
[89] Lubben, *supra* note 84, at 25.

> necessary to prevent the "insolvency of one commodity firm from spreading to other brokers or clearing agencies and possibly threatening the collapse of the market." It believed that: "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, then, carved derivatives out of the scope of the automatic stay in order to reduce the likelihood of systemic risk, i.e., the possibility that the insolvency of a party to a derivatives contract might expose a counterparty (such as a commercial or investment bank) and that counterparty's counterparties (other banking institutions) to financial distress, which would destabilize financial markets.[90]

The legislative history makes clear that the Congressional proponents of special treatment embraced the threat of systemic risk to justify the treatment. The Financial Netting Improvements Act of 2006 was described as a means to "amend banking, bankruptcy, and securities laws related to the disposition of financial contracts in the event of insolvency," and "to reduce the risk—especially the systemic risk associated with activities in derivatives markets—that the failure of one entity will disrupt and endanger financial markets."[91] One Congressman stated that the legislation was necessary,

---

[90] Edwards & Morrison, *supra* note 62, at 97-98.

[91] H.R. REP. NO. 109-648, pt. 1, at 2 (2006). This legislation amended, among other provisions, 11 U.S.C. § 101(53B). *Id.* at 5. As for the definition of systemic risk, one commentator observed:

> A common factor in the various definitions of systemic risk is that a trigger event, such as an economic shock or institutional failure, causes a chain of bad economic consequences—sometimes referred to as a domino effect. These consequences could include (a chain of) financial institutions and/or market failures. Less dramatically, these consequences might include (a chain of) significant losses to financial institutions or substantial financial-market price volatility. In either case, the consequences impact financial institutions, markets, or both.

Steven L. Schwarcz, *Systemic Risk*, 97 GEO. L.J. 193, 198 (2008).

> to prevent the failure of one entity from causing a domino effect of more serious disruption, known as systemic risk. Absent the adoption of these provisions with the growth in size of hedge funds and in number of hedge funds, there is considerable market uncertainty as to how a bankruptcy proceeding would affect market liquidity . . . . [T]his [legislation] will provide a safe and secure mechanism to unwind complex financial relationships, minimizing market instability, providing market liquidity and ensuring that our economic system is not adversely impacted by the demise of a hedge fund.[92]

As described by the proponents, the legislation sounds like a sensible, precautionary measure to prevent widespread financial collapse.

Another perspective might suggest a different interpretation. There could have been a hypothetically different situation where Congress gave special treatment to derivatives because it did not know how dangerous they could be. In such a situation, Congress could claim the excuse that it never would have passed such laws if it had only known the dangers. This excuse is clearly unavailable, as evidenced by the legislative history. What is therefore remarkable is that the Congressional proponents openly acknowledged the danger posed by derivatives, and then took the position that derivatives need special and favored treatment precisely because they are so dangerous.[93] In hindsight, these statements of support have a Dr.

---

[92] 152 Cong. Rec. H8651 (2006) (statement of Rep. Baker). Other representatives echoed this position as well. *See, e.g.*, 152 Cong. Rec. H7601 (2006) (statement of Rep. Wasserman Schultz).

[93] The danger of derivatives was discussed by Warren Buffett, considered by many to be the greatest investor of all time. Earlier this decade, Buffett offered his view that derivatives are "time bombs, both for the parties that deal in them and the economic system." BERKSHIRE HATHAWAY INC., 2002 ANNUAL REPORT 13 (2003). He went on to add that "derivatives are financial weapons of mass destruction, carrying dangers that, while now latent, are potentially lethal." *Id*. at 15.

Interestingly enough, the Bankruptcy Code does address in one section the treatment of more commonly acknowledged forms of weapons of mass destruction. See 11 U.S.C. § 362(b)(4), which states that the automatic stay does not apply to exercises of authority under the Convention on the Prohibition of the Development, Production, Stockpiling

Strangelove-type of feel to them. There was no effort to downplay or mask the dangers of derivatives. Congressional representatives were willing to go on record to say that these things are so dangerous as to have the potential for blowing up the world, and that they should be treated differently and better than other types of contracts. If nothing else, this level of support is strong evidence of the political influence exerted by the financial industry. What is also remarkable is the absence of a forceful, countervailing view. If derivatives are so dangerous, where was the legislation to tightly regulate or even ban them?[94] It defies common sense to suggest that anything so dangerous as to pose the threat of systemic risk and global collapse should receive favorable treatment and little regulatory oversight.[95] Yet, that is exactly what happened.[96]

---

and Use of Chemical Weapons and on Their Destruction. Further on in § 362(b), subparagraphs (6), (7) and (27) state that the automatic stay does not apply to derivatives. The obvious difference in treatment, however, is that (b)(4) is designed to combat the use of chemical weapons, while (b)(6), (7) and (27) are designed to encourage the use of derivatives.

