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Bankruptcy or Bailouts?


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Bankruptcy or Bailouts?

Kenneth Ayotte & David A. Skeel, Jr.*

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I. INTRODUCTION

The onset of the current financial crisis brought with it an unprecedented intervention in financial markets by the Federal Reserve and the United States Treasury. Starting with the bailout of Bear Stearns in early 2008, these governmental bodies and

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their leaders were prominently involved in the negotiations and the ultimate resolution of each major non-bank financial institution that encountered financial distress. The government arranged outcomes on an ad-hoc basis, with varying degrees of taxpayer support. In the Bear Stearns case, taxpayer funds facilitated a merger. In the AIG case, the Federal Reserve made a substantial direct loan to the company. With Lehman Brothers, the government declined to offer any money, and the company ultimately filed for Chapter 11 bankruptcy.

Although it was hard to distill a consistent policy rule from the government's rescue efforts, one guiding principle was its preference to avoid all possible bankruptcy filings because of the supposedly severe consequences that would follow. Federal Reserve Chairman Ben Bernanke acknowledged this policy in a rare public interview on *60 Minutes*:

There were many people who said, "Let 'em fail." You know, "It's not a problem. The markets will take care of it." And I think I knew better than that. And Lehman proved that you cannot let a large internationally active firm fail in the middle of a financial crisis.¹

Treasury Secretary Timothy Geithner echoed these sentiments in defending the rescue loan to AIG:

We were caught between these terrible choices of letting Lehman fail—and you saw the catastrophic damage that caused to the financial system—or coming in and putting huge amounts of taxpayer dollars at risk, like we did at AIG, to keep the thing going, unwind it slowly at less damage to the ultimate economy and taxpayer.²

This point of view has become the conventional wisdom, which now points to the Lehman bankruptcy as the singular, defining moment of the financial crisis. The government's decision to allow Lehman to file for bankruptcy, instead of providing a government rescue, was, in the standard account, the primary cause of the severe economic and financial contraction that followed.³

Critics emphasize two different shortcomings of bankruptcy, often without distinguishing between them. The first focuses on the effect of bankruptcy on the value of the distressed firm itself. Bankruptcy, the reasoning goes, would severely dissipate the value of the firm's assets. We will refer to this first set of concerns as the *firm-specific risks* of a bankruptcy filing. The other rationale highlights the negative repercussions of a

1. Interview by Scott Pelley with Ben Bernanke, Federal Reserve Chairman, on *60 Minutes* (CBS television broadcast Mar. 15, 2009), available at <http://www.cbsnews.com/stories/2009/03/12/60minutes/main4862191.shtml>.

2. Interview by George Stephanopoulos with Timothy Geithner, United States Treasury Secretary, on *This Week with George Stephanopoulos* (ABC television broadcast Mar. 30, 2009), available at <http://www.abcnews.go.com/ThisWeek/story?id=7200273&page=4>.

3. One example of the supposed causal link as reported in the media: "Lehman's collapse was a decisive moment in the 13-month-old credit crisis. The government's decision not to bail out the firm set off a near panic among investors and lenders world-wide, forcing the U.S. to push through a historic rescue plan for the financial system." Carrick Mollenkamp, Susanne Craig, Jeffrey McCracken & Jon Hilsenrath, *The Two Faces of Lehman's Fall—Private Talks of Raising Capital Belied Firm's Public Optimism*, WALL ST. J., Oct. 6, 2008, at A1.

bankruptcy filing outside the firm. A bankruptcy filing directly affects the firm's contractual counterparties, some of whom (such as lenders and derivatives counterparties) have direct claims on the firm, while others hold contracts whose value is tied to the distressed firm.⁴ A bankruptcy filing also may have broader spillover effects, such as a general effect on confidence. We will call these direct and indirect spillover effects *systemic risks*.⁵ This Article will seek to explore the widespread perception that firm-specific and systemic risks make bankruptcy untenable for financial institutions.

Our first goal is simply to assess the trade-offs between bankruptcy and the discretionary, government-orchestrated rescue system that was used instead as the financial system tottered, and which is reflected in the Obama administration's financial reform proposals. The merits and demerits of the two approaches are too often simply asserted without any serious comparison of the benefits and costs of the strategies. In this Article, we will take a much closer look. Drawing on the tools of corporate finance and applying them to key institutional features of bankruptcy, we will consider whether bankruptcy can effectively resolve the financial distress of a large nonbank financial institution. We then will subject the bailout alternative to a similarly careful stress test.⁶

Our conclusion can be simply stated: we believe that allowing the bankruptcy process to work is preferable to an ad-hoc approach of preventing bankruptcy with last-minute rescue efforts. The rescue loan approach favored in the financial crisis increased uncertainty, increased the costs of moral hazard, and dampened the incentive of private actors to resolve distress before a desperate "day of reckoning" arose. These forces created substantial costs, over and above the direct and substantial cost to the taxpayer of rescue funding. While there is also a downside to allowing distress to be resolved through Chapter 11, we believe the firm-specific risks of Chapter 11 are overstated, and are not sufficient to justify recent policy. On the firm-specific dimension, the law gives distressed firms several advantages in bankruptcy that are unavailable outside of bankruptcy. These advantages help preserve firm value, allocate control rights to residual claimants, and do a more effective job of handling moral hazard concerns than taxpayer-

4. If investor A sold protection on Lehman Brothers to another investor B in the credit default swap market, for example, neither A nor B would hold a direct claim on Lehman, but both would be affected by Lehman's bankruptcy filing (A would owe a payment to B). Credit default swaps are analyzed in detail in Frank Partnoy & David A. Skeel, Jr., *The Promise and Perils of Credit Derivatives*, 75 U. CIN. L. REV. 1019 (2007).

5. See, e.g., Steven L. Schwarcz, *Systemic Risk*, 97 GEO. L.J. 193 (2008) (outlining the nature and causes of systemic risk). Some commentators define systemic risk more narrowly by including only direct effects, treating crises of confidence as a separate phenomenon. See, e.g., George G. Kaufman & Kenneth E. Scott, *What Is Systemic Risk, and Do Bank Regulators Retard or Contribute to It?*, 7 INDEP. REV. 371 (2003). We use the broader definition, since both direct losses and confidence crises are potential third party effects of a default.

6. We confine our analysis in this Article to entities that can file for bankruptcy, which includes many financial firms and the parent companies of subsidiaries that cannot themselves file. Although we compare Chapter 11 to commercial bank-style resolution rules, see *infra* notes 116–22 and accompanying text, we do not discuss using Chapter 11 to resolve distress in government-insured commercial banks and governmental units such as Fannie Mae and Freddie Mac. We do so primarily because the underlying issues in these entities are different: because of implicit or explicit government guarantees on the claims on these entities, taxpayers are residual claimants, which creates an inherent value of government involvement in the resolution process. For recent work that confirms that the Federal Deposit Insurance Corporation is in effect the residual claimant in most insured bank failures, see Richard M. Hynes & Steven D. Walt, *Why Banks are Not Allowed in Bankruptcy* (Dec. 11, 2009) (unpublished manuscript, available at <http://www.southbaylawfirm.com/blog/upload/fdic-receiverships-why-banks-are-not-in-bankruptcy.pdf>).

funded rescue loans on the eve of bankruptcy.

Concerns about the systemic consequences of financial distress, by contrast, are a more serious, and more viable, objection to Chapter 11. Some of these systemic costs, however, would arise in any procedure that forces counterparties to bear losses when there are not enough assets to satisfy all counterparty claims. The costs could perhaps be reduced through the use of a “prompt corrective action” regime designed to shut down institutions before they become truly insolvent, as with commercial banks. But this approach brings important costs of its own, and it does not eliminate systemic risk.⁷

More importantly, recent examples suggest that bank regulators often are unable or unwilling to identify distressed institutions and trigger a resolution procedure before the institution becomes deeply insolvent. As a result, prompt resolution can only be guaranteed with the promise of taxpayer assistance behind it. The distress of financial firms thus poses an inescapable choice: regulators must either allow counterparties to take losses, and thus confront the possibility of systemic effects, or they must use taxpayer money to prevent the losses from being realized.⁸ Bankruptcy has proven to be an adequate mechanism for handling the former choice, and it is flexible enough to accommodate the latter.

The general “crisis of confidence” effects that follow from the bankruptcy filing of a major financial institution that is greatly interconnected with the financial system (like Lehman Brothers or AIG) cannot be discounted entirely, even if they flow purely from a self-fulfilling prophecy rather than from fundamentals. It is entirely possible, for instance, that Lehman’s bankruptcy had severe effects on the financial system simply because people believed that it would. Yet there is reason to believe that any blame for the effects of the Lehman crisis should not be laid on the doorstep of the bankruptcy laws. Other major events took place during the same time period: for example, the distressed acquisition of Merrill Lynch by Bank of America occurred the same weekend, and the announcement of the AIG rescue followed several days later. As we shall see, the AIG rescue announcement produced immediate negative reactions that were as severe as the reaction to Lehman.⁹ This suggests that the “Lehman effect” on the markets stemmed from the news that two major investment banks were financially distressed, rather than from the news that Lehman had filed for bankruptcy to resolve its distress. It is far from obvious that a rescue loan to Lehman would have prevented the general disruption and crisis of confidence in financial markets that followed.