[94] The calls for tighter restrictions, and even outright bans, have emerged since the collapse. For example, George Soros, a billionaire hedge fund manager, has called for tighter regulation of credit default swaps and a ban on certain types of such swaps. George Soros, *One Way to Stop Bear Raids*, WALL ST. J., Mar. 24, 2009, at A17.

[95] Intertwined with the notion of systemic risk is the phenomenon of “too big to fail.” This is the notion that some financial institutions are too big, too important to fail. Such institutions are linked to most, if not all, major financial institutions, and their collapse would trigger the collapse of every other institution. These were the institutions that received government bailouts in the depths of the crisis in 2008. Eric Dash, *If It’s Too Big to Fail, Is it Too Big to Exist?*, N.Y. TIMES, June 20, 2009, at WK.

The title of the just cited article seems like a reasonable, if not obvious, question to ask regarding the institutions deemed too big to fail. Yet, it appears that such a question was never considered by Congress as it enacted legislation to favor the elite financial institutions. Congress knew it was conferring special treatment on financial institutions and their derivative products even though they posed the risk of triggering global collapse. In a different reality, Congress might have acted in the following, alternative manner:

> An alternate approach is to deal with the problem before crises emerge. On a routine basis, regulators could review the largest and most connected firms in each industry, and ask themselves essentially the same question that crisis situations already force them to answer: ‘Would the

B. Does the Special Treatment of Derivatives Actually Reduce Systemic Risk?

The stated (or pretextual) reason for special treatment of derivatives is the need to avoid systemic risk. Yet, it is far from clear whether the special treatment accomplishes that goal. Notable

---

> sudden failure of this company generate intolerable knock-on effects for the wider economy?' If the answer is 'yes,' the firm could be required to downsize, or shed business lines in an orderly manner until regulators are satisfied that it no longer poses a serious systemic risk. Correspondingly, proposed mergers and acquisitions could be reviewed for their potential to create an entity that could not then be permitted to fail.

Duncan Watts, *Too Complex to Exist*, BOSTON GLOBE, June 14, 2009, http://www.boston.com/bostonglobe/ideas/articles/2009/06/14/too_complex_to_exist.

[96] Congress enacted other major legislation, as well, to remove regulatory restrictions on derivatives. Until December 2000, many experts held the opinion that credit default swaps were securities under the Securities Act and the Exchange Act. William K. Sjostrom, *The AIG Bailout*, 66 WASH. & LEE L. REV. (forthcoming 2009) (manuscript at 1, 37, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1346552). The enactment of the Commodity Futures Modernization Act ("CFMA") in December 2000 unleashed the CDS market from any regulatory oversight or restraint. *See* Commodity Futures Modernization Act of 2000, Pub. L. No. 106-554, 114 Stat. 2763 (2000). The CFMA contains several provisions that were specifically designed to remove restrictions on credit default swaps. For starters, it amended the definition of "security" in the Securities Act and the Exchange Act to exclude "any security-based swap agreement." 15 U.S.C. §§ 77b-1(b)(1), 78c-1(b)(1) (2006). Among the excluded swap agreements are credit default swaps. *See* 15 U.S.C. § 78c-1. One of New York's top regulators told Congress:

> The [CFMA], signed by President Clinton on December 21, 2000, created a 'safe harbor' [for credit default swaps] by (1) preempting state and local gaming and bucket shop laws except for general antifraud provisions, and (2) exempting certain derivative transactions on commodities and swap agreements, including credit default swaps, from CFTC regulation.

Hearing to Review the Role of Credit Derivatives in the U.S. Economy: Hearing Before the H. Comm. on Agriculture, 110th Cong. 4 (2008) (statement of Eric Dinallo, Superintendent, New York State Insurance Department).

commentators have questioned this justification. Professors Partnoy and Skeel have offered their view: "It is far from clear that the [special treatment of derivatives] reduces systemic risk; it may even increase this risk because it eliminates a possible curb on counter-parties' rush to close out their contracts in the event of a wave of failures."[97] Professors Edwards and Morrison share this deep skepticism:

> While Congress' concern with systemic risk is understandable, its decision to address it through the Bankruptcy Code is deeply puzzling. At the very least, the language of the Code encompasses far too many transactions. Fear of systemic risk is warranted only in cases involving the insolvency of a major financial market participant, with whom other firms have entered derivatives contracts of massive value and volume. Yet the Code offers special treatment to derivatives no matter how large or small the counterparty. Thus, Congress' stated justification for the special treatment is incomplete, as it applies only to a fraction of all firms that enter into derivatives contracts.
>
> At the same time, the Code's special treatment of derivatives contracts seems far too narrow. Fear of systemic risk justifies special treatment of a broad range of financial market transactions and participants, especially commercial banks. Indeed, fear of systemic risk originated in the banking sector, yet a bank cannot seize collateral whenever a debtor firm enters bankruptcy. Surely the risks that (apparently) motivated Congress' concern with derivatives are equally present when Enron, WorldCom, or United Airlines enters bankruptcy and, say, Chase Manhattan cannot collect its collateral (if it is a secured creditor) or expects only a few cents on the dollar (if it is unsecured) when the case concludes several years later. Yet nothing in the Code allows Chase to collect its collateral; nothing in the Code

---

[97] Partnoy & Skeel, *supra* note 68, at 1049. In challenging the special treatment of derivatives, Partnoy and Skeel argue, among other things, that counter-parties should not be permitted to invoke *ipso facto* clauses. *Id*. at 1050.

> gives Chase or any other bank priority in payment when the case concludes. If systemic risk arises from transactions other than derivatives contracts, as it undoubtedly does, the Code's singular focus on derivatives contracts is puzzling.[98]

Edwards and Morrison conclude their analysis with this observation:

> The real lesson . . . is that the systemic risk rationale for exempting derivatives contracts does not make much sense. A Bankruptcy Code exemption for derivatives offers little help in alleviating the potential systemic risk associated with the insolvency of a large derivatives counterparty . . . and may even exacerbate or create a systemic risk.[99]

If there is such doubt as to whether the special treatment of derivatives actually achieves Congress' stated goal to reduce systemic risk, then why was this treatment extended? Congress may simply disagree with the doubters, or, perhaps, Congress was misguided as to the effects of the legislation. Another possibility is that avoidance of systemic risk (while a legitimate concern) was a pretext for larger motives and justifications.

VIII. The Protection of Status and Wealth Through Specific Relief

The common feature between feudal land contracts and financial derivatives is that specific relief is thought necessary to protect the parties. But, going back to the original question, is this mere coincidence or do they share something in common that creates the asserted need for specific relief? In order to determine the answer, can one simply rely on the stated reasons (land is unique, and systemic risk must be avoided), or is there a need to look for an explanation elsewhere? One commentator described the need to look beyond the immediately apparent:

> Perhaps courts have failed to articulate the considerations that enlighten the choice between equitable and damage remedies because, as the reader has learned, it is a difficult, if not impossible

---

[98] Edwards & Morrison, *supra* note 62, at 98-99.
[99] *Id*. at 106.

> task. A series of shadowy and overlapping economic, moral and administrative criteria compete for attention. In a vital society, certainty and definiteness are illusory. In fashioning rules for a particular controversy or for a healthy future, policymakers may conclude that in certain instances, specific relief will vindicate an important interest better than damages. Some interests worth recognizing are speculative and conjectural, and are too difficult to valuate. Some interests may be both noneconomic and impalpable, while others are simply too important to be valued only in money. The remedy, however, often fails to comport with the substance of the interest.[100]

The key point is that specific relief is granted in order to promote policies that are not necessarily acknowledged in the expressed reasons justifying the relief.[101]

In searching for other possible reasons for specific relief, a helpful starting point is to return to the principle that specific relief is viewed as necessary when money damages are inadequate. This raises the question: Why are money damages inadequate for the contract at issue? For feudal land contracts, the answer is more evident. The land itself defined the relationship between the lord and the feudatory, with all of the attendant benefits and duties. Additionally, before the rise of industry and commerce, land was wealth (including the rents from land). There appears to have been no substitute for land's wealth and rent generation. More importantly, there was no market mechanism to put a monetary value on the status conferred by land. This is the situation that gave rise to the familiar maxim that specific performance is available when money damages are inadequate, and, of course, damages are inadequate when the loss cannot be estimated with sufficient certainty.[102] In pre-industrial England, what else existed that could rival the rent-generating nature of land and the status it conferred?[103]