Given the inherent challenges that these issues present to policymakers, we do not mean to suggest that government should not intervene in financial markets generally. In particular, we do not address the efficacy of the numerous broad-based infusions of

7. The collapse of IndyMac Bank and the botched resolution of Wachovia’s struggles, both in 2008, illustrate some of the limitations of prompt corrective action. See *infra* note 121.

8. Some systemic risks may be exacerbated by the bankruptcy process itself. We discuss this possibility *infra* in Part VII, which explores the effects of the special treatment given to derivatives and other financial contexts in bankruptcy.

9. Lehman filed for Chapter 11 bankruptcy on September 15, 2008. Merrill Lynch agreed to be acquired by Bank of America the day before, and the AIG rescue loan was announced two days later. These events have been chronicled in numerous books and articles about the crisis. See, e.g., ANDREW ROSS SORKIN, TOO BIG TO FAIL: HOW WALL STREET AND WASHINGTON FOUGHT TO SAVE THE FINANCIAL SYSTEM—AND THEMSELVES (2010).

capital into financial markets, some of which seem to have had stabilizing effects.¹⁰ Nevertheless, we hope that this Article will provide a useful framework for understanding the complicated issues involved in the interaction among financial firms, systemic risk, and Chapter 11. We also hope to challenge the common view that Chapter 11 bankruptcy is an inappropriate vehicle for resolving distress in financial firms. In particular, the common phrases used to describe Chapter 11 filings in these circumstances (such as “failing,” “collapsing,” or “going under”) provide a very misleading view of the bankruptcy process and its actual consequences, compared to the taxpayer-funded non-bankruptcy alternative.

Although we still cannot be certain that the recent wave of financial institution failures is over, attention has now shifted to regulatory reform. Congress has been debating financial reforms that would give bank regulators new powers to resolve the financial distress of the largest nonbank financial institutions—those deemed “systemically important.”¹¹ Although expanded powers could counteract a few of the perverse effects of the recent rescue loans, they also would effectively institutionalize the bailout strategy that was used throughout the onset of the financial crisis.

We begin by describing the principal problems created by financial distress—debt overhang and creditor runs—and the mechanisms bankruptcy provides for addressing these problems in Parts II and III respectively. In Part IV, we look to Drexel Burnham’s bankruptcy in 1990 and Lehman’s more recent filing for further lessons about the efficacy of bankruptcy. In Part V, we turn to firm-specific bailouts, describing this strategy’s benefits and the distortions it causes. We then shift our focus back to bankruptcy, considering the (legitimate) concern that it may not adequately counteract systemic risk in Part VI, and exploring its treatment of derivatives, one of the chief new habitats of systemic risk, in Part VII. In Part VIII, we consider the new financial reform proposals, which would give bank regulators new authority to resolve the financial distress of systemically important financial institutions. We argue that the proposed resolution authority would institutionalize the use of bailouts as the strategy of choice and should be rejected for this reason. Part IX is a brief conclusion.

II. THEORIES OF FINANCIAL DISTRESS: FIRM-SPECIFIC COSTS

Any discussion of distress resolution ultimately requires an analysis of the causes and consequences of financial distress, and the means of resolving it. Although there is no universally accepted definition, we characterize a firm as *financially distressed* if it possesses investment opportunities that are valuable to its investors if these opportunities

10. We thus do not focus directly on the interventions of the Federal Reserve in the commercial paper and other markets. For a brief summary of the Fed’s interventions, see CONGRESSIONAL OVERSIGHT PANEL, APRIL OVERSIGHT REPORT: ASSESSING TREASURY’S STRATEGY: SIX MONTHS OF TARP 25–26 (Apr. 7, 2009), available at <http://cop.senate.gov/documents/cop-040709-report.pdf> (outlining the Fed’s “unprecedented set of steps to stabilize the financial system”).

11. The reforms were initially outlined in a White Paper released in July 2009. U.S. DEP’T OF THE TREASURY, FINANCIAL REGULATORY REFORM: A NEW FOUNDATION (June 17, 2009), available at http://www.financialstability.gov/docs/regs/FinalReport_web.pdf [hereinafter TREASURY WHITE PAPER]. As of late 2009, the basic framework was included in legislation passed by the House. Wall Street Reform and Consumer Protection Act of 2009, H.R. 4173, 111th Cong. (1st Sess. 2009) [hereinafter *Frank Bill*].

are undertaken (or continued),¹² but for which the firm is not able to obtain financing. The term *investment opportunities* should be interpreted broadly. In a commercial bank, for example, these opportunities are the origination and funding of loans to businesses and individuals. In an investment bank, these opportunities include the provision of advisory services for mergers and acquisitions, raising capital on behalf of its clients in exchange for fees, and the management of trading portfolios.

This description of financial distress suggests a natural question: why would any entity ever face costs of financial distress? In other words, if an investment is expected to generate value for investors, why wouldn't some investor step in to fund it? Economists have proposed many explanations, but we focus on two that we believe are most relevant to the issues at hand.

A. Debt Overhang

When a firm is highly leveraged (that is, its debt-to-equity ratio is high), it may be forced to forego profitable investments because of debt overhang.¹³ The idea is as follows: suppose a firm on the verge of default tries to fund itself by issuing new equity (we consider equity for simplicity, but the argument works with any low priority security like unsecured debt). Equity holders are aware, of course, that their interest is last in priority: in a default, they get paid only if debt holders are paid in full. If the firm's prospect of default is sufficiently high, new investors may refuse to contribute new equity. These investors know that, while the firm's projects may be valuable, they will not see any of that value. Instead, the cash flows made possible by their investment will merely enhance the recovery of debt holders in the event that a default occurs.¹⁴

B. Creditor Runs

Financial firms typically have a very particular capital structure: they borrow money on a short-term basis, while their assets have longer maturity and are less liquid.¹⁵ A classic example of this is a commercial bank. Much of a bank's funding comes from consumer deposits, which can be withdrawn from the bank at any time. Its assets, by

12. To use finance terminology, the firm has investments that have positive net present value (NPV). Finance scholars distinguish *financial distress* from *economic distress*, in which a firm has only negative-NPV projects. See, e.g., Michelle J. White, *Corporate Bankruptcy as a Filtering Device: Chapter 11 Reorganizations and Out-of-Court Debt Restructurings*, 10 J.L. ECON. & ORG. 268 (1994) (explaining the difference between firms that should and should not liquidate). One goal of bankruptcy law is to separate out the financially distressed firms from the economically distressed ones, allowing those with financial distress to continue in business, and liquidating the economically distressed ones.

13. The concept of debt overhang was first formalized in Stewart C. Myers, *The Determinants of Corporate Borrowing*, 5 J. FIN. ECON. 147 (1977).

14. A related theory is the adverse selection ("lemons") problem. Like debt overhang, it predicts that investments may be foregone when they must be funded with low-priority securities like equity. The firm's decision to issue equity to outsiders signals to the market that the stock must be overvalued, so the stock price falls. George A. Akerlof, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*, 84 Q.J. ECON. 488, 492-94 (1970).

15. This observation and the implications discussed in the next two paragraphs are generally associated with the seminal work of Diamond and Dybvig. See Douglas W. Diamond & Philip H. Dybvig, *Bank Runs, Deposit Insurance, and Liquidity*, 91 J. POL. ECON. 401 (1983) (analyzing the relationship between liquidity, bank runs, and efforts to prevent future bank runs).

contrast, are loans to homeowners, businesses, and entrepreneurs, which may have maturities of many years and are difficult to quickly convert into cash. As we have seen in the current crisis, investment banks (which are funded heavily by short-term “repo” loans)¹⁶ and money market funds also fit this pattern.¹⁷

This “maturity mismatch” between assets and liabilities can be perfectly functional in normal times. Banks will hold short-term assets in proportion to the amounts they expect depositors to withdraw, but they will not hold enough short-term assets to satisfy all depositors at once if everyone withdraws. By limiting their short-term assets to amounts needed to meet expected withdrawals, banks free up the rest for more productive, higher-return uses.

The danger of this type of capital structure is that it can be susceptible to bank runs. All depositors are aware that if other depositors choose to withdraw, the bank will need to liquidate long-term assets, perhaps at steep losses, to satisfy depositor withdrawals. If these liquidation losses are steep enough, the bank will be insolvent and depositors will suffer losses themselves if they do not withdraw their money quickly enough. Bank runs can be triggered, on one hand, by a fear about the quality of the bank’s assets: if too many of the bank’s loans have gone bad, the bank will not have enough assets to cover all deposits, causing depositors to run. They can also be triggered by panic: even if the bank funds valuable loans and is solvent when depositors do not run, the bank will be insolvent when depositors do run because of losses from premature liquidation of assets. Thus, the fear of a run can provoke the run itself.¹⁸

AIG’s securities lending operation is a prominent example of this common phenomenon outside the normal banking context. AIG held a large portfolio of securities that it would lend out in exchange for cash collateral.¹⁹ Similar to deposits in commercial banks, these lending transactions were short-term in nature. To improve its returns, AIG took the cash collateral it received and invested it in risky, illiquid securities such as subprime mortgage bonds.²⁰ When the value of these bonds deteriorated, AIG’s counterparties increasingly demanded a return of their cash collateral. This forced AIG to liquidate their illiquid securities at distressed prices, which further exacerbated their losses.²¹

■

16. In a repo—or repurchase—loan, the financial institution borrower sells a security or other asset to the lender and agrees to buy it back at a higher price on a later date. The difference in prices is the equivalent of paying interest on a loan. For a discussion of these markets and the perverse feedback loop they can generate in a crisis, see Markus K. Brunnermeier, *Deciphering the Liquidity and Credit Crunch 2007–08*, 23 J. ECON. PERSP. 77, 91–98 (2009).