---

[100] Rendleman, *supra* note 19, at 358.
[101] Laycock, *supra* note 6, at 726-27.
[102] FARNSWORTH, CONTRACTS, *supra* note 7, § 12.6, at 746-47.
[103] The protection of land contracts in feudal England also reflects the reality that law is, at its foundation, a conservative system. It is conservative in the sense that the law tends to protect the status quo, and hesitates to

Implicit in this discussion of contract remedies for land in pre-industrial England is the need to examine the relationship of the contract to the market. A general summary of the law would be that damages are available when there is a market from which valuation of damages may be ascertained, and that specific relief is necessary when there is no such market. From an economist's viewpoint, every economic good has substitutes, and the market provides a means to determine those substitutes.[104] By declaring the "uniqueness" of some contracts, the law is acknowledging the absence of a market to conduct a valuation of the contractual loss. Another and compatible reason is that specific relief is used to shelter some contracts from the forces of the market. Why are some contracts deemed to be so special as to be immune from market forces? The answer lies in considering the antithesis to market forces—status.

In its purest sense, status is a relationship, or web of relationships, based on immutable characteristics.[105] An example would be blood ties within a family or tribe.[106] Status is then further refined through more particularized immutable characteristics, such as age or gender, and such status commonly formed the basis of, and

---

upset the existing order. This makes sense. Law is made by those with power, legal systems are administered by elites, and it is in their interest to preserve their privileged situation, not overturn it. Specific relief serves this purpose because it prevents harm from occurring in the first place, as opposed to damages, which attempt to provide a remedy after the harm has occurred. *See* Laycock, *supra* note 6, at 689.

[104] Kronman, *supra* note 3, at 359.

[105] This view of the status of status is derived from the discussion of status in HENRY SUMNER MAINE, ANCIENT LAW 168-70 (Transaction Publishers 2002) (1861). This view is consistent with the writings of contemporary scholars. As observed by Professor Carriere: Status refers "to attributes 'inherent in the person,' over which 'private individuals have no power . . . . They cannot alter or dispose of such attributes by agreements, at their pleasure, as they can do with their property.'" Jeanne Louise Carriere, *From Status to Person in Book I, Title I of the Civil Code*, 73 TUL. L. REV. 1263, 1270 (1998) (quoting 1 PLANIOL & RIPERT, TREATISE ON THE CIVIL LAW (La. L. Inst. trans., 12th ed. 1959)). Similarly, a leading treatise stated that status is used with reference to "those comparatively few classes of persons in the community who, by reason of their conspicuous differences from normal persons, and the fact that by no decision of their own can they get rid of these differences, require separate consideration in an account of the law." EDWARD JENKS, THE BOOK OF ENGLISH LAW 109 (P.B. Fairest ed., 6th ed. 1967).

[106] MAINE, *supra* note 105.

determined, legal and social positions within a society. This explains why many ancient societies were led by male elders. The inherent nature of status meant that status could not be purchased. One cannot purchase age or a blood relationship. Thus, a system based on status is the antithesis of a system based on the market. Because status is not purchased on the market, there is only a limited role for contracts in a status system. Contracts are the mechanism by which market transactions are effected. If something cannot be the subject of a market transaction, there is no need for contract.

These observations have interesting implications for the discussion concerning land contracts and derivatives. Specific relief may be necessary because there is no market to determine the value of the subject of the breached contract. Because there was no market for the status based on land in feudal times, it is understandable why specific performance was viewed as the appropriate remedy. But even if a market determination is available, policymakers may decide that the contract should not be subject to market forces. Thus, specific relief may be used to remove the determination of contract losses from the test of the market. To the extent specific relief is used in this manner, it means that the type of contract at issue is removed from a judicial determination of value.

This is the treatment now accorded to derivatives contracts, as shown in *In re National Gas Distributors*.[107] One conclusion from

---

[107] 556 F.3d 247 (4th Cir. 2009). National Gas Distributors, LLC (the debtor) was a distributor of natural gas, which entered into contracts with certain customers under which it was obligated to supply natural gas at a fixed price. *Id.* at 250-51. The purpose of the contracts was to protect the customers from price fluctuations. *Id.* at 251. The bankruptcy trustee commenced adversary proceedings to avoid the contracts, arguing that the contracts were fraudulent conveyances because the contracts were made for less than market value. *Id.* The customers moved to dismiss, arguing that the contracts were "swap agreements," a type of derivatives contract, and that they therefore had a complete defense under the Bankruptcy Code *Id.* at 250; *see also* 11 U.S.C. §§ 546(g), 548(c), 548(d)(2)(D) (2006). The bankruptcy judge ruled in favor of the trustee. *In re* National Gas Distributors, 556 F.3d at 250. He ruled that the contracts were simply contracts to purchase a commodity, and not a swap agreement because they were insufficiently related to the financial markets. *Id.* at 260-61.

The resolution of the issue depended on whether the contracts were "commodity forward agreements" because 11 U.S.C. § 101(53B) defines "swap agreement" to include commodity forward agreements. *Id.* at 257. The bankruptcy judge ruled that the contracts did not fall within that this case is that form prevails over substance when derivatives are involved. If a party to a contract calls it a derivative, then it is a derivative, and any attempt by a seasoned bankruptcy judge to determine the true substance of the contract will be severely limited. Thus, the statutory treatment of derivatives sharply curtails any judicial role regarding the operation of the contract. There is only an extremely limited role for the court to determine or value loss. Third party scrutiny of the contract is virtually eliminated. The ruling in *National Gas* demonstrates that the financial industry obtained the legislation (and the judicial outcomes) it wanted.

By saying that some contracts are not appropriate for market-based scrutiny, the law is in a sense elevating such contracts to the level of status. Another way to put it is that the proponents of such treatment seek to remove their contracts from a market determination of value. This explains why contracts for land, the embodiment of status in pre-industrial England, were protected by specific relief. The loss of land could not be determined by the market. In that society, as constructed, there was no market mechanism to value land

---

category because "'commodity forward agreements' must be 'regularly the subject of trading' in financial markets and must be settled by financial exchanges of differences in commodity prices, whereas the contracts in this case were directly negotiated between the seller and purchaser and contemplated physical delivery of the commodity to the purchasers." *Id.* 251-52.

The Fourth Circuit reversed on the ground that the lower court's interpretation of "commodity forward agreement" was too narrow, and remanded the matter for further determination as to whether the contracts fell within that category. In so ruling, the appellate court observed:

> Indeed, [Congress'] repetitive generalized comments about protecting financial markets from the instability that bankruptcy proceedings might cause and the potpourri of agreements included in the term "swap agreement" barely distinguish any major commercial contract from a swap agreement.
>
> Moreover, the policies informing these provisions of the Bankruptcy Code are often in tension. Even though an overarching policy of the Bankruptcy Code is to provide equal distribution among creditors (citation omitted) in enacting 11 U.S.C. §§ 546(g) and 548(d)(2)(D), Congress intended to serve a countervailing policy of protecting financial markets and therefore favoring an entire class of instruments and participants.

Id. at 258.

and its related status. The purest form of status is something that does not have a market price, and land was the tangible expression of that form.[108] Thus, specific relief was the only available means to address a breach of contract.

The situation for derivatives is obviously different, and yet, the role of status plays a key role. The treatment of derivatives in bankruptcy may be viewed in two ways. First, because the non-debtor parties are able to "net-out" their derivatives, it may be said that derivatives are largely protected from the market mechanism of valuing the loss. Derivatives dealers successfully sought to avoid this valuation because holding an unsecured claim for damages does not come close to recovering the full amount of the loss. An alternative and polar way to view it is to say that, in the event of bankruptcy, the market mechanism for compensating the loss has failed. All that is left for the non-debtor party is a dysfunctional market that is only capable of paying compensation in relatively worthless bankruptcy dollars. In this situation, the derivatives dealers can claim that the market mechanism is inadequate for valuing their loss, and that specific relief is necessary.[109] Either way, the derivatives dealers are no longer subject to a market determination of their loss. Their contracts are treated as if they occupy a position of status such that they should be protected from market forces. What they have managed to accomplish is the treatment of their contracts as if they are on the same plane as feudal land contracts. This has created a genuinely privileged position. This is not some mere symbolic benefit. This results in an actual transfer of wealth to the financial elite:

> The Code reduces the transaction costs of hedging risk by placing derivatives counterparties ahead of other creditors in bankruptcy proceedings. Counter-parties are free to cancel executory contracts and seize collateral while other contractual partners are

[108] Because true status is viewed as something that cannot be purchased, the pre-existing elite of any given era has always been appalled at the ability of the nouveaux riches to buy the trappings or badges of status. But then, the nouveaux riches eventually become the prevailing elite, and they in turn become appalled by the next wave of arrivistes who mimic their status. This replacement of elites by new waves of elites is an underlying theme of this paper.