17. *Id.* at 90.

18. With commercial banks, the risk of runs is reduced by deposit insurance, which guarantees that customers will not lose their deposits up to a specified ceiling. But the investors in other firms do not have the same protection. See, e.g., *id.* at 96 (discussing the vulnerability of investment banks like Lehman and insurers like AIG).

19. Serena Ng & Liam Plevin, *An AIG Unit’s Quest to Juice Profit*, WALL ST. J., Feb. 5, 2009, at C1.

20. *Id.*

21. *Id.* For an account of AIG’s squabbles with Goldman Sachs over the amounts of collateral AIG needed to post, see Gretchen Morgenson & Louise Story, *Testy Conflict with Goldman Helped Push A.I.G. to the Edge*, N.Y. TIMES, Feb. 7, 2010, at A1.

III. BANKRUPTCY LAW AND FIRM-SPECIFIC SOLUTIONS TO FINANCIAL DISTRESS

U.S. bankruptcy law provides several important features that are designed to cure the debt overhang and panic run problems that cause financial distress. The first is debtor-in-possession (DIP) financing. Bankruptcy's DIP financing rules allow firms to issue senior, secured claims that take priority over other creditors.²² It is well understood in the corporate finance literature that senior securities are an effective cure for the debt overhang problem, because the new lender is less likely to be subsidizing old claimholders with the new loan if the lender has priority.²³ A priority lender will receive more of the return from its new investment and thus will be more willing to lend. While new, secured loans are sometimes available outside of bankruptcy, in other cases they may not be possible. Most bond indentures, for example, contain negative pledge clauses that limit or prevent the incurrence of new, senior debt. Bankruptcy, in contrast, renders these clauses ineffective.²⁴

A second feature that relates to curing debt overhang is the ability to sell assets free and clear of liens and other liabilities.²⁵ A firm whose liabilities exceed its assets is less likely than a healthy firm to be acquired, because the acquirer could be assuming a net liability. Although an acquirer can circumvent this problem by buying only the distressed firm's assets, there is always a risk that the acquirer will be held responsible for some of the liabilities it sought to avoid. In bankruptcy, the acquirer can purchase the assets free and clear of any claims, with the proceeds from the sale distributed to creditors through the reorganization plan.²⁶ In recent history, this has been the most common outcome in large Chapter 11s. A recent empirical study co-authored by one of this Article's authors finds, for instance, that roughly two-thirds of all large bankruptcy outcomes involve a sale of the firm, rather than a traditional negotiated reorganization in which debt is converted to equity through the reorganization plan.²⁷

22. 11 U.S.C. § 364 (2006). The role of DIP financing as a solution to debt overhang is explored in George G. Triantis, *A Theory of the Regulation of Debtor-in-Possession Financing*, 46 VAND. L. REV. 901 (1993), and its historical antecedents in David A. Skeel, Jr., *The Past, Present and Future of Debtor-in-Possession Financing*, 25 CARDOZO L. REV. 1905 (2004).

23. See, e.g., Triantis, *supra* note 22, at 919 (stating that the "ability to issue senior or secured debt can mitigate the incentive to underinvest in profitable projects").

24. 11 U.S.C. § 541(c)(1)(B). The Fed's original \$85 billion loan to AIG resembled a DIP loan in some respects: it was a senior loan secured by all free assets of AIG, which is common in DIP lending. See, e.g., William K. Sjostrom, Jr., *The AIG Bailout*, 66 WASH. & LEE L. REV. 943, 967 (2009) (describing AIG's guarantee and pledge agreement). The amount was, of course, unprecedented. But if AIG had filed for Chapter 11, it would not have needed this much, as it would not have had to pay its creditors in full. As we will discuss later, the terms of the AIG loan were subsequently revised to be more favorable to AIG and include more junior securities. See *infra* notes 79–85 and accompanying text.

25. 11 U.S.C. § 363 (authorizing bankruptcy sales).

26. Douglas G. Baird, *The New Face of Chapter 11*, 12 AM. BANKR. INST. L. REV. 69, 97 (2004) (discussing how free and clear sales are a major attraction of bankruptcy).

27. Kenneth Ayotte & Edward Morrison, *Creditor Control and Conflict in Chapter 11* (Columbia Univ. Ctr. For Law and Econ., Research Paper No. 321, Northwestern Univ. Law Sch. Law & Econ. Research Paper Series, Paper No. 08-16), available at <http://ssrn.com/abstract=1081661>. The recent Chrysler and GM bankruptcies were structured as sales—albeit unorthodox ones. See, e.g., Zach Lowe, *GM and Chrysler: The End of Bankruptcy as We Know It?*, LAW.COM, July 9, 2009, <http://www.law.com/jsp/law/Article.jsp?id=1202432107397> (last visited Feb. 19, 2010).

A third feature that deals with the “panic run” problem is bankruptcy’s automatic stay.²⁸ Banking literature suggests that suspending convertibility (prohibiting depositor withdrawals so that the bank need not liquidate long-term assets) is perhaps the most effective response to a panic run.²⁹ The automatic stay serves the same function in bankruptcy: it effectively places a shield around the firm’s assets, and ceases creditor collection efforts.³⁰ This can provide the firm with the breathing space it needs to conduct its business in an orderly fashion, preventing a desperate scramble to satisfy the claims of withdrawing creditors. The breathing space can be valuable not only if the firm plans to remain as a going concern, but also if it plans to liquidate its assets but needs time to do so.³¹

The widespread belief that bankruptcy is not a plausible response for a troubled financial institution is only compelling if the mechanisms just described are not likely to prove effective. However, brief case studies of the two largest investment bank bankruptcy filings will show that under the right circumstances, bankruptcy is capable of assisting distressed financial firms.

IV. FINANCIAL INSTITUTION BANKRUPTCY: DREXEL AND LEHMAN

Lehman was not the first major investment bank to file for bankruptcy. Two decades ago, Drexel Burnham did the same thing after rising to prominence based on its preeminence in the market for high-yield debt. We begin this Part by recounting Drexel’s trip through Chapter 11. We then return to Lehman. Our analysis suggests that the conventional wisdom—which points to Lehman as irrefutable evidence that bankruptcy does not work in these cases—is mistaken.

A. The Drexel Burnham Bankruptcy

A mediocre bank when Michael Milken arrived in the early 1970s, Drexel rose on the wings of the junk bond franchise Milken created, first through investments in “fallen angels” and other junk bonds, and then by issuing junk bonds as a form of takeover financing.³² After earning enormous profits in the 1980s takeover boom, Drexel was hobbled at the end of the decade by Milken’s indictment for securities violations, the bank’s own \$650 million securities fraud settlement, and the collapse of the junk bond market.³³ In early 1990, Drexel desperately needed short term financing to remain afloat. Unable to roll over \$250 million in commercial debt, Drexel negotiated for a loan from a

28. 11 U.S.C. § 362(a).

29. See Diamond & Dybvig, *supra* note 15, at 410.

30. 11 U.S.C. § 362(a) (stating that the bankruptcy stay halts, among other things, the “commencement or continuation” of litigation and any act to take possession or control over any property of the debtor’s estate).

31. Unlike most obligations, derivatives and other financial contracts are not subject to the automatic stay. See, e.g., 11 U.S.C. § 362(b)(6) (exempting commodity contracts, forward contracts, and securities contracts from the stay); § 362(b)(7) (exempting repos); § 362(b)(17) (exempting swaps); § 362(b)(27) (exempting master netting agreements). We discuss the reasons for and implications of this special treatment in detail in Part VII, *infra*.

32. In our opinion, the most entertaining account of Drexel’s rise, and still one of the best, is CONNIE BRUCK, *THE PREDATORS’ BALL: THE INSIDE STORY OF DREXEL BURNHAM AND THE RISE OF THE JUNK BOND RAIDERS* (1989).

33. See, e.g., *id.* at 360 (detailing Milken’s indictment); 369 (describing the \$650 million settlement).

group of banks led by Citibank and explored possible sales to foreign buyers, while the Securities and Exchange Commission (SEC) and Federal Reserve closely monitored its travails.³⁴ The regulators' principal concern was the stability of the financial markets and the banking system. Once they concluded that neither would be jeopardized by a Drexel bankruptcy, "the officials saw no reason to launch any heroic efforts to keep the company alive" when Drexel's prospects for a loan or sale fell through.³⁵ On February 13, 1990, Drexel's holding company filed for Chapter 11.³⁶ "In allowing the fall," the *Wall Street Journal* wrote, "the government backed away from a policy that has guided regulation since the New Deal: that some financial institutions are just too big to fail."³⁷

Drexel's difficulties with the government did not end with its bankruptcy filing. Drexel's single largest creditor was the Justice Department. Drexel owed the Justice Department \$650 million under its securities fraud settlement, and government regulators were actively involved in the case. The SEC asked to be included on the creditors' committee, an unprecedented request given that the committee ordinarily consists of private individuals and institutions.³⁸ Savings and loan (S&L) regulators also thrust themselves into the case, claiming that Drexel owed \$6.8 billion to compensate S&Ls that regulators took over for the losses they suffered from Drexel-related investments.³⁹ The most obvious effect of this intense government involvement was to limit Drexel's options for reorganization. Bank regulators insisted that Drexel not re-enter the investment banking business in anything like its former capacity.⁴⁰

The patina of fraud surrounding Drexel, and the government's stance in response, distinguishes its travails from financially distressed banks like Bear Stearns or Lehman Brothers that did not have quite the same reputation for misbehavior. But the general trajectory of the case is revealing nonetheless. Drexel itself was a harbinger of current investment banks. Its business was much more similar to today's investment banks—and its bankruptcy is thus more relevant—than many of its late 1980s peers would have been.