[109] Of course, every non-debtor contracting party may make the same argument, but only the derivatives players have the law on their side.

> vulnerable to cherry-picking and other secured creditors must bear some of the costs of the bankruptcy proceedings (including delay in accessing collateral). *The Code, then, redistributes wealth from ordinary creditors to derivatives counterparties*.[110]

The role of status in society is obviously weaker today than it was 500 years ago in that immutable characteristics (as a general rule) no longer determine social and legal position, and the elite of the landed nobility has been replaced by successive waves of new elite groups. A common thread, however, is the protection and preservation of status (or the creation of status-like position) through specific relief. Pure status, which cannot be altered through the market or by contract, is the antithesis of a relationship that may be altered through contract. Henry Maine described this process in the development of societies as a progress from status to contract.[111] As societies modernized, people were allowed greater freedom to change their relationships with one another through mutual consent and the exercise of individual autonomy.[112] Thus, relationships were no longer rigidly determined by immutable characteristics. Relationships once based on status became mutable through contract.

---

[110] Edwards & Morrison, *supra* note 62, at 118 (emphasis added).

[111] MAINE, *supra* note 105.

[112] This may explain why personal service contracts are not enforceable through specific performance. Courts do not want to impose an order creating a situation that resembles involuntary servitude. FARNSWORTH, CONTRACTS, *supra* note 7, § 12.7, at 755. Involuntary servitude or slavery, in its most extreme form, is a status relationship. Slaves did not become slaves through the exercise of individual autonomy, and they were usually unable to contract their way out of slavery. Thus, the law of contracts does not want to impose a remedy that is the antithesis of contract. Because the law of contracts is about the exercise of individual autonomy, individuals should be able to choose between honoring their contracts and breaching their contracts (subject to a damages remedy). They should not have a status imposed on them because of a contract. This explains why personal services contracts are not specifically enforced.

This is more than an idle observation, because the irony surrounding the treatment of financial derivatives is that those who have attained their exalted position through contract are attempting to preserve their position through an imposition of status barriers, which prevent contracts-based challenges to their position.

Most would hail this progress as a welcome development. However, change produces winners and losers, and this type of progress produced an obvious set of losers. The rise of commerce and industry meant the end of social dominance by the landed aristocracy, who could not keep up with the accumulation of wealth by the new elite of the industrial age.[113] Today, the dominance of industrial fortunes has been eclipsed by the dominance of the new wealth generated by the new elite in finance.

The rise of each new wave of successive elites was made possible by the weakening of status as the determinant of social position. What is ironic, however, is that each new set of elites seeks to impose new status restrictions in order to keep outsiders from breaching their privileged positions.[114] The new elites maintain their defense of their exalted position until the defense is breached by the newest wave of elites, who then (like their predecessors) attempt to resurrect status barriers to new challengers.

The modern barriers, however, are not the pure form of status—status based on immutable characteristics. They cannot be the pure form because the new elite group attained its position in a

---

[113] It may be an overstatement that the pre-existing elite loses its exalted role. An alternative view may be that the old elite absorbs or co-opts the new elite, which eagerly embraces the approval and trappings of the old elite. This would explain the penchant of new money to mimic the lifestyle of a bygone landed aristocracy through dress, manner and consumer consumption.

[114] And what happens to those groups who do not attain such elite status? An interesting comparison to the special treatment of the financial industry and their derivatives is the treatment of collective bargaining agreements under the Bankruptcy Code. Section 1113 of the Bankruptcy Code explicitly provides for the right of the debtor to reject a collective bargaining agreement. 11 U.S.C. § 1113 (2006). This provides a stark example of the respective roles of finance and labor in our society.

In a different type of society, Congressional representatives would propose legislation prohibiting the rejection of collective bargaining agreements in bankruptcy. They would cite the need to protect the rights of labor, and might even raise the possibility of systemic risk due to labor unrest in the event of rejected agreements.

This article does not assert that such a world would be more desirable than the actual one where financial interests are favored. The point of this hypothetical illustration is to show that there is nothing inherent in social forces that made the favorable treatment of derivatives an inevitable outcome. Alternative outcomes are hypothetically available. Our society chose the outcome in favor of finance.

world based on contract, not status. The new elite arrived in their position because individuals are permitted to alter their social position through market mechanisms. This is particularly true for the financial elite, whose entire claim to position is based on free market ideology. Thus, they cannot claim their position on the basis of an immutable quality, such as direct descent from a sun god. They must, instead, rely on diluted forms of status, which carry the impression that the status may not be purchased.[115] One form of such status would be the kind erected by political power or protection—the ability to create, preserve and protect status through political means:

> The great consolidations of banking and investment banking into financial mega-players has proliferated armies of mega-income executives. Besides driving cash income shares toward the top of the payroll

---

[115] Modern day examples would include the hiring practices of elite financial institutions and law firms to concentrate their recruitment on those with "prestigious" educational qualifications. Thus, a degree from an elite institution is a form of diluted status (except for legacy admits who may represent a pure form of status based on birthright). Those who possess such degrees like to believe that they cannot be purchased, but are rather a badge of innate qualities. Whether that is true, or whether such institutions are simply mechanisms to perpetuate already existing class and status hierarchies is an open question.

By definition, any exclusive group is one that is closed to outsiders—those deemed not up to snuff by the group's members. The irony that is apparently lost on newly-arrived exclusive groups (with the exception of archaic holdovers such as European nobility or Mayflower descendants, which is not to suggest that they are or are not able to appreciate irony) is that privileged positions in contemporary society are attainable because contract, not status, permits social mobility. Yet, once a privileged group attains a desired position, it then resorts to newly-invented forms of status (at least, diluted forms) to ensure that others may not resort to contract to join the privileged group. This type of behavior was observed by one financial reporter:

> When bankers talk about derivatives, they delight in swathing the concept in complex jargon. That complexity makes the world of derivatives opaque, which serves bankers' interests just fine. Opacity reduces scrutiny and confers power on the few with the ability to pierce the veil. But though derivatives have indeed become horribly complex, in actuality, they are as old as the idea of finance itself.

TETT, *supra* note 71, at 9.

> pyramid, it has greatly enhanced the political clout of Wall Street—as evidenced by steady cuts in taxes on capital gains and dividends and the persistence of absurd tax advantages for private equity funds.[116]

The powerful lobby continues its efforts to block legislative measures to impose additional regulation because additional regulation means smaller profits.[117] More significantly, this political clout has been used to carve out protection from the workings of a free market:

> The reason for the permanent advantage of financial services is that they don't really compete in free markets. They earn high profits because they take big risks, as evidenced by their very high degree of leverage compared to other industries. In truly free markets, however, periods of high risks and high profits are offset by periods of large losses. But in financial services, although the high profits accrue to managers and shareholders, their losses are usually partly socialized.[118]

This is the classic "heads I win, tails you lose" situation. During the boom years, financial firms, and many individuals within them, enjoyed mind-boggling profits and compensation. When the bust occurred, the profits and compensation were not returned. Instead of exclusively bearing the losses (like the exclusive enjoyment of the rewards), the losses of the financial industry were socialized in that the federal government, and the American taxpayer had to step in to bail out the collapsed firms.[119]

---

[116] MORRIS, *supra* note 42, at 155.

[117] *See* Gretchen Morgenson & Don Van Natta, Jr., *In Crisis, Banks Dig In for Fight Against Rules*, N.Y. TIMES, May 31, 2009, at A1.

[118] MORRIS, *supra* note 42, at 153.

[119] According to some estimates, the cost of the bailout to the taxpayer is over $23 trillion. Ronald D. Oral, *Bank Rescue Could Cost $23.7 Trillion, Says Bailout Overseer*, MARKETWATCH, July 20, 2009, http://www.marketwatch.com/story/us-financial-rescue-tab-pegged-at-24-trillion. Now, the elite financial institutions have returned to paying record compensation. As of July 2009, they are set to pay as much as, or even more than, the amounts they paid before the economic collapse in 2008. Tomoeh Murakami Tse, *Wall Street Jacks Up Pay After Bailouts*, CAPITAL TIMES, July 23, 2009, http://www.madison.com/tct/news/stories/459370. Thus, the losses are borne by the taxpaying public, while the rewards are enjoyed by

IX. Conclusion

The economic collapse has created shock waves of losses around the world. Yet, the elite financial interests seem to have emerged stronger than ever, while most everyone else is left to pick up the pieces.[120] Attempts at reform are being considered in

---

an elite few, and the good times have returned for those fortunate few. "Investment banks, of all things, are making serious money again, thanks in part to government aid. Ironically, they are benefiting from the crisis they helped to create. As profits go up, so do salaries—only this time, it's the taxpayers who are shouldering the risks." Frank Hornig, Christoph Pauly & Wolfgang Reuter, *Banks Reopen Global Casino*, DER SPIEGEL, July 28, 2009, http://www.spiegel.de/international/business/0,1518,638732,00.html.