For much of the 19th and 20th centuries, investment banks profited from their superior knowledge about the value of the companies whose stock and debt the banks underwrote.⁴¹ When J.P. Morgan, the preeminent bank of the era, agreed to sell a company's stock or bonds, the bank was in essence certifying that its partners had concluded, based on their tacit knowledge of the market, that the company was high

34. See, e.g., Michael Siconolfi et al., *Embattled Drexel Puts Itself up for Sale—Financial Vise Tightens as Firm Asks for Loans*, WALL ST. J., Feb. 13, 1990, at C1.

35. Alan Murray & Kevin G. Salwen, *The End of Drexel: Fed, SEC Officials Decided Hands-Off Policy Was Best*, WALL ST. J., Feb. 14, 1990, at A6.

36. *Id.*

37. *Id.*

38. 11 U.S.C. § 1102(a)–(b) (2006) instructs the U.S. Trustee to select a committee from the seven largest creditors who are willing to serve. The provision does not distinguish private and governmental creditors, so the SEC was not speaking out of school when it asked to be included.

39. See, e.g., Paulette Thomas & Wade Lambert, *S&L Regulators are Seeking \$6.8 Billion in Drexel Burnham Bankruptcy Case*, WALL ST. J., Nov. 15, 1990, at A4.

40. See, e.g., George Anders, *A Shadow of Itself, Drexel Comes Back from Bankruptcy*, WALL ST. J., Apr. 30, 1992, at C1 (noting that the Federal Deposit Insurance Corp. squelched the reorganized entity's plans to provide advisory and underwriting services).

41. The discussion in this paragraph draws on ALAN D. MORRISON & WILLIAM J. WILHELM, JR., *INVESTMENT BANKING: INSTITUTIONS, POLITICS, AND LAW* (2007).

quality. But technological advances had made it easier to value companies by the 1960s, eroding the value of the soft information that had been investment banks' key asset.⁴² By the 1970s and 1980s, investment banks' emphasis on traditional advisory services had diminished considerably, and their reliance on proprietary trading operations had increased.⁴³ Drexel stood squarely in the middle of this transition. Drexel profited handsomely from the advisory services it provided in connection with takeovers. But it also held an extensive portfolio of securities for itself, and traded actively for its own account.⁴⁴ As a result, Drexel had substantial assets when it filed for bankruptcy.

Drexel's efforts to maximize the value of its assets proceeded in three general steps. First was the bank's human capital. Even before Drexel filed for bankruptcy, it began trying to sell some of its trading operations. Given the likelihood that "strategic personnel [would quickly] flee a sinking Drexel," as a media account put it, Drexel was particularly anxious to sell its "big equity trading and research operation," which the department's head touted as "an equity department for hire, with instant credibility, instant distribution."⁴⁵ These efforts to profit from Drexel's human capital before it walked out the door met with only limited success, largely because competitors knew they could simply hire many of the employees directly, without giving a cut to Drexel.⁴⁶ Second, Drexel moved to sell the most liquid securities in its portfolio as quickly as possible, in part to provide funding for the bankruptcy process and in part to assuage the government's concerns that Drexel's predicament would interfere with the market for government bonds.⁴⁷ Within a week, the bank had sold 82% of its securities, leaving mostly low quality, hard to value junk bonds in its portfolio.⁴⁸ Third, with the remainder of its assets—which included illiquid junk bonds and tangible assets—Drexel moved much more slowly. Four months after the filing, Drexel held a liquidation sale that featured the "desks, computers, kitchen equipment and even [the] brass coat racks" in its New York City headquarters.⁴⁹ It held onto its most hard to value junk bonds even longer, leaving much of the portfolio for the entity that later emerged from Drexel's reorganization.⁵⁰

42. *Id.* at 279 (describing the effect of computers).

43. The shift to proprietary operations, which require that banks have much more capital, is the principal reason that nearly every major investment bank shifted to the corporate form and raised money through an IPO. *Id.* at 278–80 (noting that by 1987 the only holdouts were Goldman Sachs and Lazard Frères, which finally went public in 1999 and 2005, respectively).

44. *See, e.g., id.* at 261–62.

45. William Power, *Drexel's Wall Street Rivals Swoop in to Pick Over What's Left of Dying Firm*, WALL ST. J., Feb. 15, 1990, at C1.

46. *See, e.g., id.* (noting that "personnel defections are already rocking Drexel's 900-member commodities group" and that the "uncertainty of whether Drexel employees will still be around a few days from now is one reason rival firms are sizing up Drexel units somewhat warily").

47. *See generally* Michael Siconolfi, *Drexel Has Sold 82% of Its Stock, Bonds Since Feb. 9*, WALL ST. J., Feb. 21, 1990, at C13 (stating that Drexel announced sales "to 'comfort a lot of people' who were worried that a mass liquidation could disrupt the markets").

48. *Id.*

49. George Anders, *From Junk Market to Flea Market: Drexel Holds Liquidation Sale*, WALL ST. J., June 11, 1990, at C1.

50. *See, e.g., Anders, supra* note 40 (noting that the reorganized entity's principal function would be managing a \$450 million junk bond portfolio).

The most sensitive and contentious issue in Drexel's bankruptcy was resolving a blizzard of securities fraud litigation, which consisted of dozens of suits in which Drexel was a defendant and another set of claims (mostly suits against Milken, current Drexel president Fred Joseph, and other Drexel executives) in which Drexel was one of the plaintiffs. Both bundles of cases were eventually assigned to District Judge Milton Pollack, who had developed a national reputation for resolving complex, nationwide litigation.⁵¹ Judge Pollack was initially asked to value the suits against Drexel for the purposes of determining the amount of their claims in the bankruptcy case. He subsequently pushed for a global settlement of the litigation against Milken and the other defendants. Once Judge Pollack successfully brokered a deal on the Milken litigation—which he tearfully proclaimed as “his lifetime masterpiece”—the case quickly moved to completion.⁵² Drexel was reorganized as a much smaller firm, known as New Street Capital, that would manage \$450 million in junk bonds that had not been sold and also provide advisory services.⁵³

Drexel's trip through the bankruptcy courts offers several early lessons about resolving the financial distress of investment banks and other financial institutions. The first was simply that investment banks are not precluded from reorganizing in bankruptcy. Although brokerages theoretically must be liquidated under Chapter 7 if they file for bankruptcy, Drexel sidestepped this obstacle by putting its holding company rather than the brokerage subsidiary into bankruptcy.⁵⁴ The brokerage subsidiary was kept out until all of the customer accounts had been moved to other entities.⁵⁵ Second, Drexel showed, nearly two decades before Lehman, that bankruptcy need not take too long to effectively resolve the financial distress of a financial institution. Drexel filed for bankruptcy in 1990, at a time when delay was seen as a great shortcoming of Chapter 11.⁵⁶ To be sure, the case did take more than two years to complete. But even in an era of long cases, Drexel's most time sensitive assets were redeployed almost immediately, long before the eventual reorganization.⁵⁷ Although Drexel's competitors derived more benefit from the redeployment than Drexel did, this is not problematic from the perspective of overall social welfare. Assuring that value not be destroyed is the principal

51. See, e.g., Jonathan M. Moses, *Pollack to Oversee Big Milken Settlement*, WALL ST. J., Feb. 19, 1992, at B10 (providing an overview of the litigation and Judge Pollack's role in its resolution).

52. See Editorial, WALL ST. J., Dec. 30, 1993, at A8.

53. See Anders, *supra* note 40.

54. The exclusion from Chapter 11 is in 11 U.S.C. § 109(d) (2006), which excepts stockbrokers and commodities brokers from Chapter 11. For an argument that the exclusion should be removed, see David A. Skeel, Jr., *Bankruptcy Boundary Games*, BROOK. J. CORP. FIN. & COM. L. (forthcoming 2010).

55. See, e.g., Siconolfi et al., *supra* note 34 (noting the brokerage subsidiary was not initially put in bankruptcy); Wade Lambert, *Drexel Subsidiaries Seek Protection Under Chapter 11*, WALL ST. J., May 30, 1990 (reporting that the brokerage and fourteen other subsidiaries filed for Chapter 11 bankruptcy).

56. See, e.g., Lynn M. LoPucki, *The Trouble with Chapter 11*, 1993 WISC. L. REV. 729, 752 (discussing data about the time companies spend in Chapter 11 and advocating procedural changes to reduce delay).