New York's Attorney General investigated the compensation practices of the leading financial institutions and concluded in a July 2009 report: "Thus, when the banks did well, their employees were paid well. When the banks did poorly, their employees were paid well. And when the banks did very poorly, they were bailed out by taxpayers and their employees were still paid well." Andrew M. Cuomo, *No Rhyme or Reason: The 'Heads I Win, Tails You Lose' Bank Bonus Culture*, http://www.oag.state.ny.us/media_center/2009/july/pdfs/Bonus%20Report%20Final%207.30.09.pdf. In light of the fact that exorbitant bonuses were paid after the government bailout of the banks, Mr. Cuomo reportedly asked: "If the bank lost money, where do you get the money to pay the bonus?" Louise Story & Eric Dash, *Bankers Reaped Lavish Bonuses During Bailouts*, N.Y. TIMES, July 30, 2009, at A1. An example of this phenomenon is the controversy surrounding the payment of a $100 million bonus to one trader employed by Citigroup, which received $45 billion in taxpayer aid. David Segal, *$100 Million Payday Poses Problem for Pay Czar*, N.Y. TIMES, Aug. 1, 2009, at A1.

The further irony regarding this socialization of losses is that the derivatives players succeeded in exempting themselves from the collective mechanism of the Bankruptcy Code. Thus, where the law imposes a collective remedy, the derivatives players carved out an exemption for themselves because acting collectively did not benefit them and they stood to gain from individualized, special treatment. On the other hand, when it comes to losses in the market (which are usually borne individually), they managed to spread the losses away from themselves.

This is also an example of moral hazard, because the lesson to be drawn is that those who engage in risky and destructive behavior will not bear the consequences of their actions. This will only encourage more behavior of this kind.

[120] Professor Partnoy believes this is a recurring story: "I believe derivatives are the most recent example of a basic theme in the history of finance: Wall

Congress. Yet, it is clear that lawmakers are too late. Where were these attempts and concerns in 2006, or any other time?[121] Seemingly laudable reasons were presented to justify the special treatment of derivatives, but perhaps the special treatment was conferred just because some players' money is indeed more important than others. A debtor in a large bankruptcy case may have thousands of contractual counter-parties. Yet, a special few, the derivatives players, are treated in a way that runs counter to the fundamental policies of the Bankruptcy Code.

Moreover, there is an element of a "seat of the pants" and a rushed *ad hoc* approach to reform. Lawmakers are attempting to fix the problem after the fact without a full understanding of how the problem came into existence in the first place. The purpose of this article is to suggest that the existence of broader and unrecognized factors in the treatment of derivatives and the financial sector. If one accepts the view that status and the creation or preservation of status play a role in why derivatives are accorded such special treatment, then recognition of this possibility might lead policymakers to think about the real reasons why certain parties want or deserve special treatment (although it is undoubtedly naïve to believe that reasoned discourse can counterbalance waves of lobbying and campaign contribution money). The point is that it seems most people, at least in America, would agree that status should not conclusively determine social position or privilege. Indeed, this concept is enshrined in the Constitution.[122] The next time another group argues that they are entitled to specific treatment (in this instance, in the form of specific relief) when others are not, policymakers might be guided by considering the role of status, and whether that is a desirable policy to pursue.

Street bilks Main Street. Since the introduction of money thousands of years ago, financial intermediaries with more information have been taking advantage of lenders and borrowers with less." PARTNOY, *supra* note 1, at 269.

[121] Instead of reining in the danger, Congress elevated the derivatives dealers to a position ahead of everyone else. This observation is not unique to this article. "A cynic might argue that the financial safe harbors are indeed a 'bankruptcy opt-out clause' for a certain class of capitalists because their money is more important than everyone else's." Campbell, *supra* note 81, at 712.

[122] *See*, *e.g.*, U.S. CONST. art. I, § 9, cl. 8 (prohibiting the granting of titles of nobility).