57. During the same period as Drexel's bankruptcy, many bank and S&L holding companies also filed for bankruptcy. These bankruptcies followed a very similar pattern, with the debtor dealing with its human capital assets quite quickly and deploying its tangible assets on a more leisurely time frame. One of the more colorful illustrations is Southeast Banking Corp., a large Miami-based bank whose managers had assembled a large contemporary art collection to adorn its halls. After its assets were sold, the firm eventually reorganized as an art dealership. See, e.g., Martha Brannigan, *Buy Our Art, Please: Southeast Banking to Return as Gallery*, WALL ST. J., Nov. 18, 1994, at B9C.

concern; it is less important who gets the value.

Even from an *ex post* perspective, the Drexel bankruptcy was surprisingly successful. Drexel's general creditors received more than half of what they were owed,⁵⁸ and the company managed to achieve a limited reorganization despite the government's refusal to allow it to resume its former business. Drexel was further constrained by a perception that the reorganized entity might still be subject to litigation based on its prior misbehavior.⁵⁹ Financial institutions that do not enter bankruptcy under similar clouds have much more room to maneuver in Chapter 11.

B. Lehman Brothers

The Drexel bankruptcy suggests that bankruptcy is surprisingly well-designed to handle the failures of nonbank financial firms. Contrary to the assumptions of many commentators, bankruptcy judges are perfectly capable of overseeing prompt sales of assets where speed is essential. Lehman, the other great investment bank filing, is in many respects a poor test of the efficacy of bankruptcy.⁶⁰ The bailout of Bear Stearns had sent a strong signal to the markets that the government would rescue any large nonbank financial institution that stumbled. Lehman, its potential buyers, and just about everyone else fully expected a bailout as the bank desperately trolled for buyers in its final days.⁶¹ By refusing to provide funding, Treasury Secretary Paulson and other regulators essentially dumped Lehman into bankruptcy.⁶² Lehman could hardly have been less prepared for Chapter 11.

Yet the bankruptcy process has been remarkably effective in many respects. Three days after filing for bankruptcy on September 15, 2008, Lehman arranged a sale of its North American investment banking business to Barclays, and the sale was quickly approved by the court after a lengthy hearing.⁶³ Barclays provided a \$450 million debtor-in-possession loan to fund Lehman's operations through the completion of the sale.⁶⁴ As is common, the loan agreement required Lehman to appoint a professional turnaround manager to run the company.⁶⁵ Its operations in Europe, the Middle East, and Asia were

58. Drexel's nonlitigating creditors would be paid \$1.53 billion on their \$2.6 billion of claims, and the securities claimants would share \$475 million. See Wade Lambert, *Drexel Plan Calls for Fixed Creditors to Get \$1.53 Billion*, WALL ST. J., May 14, 1991, at B5.

59. See, e.g., Anders, *supra* note 40.

60. For a similar argument, see David A. Skeel, Jr., *Governance in the Ruins*, 122 HARV. L. REV. 696, 740 (2008).

61. See, e.g., Yalman Onaran & John Helyar, *Lehman's Last Days*, BLOOMBERG MARKETS, Jan. 2009, at 50, 59.

62. See, e.g., *id.* at 62 ("Fuld was stunned . . . when Paulson didn't throw him a lifeline in the end."). Paulson has subsequently claimed that regulators were hamstrung by a lack of legal authority to provide a rescue loan, as in a new book chronicling the crisis, HENRY M. PAULSON JR., *ON THE BRINK: INSIDE THE RACE TO STOP THE COLLAPSE OF THE GLOBAL FINANCIAL SYSTEM* 209, 229–30 (2010), but a decision to signal regulators' toughness seems a more likely explanation. See, e.g., SORKIN, *supra* note 9, at 324 (relating that Paulson and Geithner stated that they weren't getting involved), 536 (noting that the Fed and Treasury initially said they were sending a signal, then subsequently insisted they had been powerless to step in); Onaran & Helyar, *supra* note 61, at 61 ("Paulson was putting out the word there would be no more federal bailouts, that the government couldn't rescue every failing investment bank.").

63. See, e.g., Ben Hallman, *A Moment's Notice*, AMERICAN LAW., Dec. 2008, at 85, 91.

64. See, e.g., John Blakeley, *Court Blesses Rules For Lehman Sale*, THE DAILY DEAL, Sept. 19, 2008.

65. See, e.g., *In re Lehman Brothers Holdings Inc. et al.*, at 71 (Bankr. S.D.N.Y. Nov. 13, 2008) (interim

bought by Nomura, a large Japanese brokerage firm.⁶⁶

The Lehman bankruptcy illustrates several key features of Chapter 11 even more vividly than Drexel and other prior financial institution bankruptcies. First, it shows that the law can facilitate an acquisition inside bankruptcy that would be troublesome outside bankruptcy. Barclays had expressed interest in Lehman prior to its filing, but would not acquire Lehman without substantial government assistance.⁶⁷ After Lehman filed, Barclays was willing to purchase the assets it found most valuable, and also provided the financing required to keep Lehman liquid. The second feature is the speed with which acquisitions can be completed. Some commentators have argued that Chapter 11 is an inappropriate solution to distress because the process is too slow and costly.⁶⁸ The Lehman case shows exactly the opposite: faced with extreme time pressure, buyers materialized, and Lehman quickly sold its viable subsidiaries, allowing them to remain in business under different ownership.

Other commentators have expressed the opposite concern: that bankruptcy leads to an immediate dumping of assets.⁶⁹ The “fire sale” of valuable assets at depressed prices in a bankruptcy reduces creditor recoveries⁷⁰ and can lead to failures in other firms that hold the same assets. This concern was an important motivation for the decision to extend rescue financing to AIG.⁷¹ Whatever its accuracy with AIG, the fire sale objection has no more support in the Lehman case than worries about bankruptcy delay. As of mid 2009, Lehman continued to hold a significant portfolio of assets, including a loan portfolio, real

order (i) authorizing debtor to obtain postpetition financing pursuant to sections 363 and 364 of Bankruptcy Code, (ii) granting liens and superpriority claims to postpetition lenders pursuant to section 364 of Bankruptcy Code, and (iii) scheduling final hearing) (“Borrower shall have appointed Mr. Brian Marsal of Alvarez & Marsal, LLC as chief restructuring officer (the ‘Chief Restructuring Officer’), on terms reasonably acceptable to Administrative Agent and Requisite Lenders.”).

66. See, e.g., Alison Tudor, *Crisis on Wall Street: Nomura Grows in Europe As It Buys More of Lehman*, WALL ST. J., Sept. 24, 2008, at C2.

67. See, e.g., Onaran & Helyar, *supra* note 61, at 61 (noting that U.S. regulators declined to make the debt guarantee necessary to save the deal). The U.K.’s Financial Services Authority also seems to have insisted on U.S. financing before it would give its blessing to the proposed sale. See, e.g., PAULSON, *supra* note 62, at 210–11 (suggesting that the FSA balked, and hesitated to waive a shareholder vote that would otherwise be required).

68. See Luigi Zingales, *Why Paulson is Wrong*, ECONOMIST’S VOICE, Sept. 2008, available at <http://www.bepress.com/ev/vol15/iss5/art2> (arguing that Chapter 11 burdens the taxpayer).

69. Lynn LoPucki has been the most prominent critic of bankruptcy sales. See, e.g., Lynn M. LoPucki & Joseph W. Doherty, *Bankruptcy Fire Sales*, 106 MICH. L. REV. 1 (2007).

70. Some commentators have suggested that Lehman sold its investment banking businesses at too low a price. But any inadequacy in the price seems to have stemmed more from Lehman’s failure to prepare for a bankruptcy filing than from bankruptcy itself. See, e.g., Jeffrey McCracken, *Lehman’s Chaotic Bankruptcy Filing Destroyed Billions in Value*, WALL ST. J., Dec. 29, 2008, at A10. The prospect of a rescue loan, which Lehman fully expected, created a disincentive to take steps to maximize the firm’s value in the event of bankruptcy. This effect is discussed further *infra* in the text accompanying notes 86–87.

71. Federal Reserve officials used precisely these terms to defend the AIG loan. While acknowledging that “[a]n eventual liquidation of the company is most likely,” they argued that “with the government loan, the company won’t have to go through a tumultuous fire sale.” The Fed also issued a statement suggesting that “a disorderly failure of AIG could add to already significant levels of financial market fragility and lead to substantially higher borrowing costs, reduced household wealth and materially weaker economic performance.” Tami Luhby, *Fed in AIG Rescue - \$85B Loan*, CNNMONEY.COM, Sept. 17, 2008, <http://money.cnn.com/2008/09/16/news/companies/AIG/index.htm>.

estate, and private equity investments.⁷² The firm's ability to obtain priority financing in bankruptcy has allowed them to take time with these assets, and sell them into the market at a time and price that is driven more by value maximization than by a desperate scramble for liquidity.⁷³

Third, the bankruptcy laws provide numerous formal and informal mechanisms for creditors to exercise control over the liquidation process. These include formal rights given to creditors' committees, the opportunity of creditors to object to the terms and timing of asset sales, and indirect control over the debtor through covenants in DIP loan agreements.⁷⁴

To be sure, the process of selling assets in bankruptcy is not without its conflicts and inefficiencies, as we have each written in prior work.⁷⁵ In particular, a recent study co-authored by one of this Article's authors finds some evidence that fire sales do occur in Chapter 11, due to the control rights in bankruptcy exerted by senior, secured lenders.⁷⁶ Thus, it is overly simplistic to assume that creditors in bankruptcy act as a single, value-maximizing constituency. But the government-managed alternative has its own corporate governance problems.

V. FIRM-SPECIFIC COSTS OF GOVERNMENT AD-HOC RESCUE

The discussion thus far has sought to dispel the widespread belief that bankruptcy could not possibly be an effective means of resolving the financial distress of a financial institution. We will later consider the most significant limitation of bankruptcy—that it does not address systemic risk concerns. But we first explore the strategy that has been used throughout the recent financial crisis: ad hoc rescues. We begin by describing the conditions under which rescues are most effective. We then show the serious distortions they can cause.

A. The Case for Rescue Loans: Illiquidity vs. Insolvency

Understanding the key differences between bankruptcy resolution and rescue lending requires us to introduce one more distinction, the distinction—familiar to the finance literature—between illiquidity and insolvency.⁷⁷ When a company arrives at the brink of a bankruptcy filing and is seeking a rescue loan, it is at minimum *illiquid*—it

72. See generally Alvarez & Marsal, *The State of the Estate*, Nov. 18, 2009, available at <http://documents.epiq1.com/ViewDocument.aspx?DocumentPk=994B7318-36B2-4828-AEDE-912AE24EA6C1>.

73. According to a November 2009 report to the creditors' committee, Lehman holds \$2.9 billion in cash, which suggests that its liquidity position improved in the months after its bankruptcy filing. *Id.* at 9.

74. See, e.g., 11 U.S.C. § 363(b)(1) (2006) (requiring notice and hearing for sale of assets); David A. Skeel, Jr., *Creditors' Ball: The "New" New Corporate Governance in Chapter 11*, 152 U. PENN. L. REV. 917 (2003) (discussing the recent prevalence of DIP financier control); Douglas G. Baird & Robert K. Rasmussen, *The End of Bankruptcy*, 55 STAN. L. REV. 751 (2002) (same).

75. Ayotte & Morrison, *supra* note 27; Kenneth Ayotte & David A. Skeel, Jr., *An Efficiency-Based Explanation for Current Corporate Reorganization Practice*, 73 U. CHI. L. REV. 425 (2006); Skeel, *supra* note 22, at 1929–32.

76. See generally Ayotte & Morrison, *supra* note 27.

77. See, e.g., Douglas W. Diamond & Raghuram G. Rajan, *Liquidity Shortages and Banking Crises*, 60 J. FIN. 615 (2005) (discussing the interaction between liquidity and solvency problems).

does not have access to enough cash to remain current on its immediate obligations. At the same time, it is likely, but not guaranteed, that the firm is also *insolvent*—the value of all its liabilities exceeds the total value of its assets. The two are usually observed together in the rescue context because if a firm is illiquid but obviously solvent it should be able, at least under ordinary circumstances, to obtain new financing backed by its existing assets without the need for government assistance. Given that financial markets are imperfect, though, it is possible for a firm to be illiquid yet solvent.

With a rescue loan, as contrasted with a bankruptcy filing, the government uses outside money to keep the firm liquid so the firm can continue paying its debts, rather than suspending the firm's obligations through bankruptcy's automatic stay. In the rescue loan context, the degree of taxpayer commitment will depend on the relationship between the firm's liquidity and its solvency. If the firm is only slightly illiquid and obviously solvent, a small, short-term government loan can be extended to the firm in exchange for a security that is very likely to repay taxpayers in full. The loan need only remain in place until the firm's liquidity problem subsides, and the temporary intervention will prevent firm value from being destroyed through premature liquidation. This ideal scenario is the best-case scenario for government intervention.⁷⁸

B. Direct Costs to Taxpayers

More frequent, however, particularly with financial firms during an economic crisis, is the opposite scenario: the firm has a large and prolonged liquidity shortfall, and liabilities that greatly exceed its assets.⁷⁹ Financial firms rely heavily on short-term liabilities, and in financial crisis, of course, new lending is difficult to obtain.⁸⁰ In such circumstances, the government faces a difficult choice: if the government provides a rescue loan, they may be stuck with a large and long-term commitment of taxpayer money, whereas not intervening could mean a fire sale liquidation of assets that damages the firm, its counterparties, and possibly the financial system more generally.

This tension was demonstrated clearly in the rescue of AIG. Fearing that default would have devastating effects, particularly on the credit default swap market, regulators arranged a rescue loan.⁸¹ Given the extent of AIG's illiquidity problem, the original loan

78. The Chrysler bailout in 1979–1980 and, internationally, the bailout of the Mexican government in 1994 are often cited as examples of rescue loans that successfully quelled a liquidity crisis at relatively little cost to taxpayers. See, e.g., Andrew Beattie, *Chrysler Bailout 2009: Third Time's a Charm?*, FINANCIAL EDGE, June 4, 2009, available at <http://financialedge.investopedia.com/financial-edge/0609/Chrysler-Bailout-2009-Third-Times-A-Charm.aspx> (noting that the 1979 Chrysler bailout is seen as a success); LEX RIEFFEL, *RESTRUCTURING SOVEREIGN DEBT: THE CASE FOR AD HOC MACHINERY 200–02* (2003) (stating that the results of the Mexican bailout were “stunning” and the “U.S. government actually made money”). This is not to say that either was cost-free. Both introduced some of the distortions discussed below.

79. This certainly was the case with Lehman, as its unsecured debt traded for less than ten cents on the dollar after its bankruptcy filing, suggesting deep insolvency. See, e.g., Shannon D. Harrington & Neil Unmack, *Lehman Credit-Swap Auction Sets Payout of 91.38 Cents*, BLOOMBERG.COM, Oct. 10, 2008 (noting that auction to determine credit default swap payouts suggested value of debt was 8.625 cents on the dollar).

80. See, e.g., Brunnermeier, *supra* note 16 (discussing the financial markets and related events in 2001 and 2008).

81. According to a subsequent report by the Special Investigator General for TARP, Federal Reserve and Treasury officials feared a panoply of potential consequences if AIG stopped making payments to counterparties: “the impact on the American retirement system [because many retirement plans had bought

was of unprecedented size (\$85 billion).⁸² The terms (short maturity and high interest rate) were intended to give AIG a clear incentive to pay back the loan quickly to avoid a long-term taxpayer commitment.⁸³ This soon proved to be impossible. By November, AIG convinced the Fed and Treasury that the initial loan terms could not be met without forcing AIG to conduct a fire sale of its assets.⁸⁴ As a result, the government extended the maturity of the loan (to five years from two), dramatically cut interest rates (by 5.5%), increased the amount of committed funding (to nearly \$150 billion), and agreed to take lower priority securities (preferred stock) in exchange for some of the new money.⁸⁵ All of these changes reduced the possibility of a fire sale, but they required a longer and larger taxpayer commitment to the firm.

C. Moral Hazard (of Equity and Debt)

If the firm is in fact insolvent (that is, its liabilities exceed its assets), losses must be borne by someone. Rescue lending is designed to prevent a firm's creditors and counterparties from bearing these losses (at least temporarily), for fear of the systemic consequences that would follow. Taking extraordinary steps to protect the credit markets can have a significant price tag, however, in terms of both the direct costs discussed in the previous section and the incentives it creates for investors.

The principal incentive problem is moral hazard. Moral hazard is the familiar concern that someone who is protected against the consequences of a risk has less incentive to take precautions against the risk. If the investors who fund a financial institution by lending money or buying stock anticipate that the firm will be rescued if it runs into trouble, they may extend funding beyond what they would extend otherwise. This willingness to continue funding may enable the firm to delay a needed restructuring of operations or a merger with a healthy acquirer.

The possibility of subsidized taxpayer funding on the eve of bankruptcy also encourages both potential investors and the firm itself to play a dangerous game of chicken with the government. A potential acquirer of a distressed firm might, in lieu of making the acquisition at an earlier date, wait until the target's condition is so desperate that it can argue for taxpayer assistance as a prerequisite to completion of the deal.⁸⁶ Similarly, the managers of the troubled firm may deliberately fail to take steps to prepare for bankruptcy since the firm's case for a governmental subsidy becomes stronger if

'stable value fund' contracts from AIG]; the impact of AIG's commercial paper obligations, the broader effect on the already frozen credit markets and money market mutual funds; and the considerable systemic risk to the global financial system." OFFICE OF THE SPECIAL INSPECTOR GENERAL FOR THE TROUBLED ASSET RELIEF PROGRAM (SIGTARP), FACTORS AFFECTING EFFORTS TO LIMIT PAYMENTS TO AIG COUNTERPARTIES 9 (Nov. 17, 2009), available at http://www.sig tarp.gov/reports/audit/2009/Factors_Affecting_Efforts_to_Limit_Payments_to_AIG_Counterparties.pdf.

82. *Id.* at 1–2; Sjostrom, *supra* note 24, at 964.

83. The original \$85 billion loan was for a 24-month term, the interest rate on the loan was 8.5% above LIBOR, and AIG was required to pay 8.5% on the undrawn portion of the credit facility. *See id.* at 964.

84. *Id.* at 969–70.

85. After a second restructuring in March 2009, estimates of the government commitment to AIG now range from \$180 billion to \$200 billion. *See, e.g.*, Sjostrom, *supra* note 24, at 972–74 (describing restructured facility), 975 (estimating commitment at \$182.5 billion).

86. *See, e.g.*, Onaran & Helyar, *supra* note 61 (discussing expectations by Lehman and its potential purchasers that the government would provide funding).

bankruptcy is not a realistic option.⁸⁷ Thus, the possibility of rescue funding may contribute to the exact instability that government backing is trying to prevent.

In several distressed corporations' resolutions, particularly those that occurred at the onset of the crisis, the government made a deliberate attempt to penalize shareholders in connection with government-backed rescue deals to limit moral hazard. When government loans were used to back a sale of Bear Stearns to J.P. Morgan Chase, for example, all of Bear Stearns's liabilities were assumed by the buyer, but the original purchase price of the shares was forced substantially below the trading price of the stock.⁸⁸ In the original terms of the AIG rescue loan, the government took warrants allowing it to purchase just under 80% of the equity, which severely diluted AIG's existing shareholders.⁸⁹ These measures were designed to limit some of the moral hazard concerns expressed above, while at the same time limiting the systemic risks that come from allowing creditors to take losses.

This "hybrid" solution (subsidizing creditors and penalizing shareholders) addresses the problem of shareholder moral hazard, but magnifies the moral hazard of debt. Investors may bid down the stock of the debtor, but the policy gives lenders no reason to stop extending credit. If markets anticipate the policy, distressed firms might find it even more difficult to issue new equity to repair their balance sheets.⁹⁰ The penalty to shareholders thus adds to market frictions like debt overhang that make equity issues difficult, as we have discussed.⁹¹ Rather than attempting to sell stock to raise capital when they face a liquidity crisis, firms will turn toward the most subsidized security (debt). The added debt can exacerbate the firm's financial distress and create a greater necessity for last-minute rescue efforts.

D. Corporate Governance Distortions

Still another cost of rescue loans is corporate governance distortions. Rescue loans often bring government intervention in the internal governance of the company receiving a loan. Management turnover is the norm for companies in financial distress, but ordinarily companies' investors drive the decision.⁹² When the government insists that a

87. During the recent crisis, both Lehman and General Motors seem to have deliberately failed to prepare for bankruptcy, quite possibly for these reasons. See, e.g., McCracken, *supra* note 70 (discussing Lehman's failure to prepare for bankruptcy); Philip Nussel, *Wagoner's Words Underscore Industry Crisis*, AUTOMOTIVE NEWS, Mar. 30, 2009 (quoting former GM CEO Rick Wagoner's insistence that bankruptcy would be "a highly risky and highly costly process" and should not be considered).

88. Indeed, the Treasury apparently pressured the buyer to pay less than it originally intended, precisely to insure that Bear Stearns's shareholders were punished. Kate Kelly, *Bear Stearns Nearing Collapse Twice in Frenzied Final Week*, WALL ST. J., May 29, 2008, at A1.

89. See, e.g., Sjostrom, *supra* note 24, at 966 (noting that the government stake was "purposely set below 80% so that it would not have to consolidate AIG's financials with its own").

90. The expectation of future government intervention seems to have played a role in the ultimate resolution of Fannie Mae's and Freddie Mac's distress. According to one account: "Two things would soon force Treasury's hand. Uncertainty about Treasury's plans and how any intervention would affect shareholders caused shares of Fannie and Freddie to fall sharply, making it all but impossible for them to raise equity." Deborah Solomon et al., *Mounting Woes Left Officials With Little Room to Maneuver*, WALL ST. J., Sept. 8, 2008, at A1.

91. See *supra* notes 13–14 and accompanying text.

92. See, e.g., M. Todd Henderson, *Paying CEOs in Bankruptcy: Executive Compensation When Agency*

CEO be replaced—as when Treasury Secretary Paulson insisted that AIG CEO Robert Willumstad resign as a condition of government help—the decision is likely to be influenced by factors other than optimal corporate governance, such as concern for the public response to the rescue.⁹³

The distortions may be still greater if the government oversees the investment decisions made by the company even after the initial rescue loan.⁹⁴ Two of AIG's most recent replacement CEOs, Edward Liddy and Robert Benmosche, have encountered significant difficulty trying to maximize the ongoing value of AIG while complying with public oversight and scrutiny over compensation practices. Liddy faced sharp criticism over the decision to pay retention bonuses to employees in the Financial Products division.⁹⁵ Benmosche publicly expressed his frustration over the constraints on executive compensation imposed by Kenneth Feinberg, the Obama administration's "pay czar," and threatened to quit his post. Though he chose not to resign, Benmosche argued that compensation constraints are a "barrier" that "stands in the way of restoring AIG's value."⁹⁶ Both because of the limits of their expertise and because of the conflicting pressures it faces, the government's track record when it shifts from regulator to decision maker is not a good one.⁹⁷

E. A Comparison to Bankruptcy Resolution

As discussed earlier, the bankruptcy process provides alternative solutions to the firm's liquidity problems through the automatic stay and DIP financing.⁹⁸ The automatic stay puts a stop to creditor collection activity. As a result, the size of a new loan required to maintain operations need not be as large inside of bankruptcy as a rescue loan would

Costs Are Low, 101 NW. U. L. REV. 1543, 1595–96 (2007) (finding that "over 60% of CEOs were replaced in the zone of insolvency," and attributing this to the influence of creditors).

93. See generally Sjostrom, *supra* note 24, at 967 (noting Paulson's insistence that Willumstad resign). Several of the recent rescues also interfered with established corporate law doctrine. The sale of Bear Stearns to J.P. Morgan, for instance, included deal protection provisions (such as a 39% share exchange) that cannot easily be squared with the fiduciary duty standards of Delaware corporate law. See, e.g., Marcel Kahan & Edward Rock, *How to Prevent Hard Cases from Making Bad Law: Bear Stearns, Delaware and the Strategic Use of Comity*, 58 EMORY L.J. 713, 721–44 (2009). The government-brokered interference with settled law may be treated as *sui generis*, but it also could add uncertainty to corporate transactions.

94. The bailouts of Chrysler and General Motors raise these issues. The government originally planned to put significant decision making authority in a single "car czar." GM and its unions delayed serious negotiations while they awaited appointment of the czar. The Obama administration later shifted course, appointing a panel rather than a single czar. The government dictated the car companies' decisions to file for bankruptcy and the terms of their restructuring through a "sale" of each company's assets. See David von Drehle, *Saying No to a Car Czar: A Smart First Step on Detroit*, TIME, Feb. 17, 2009, available at <http://www.time.com/time/politics/article/0,8599,1880077,00.html>; Steve Rattner, *The Auto Bailout: How We Did It*, FORTUNE, Oct. 21, 2009.

95. See, e.g., Michael R. Crittenden & Patrick Yoest, *AIG's Liddy Asks Employees to Give Back Bonuses*, WALL ST. J., Mar. 18, 2009.

96. See, e.g., Serena Ng et al., *AIG CEO Says He's 'Committed' to Leading Insurer*, WALL ST. J., Nov. 12, 2009, at C1.

97. The most notorious illustration was the National Recovery Administration during the New Deal, which attempted to establish guidelines for industry cooperation. The shortcomings of the NRA, "a big, splashy bad idea that lasted only a couple of years," are discussed in JONATHAN ALTER, *THE DEFINING MOMENT: FDR'S HUNDRED DAYS AND THE TRIUMPH OF HOPE* 301–03 (2006).

98. See *supra* notes 22–24, 28–29 and respective accompanying text.

be, because the loan proceeds can be directed to operations and not to the repayment of pre-bankruptcy creditors. This increases the likelihood that a private loan will be available. Also, because a DIP loan is senior in priority to pre-bankruptcy unsecured creditors, the pre-bankruptcy creditors bear more of the costs of the reorganization process. As compared to rescue loans, DIP loans are likely to be smaller in size and to significantly reduce the moral hazard of debt.⁹⁹

Finally, since the priority of DIP lenders, pre-bankruptcy creditors, and shareholders is determined by the rules of the bankruptcy process, predictability of recoveries is greater than it would be under an ad-hoc system of rescue lending. Shareholder interests can be, and usually are, eliminated in bankruptcy.¹⁰⁰ But if the firm is solvent, shareholders are entitled to receive a distribution.¹⁰¹ Relative to the hybrid solution described above, this facilitates the issuance of equity prior to bankruptcy.

A system-wide lending failure like the recent credit crisis raises the question whether private sources of bankruptcy financing will always be available. Through much of 2008, few companies that filed for bankruptcy were able to obtain financing.¹⁰² It is important to keep in mind that the absence of lending at the height of the crisis was aberrational, and more recent cases suggest that funding is once again becoming available.¹⁰³ However, if private financing becomes scarce, the bankruptcy framework does not prevent the Treasury from serving as a troubled firm's DIP financier. Any doubt about this possibility was removed by the government's decision to provide billions of dollars of DIP financing to both Chrysler and General Motors as part of the carmakers' government-orchestrated restructurings.¹⁰⁴

VI. SYSTEMIC RISK CONSIDERATIONS: IS BANKRUPTCY APPROPRIATE?

With respect to firm-specific costs, the first ostensible shortcoming of bankruptcy, we are skeptical that government rescue is likely to create more value than the bankruptcy alternative. However, systemic risk issues pose more difficult questions. In

99. In this respect, the AIG circumstances were particularly favorable to a rescue loan. AIG was apparently able to make the rescue lender senior to all existing liabilities (as a DIP loan would have been) without triggering a negative covenant in its existing debt that would have accelerated other obligations. *See, e.g.,* Sjostrom, *supra* note 24, at 967 (describing security given by AIG). In most circumstances, a company would not have sufficient unencumbered assets for the government to make this kind of loan outside of bankruptcy. Thus, the rescue loan would need to be a low-priority, subsidized loan.

100. *See, e.g.,* Douglas G. Baird & Robert K. Rasmussen, *Chapter 11 at Twilight*, 56 *STAN. L. REV.* 673 (2003).

101. The absolute priority rule set forth in 11 U.S.C. § 1129(b) (2006) assures the creditors in a class that, unless the class will be paid in full, lower priority creditors or shareholders are not entitled to any payout.

102. Lending did not disappear altogether. Some companies, such as Circuit City and Pilgrim's Pride, managed to obtain DIP financing. *See, e.g., Hearing Before the H. Fin. Servs. Comm.*, 110th Cong. 4 (2008) (statement of Dr. Edward I. Altman, Leonard N. Stern School of Business, New York University), available at <http://financialservices.house.gov/hearing110/altman120508.pdf>.

103. CIT, for instance, arranged a \$1 billion DIP loan from Carl Icahn for its prepackaged bankruptcy. *See, e.g.,* Tiffany Kary, Dawn McCarty & Lester Pimentel, *CIT Files Bankruptcy; U.S. Unlikely to Recoup Money*, BLOOMBERG.COM, Nov. 1, 2009, available at http://www.bloomberg.com/apps/news?pid=20601087&sid=a3t_GrxbL2U#.

104. For a detailed analysis of the government's role in the carmaker bankruptcies, especially Chrysler, see Mark J. Roe & David Skeel, *Assessing the Chrysler Bankruptcy*, 108 *MICH. L. REV.* (forthcoming 2010), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1426530.

their recent interventions, government officials were concerned not only about the going concern value of the troubled entities themselves, but also about the impact that entities' bankruptcy filings would have on counterparties and other creditors. The principal precedent for this concern is the collapse of Long Term Capital Management, a hedge fund whose founders included two Nobel laureates, in 1998.¹⁰⁵

The current fear is certainly not without foundation. When Lehman Brothers filed for bankruptcy, these effects did materialize. Lehman had a substantial amount of commercial paper (short-term, unsecured debt) at the time of its filing.¹⁰⁶ This paper was held by numerous money market funds. Since commercial paper has such a short maturity, it is usually considered quite safe, and carries a high credit rating; however, when Lehman filed for Chapter 11 holders of commercial paper suddenly became unsecured creditors in a bankruptcy that promises a low recovery.

The consequences of the counterparties' newly precarious status were immediate and substantial. Money market funds that held Lehman commercial paper, including one prominent fund called the Reserve Primary Fund, were forced to mark down the value of these holdings.¹⁰⁷ This led to investor redemption requests, forcing the fund to sell its holdings into the market at depressed prices, which exacerbated the fund's problems. Reserve Primary Fund ultimately "broke the buck"—valued its holdings at less than one dollar per share. Reserve Primary's travails precipitated a run on the fund that led it to suspend redemptions.¹⁰⁸

While causality is difficult to establish, most observers believe that the fear resulting from the Lehman filing and its implications for Reserve Primary Fund spilled over into redemption requests at other money market funds, many of which had negligible exposure to Lehman. Systemic concerns were substantial, because many corporate borrowers rely on the commercial paper market to fund their short-term operations, and a run on money market funds takes needed capital out of this market. The Federal Reserve was forced to step in and provide government guarantees of money market funds, which provided some relief.¹⁰⁹ Nevertheless, short-term debt markets were severely strained.

The Lehman/Reserve Primary Fund situation illustrates the difficult choice between providing a government rescue to prevent systemic consequences like these and limiting moral hazard. Reserve Primary Fund was far from typical in the money market world. It offered its investors some of the highest yields in the industry and was known to be a

105. See, e.g., PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS, HEDGE FUNDS, LEVERAGE, AND THE LESSONS OF LONG-TERM CAPITAL MANAGEMENT (1999), available at <http://www.ustreas.gov/press/releases/reports/hedgfund.pdf> (outlining the systemic risk implications of the Long-Term Capital Management collapse).

106. Commercial paper is unsecured debt issued by companies that wish to borrow funds on a short-term basis. Because the borrowers have traditionally been large, stable companies, and the obligation is repaid or rolled over quickly, the risk to lenders ordinarily is quite low. See, e.g., DAVID WESSEL, IN FED WE TRUST: BEN BERNANKE'S WAR ON THE GREAT PANIC 207 (2009) (describing commercial paper as "IOUs . . . that were backed only by the company's promise to pay").

107. See, e.g., Diana B. Henriques, *Buck Broken, but Timing May Affect Redemptions*, N.Y. TIMES, Nov. 26, 2008, at B4; WESSEL, *supra* note 106, at 206–07.

108. See, e.g., Henriques, *supra* note 107; WESSEL, *supra* note 106.

109. See WESSEL, *supra* note 106, at 228 (describing how the Fed wanted to intervene to alleviate the concern over money market funds).

substantial risk taker.¹¹⁰ Its investors understood (or at least should have understood) that these outlier rates could only be had by accepting large risks. Had the government provided a rescue loan to Lehman to prevent a bankruptcy filing, it would have subsidized this type of speculation (commonly known as a “moral hazard play”),¹¹¹ and lessened the incentive of investors to monitor borrowers and take sensible risks. On the other hand, the panic run from the money market industry might have been prevented by a loan (or a subsidy) that enabled Lehman to make its counterparties whole.

These trade-offs are real and difficult to resolve. The most important systemic consequences of Lehman’s bankruptcy followed not from its direct effects, but from a crisis of confidence. Economic theories can explain the consequences of panic runs when they occur, but they do not explain what triggers them in the first place. Could an eve-of-bankruptcy rescue loan or merger have prevented the crisis of confidence that led to the money market run? More generally, could a Lehman rescue loan have prevented the severity of the financial crisis that followed? These questions are impossible to answer with certainty, but a casual look at the data surrounding these events provides reason to be skeptical. Below is a chart that documents changes in several major indices that occurred the day after the Lehman bankruptcy filing was announced, compared with the day following the AIG rescue loan.

Index	Lehman			AIG		
	12-Sep	15-Sep	change	16-Sep	17-Sep	change
S&P 500	1251.7	1192.7	-4.71%	1213.6	1156.39	-4.71%
Volatility (VIX)	25.66	31.7	23.54%	30.3	36.22	19.54%
TED spread	1.35	2.01	0.66	2.19	3.02	0.84
13-week treasury bill	1.46	0.81	-0.65	0.86	0.02	-0.84

Looking across the four indices, the daily market reactions surrounding the news of the Lehman bankruptcy filing and the AIG rescue loan indicate that the reaction to the AIG news was of equal, if not greater, magnitude. The fall in the stock market, as measured by the S&P 500 index, was nearly identical. The rise in the VIX, an index used to measure volatility (and informally known as the “fear index”) saw a slightly higher percentage increase following the Lehman bankruptcy. The TED spread, an indicator of

110. Karen Dolan, *A Large Money Market Fund Breaks the Buck*, MORNINGSTAR, Sept. 17, 2008, <http://news.morningstar.com/articlenet/article.aspx?id=253485> (“Morningstar has data on just over 2,100 money market funds, and the Reserve Primary Fund clocked in at an average trailing 12-month yield of 4.04%—the highest in our universe—while the average was 2.75%.”).

111. This phrase and the associated behavior are well-recognized in the context of sovereign rescue lending by the International Monetary Fund. See generally Timothy Lane & Steven Phillips, *Does IMF Financing Result in Moral Hazard?* (Int’l Monetary Fund, Working Paper No. WP/00/168, 2000), available at <http://imf.org/external/pubs/ft/wp/2000/wp00168.pdf>.

credit market risk, saw a larger percentage point increase following the AIG bailout.¹¹² Similarly, yields on short-term U.S. Treasury bills (a measure of investor flight to safe assets) saw a larger fall following the AIG news.¹¹³

This evidence is far from conclusive. But it suggests, at a minimum, that the widespread belief that the Lehman Chapter 11 filing was the singular cause of the collapse in credit that followed is greatly overstated.¹¹⁴ The comparison also highlights that news of a major event can convey two distinct pieces of news at the same time: first, that a large, important entity is severely distressed and illiquid; and second, that a particular procedure was triggered to address it. In Lehman, the procedure was bankruptcy, while in AIG, the procedure was a rescue loan. The indicators above suggest that the market did not distinguish between the distress resolution procedures; it focused instead on the implications of the distress itself.

Moreover, as we have already indicated, the choice between bankruptcy and a rescue loan is not an either/or choice. If regulators conclude that the systemic risk concerns are so great that intervention is necessary, they could use an intermediate strategy of allowing the firm to file for bankruptcy, while selectively guaranteeing certain “dangerous” liabilities as an alternative to a rescue loan.¹¹⁵ With hindsight, it appears that guaranteeing AIG’s credit default swaps while allowing the company to file for Chapter 11 might have been a much better solution than the increasingly expensive rescue loan used to forestall AIG’s default. The government might have facilitated a restructuring of AIG while protecting the CDS market, at substantially lower cost.

It may be useful at this point to compare the approach just suggested—an intermediate bankruptcy strategy—to the “prompt corrective action” approach now used to resolve bank and S&L failures, which has some features in common. Under the prompt corrective action rules, bank regulators are authorized to intervene even before a bank becomes insolvent. Regulators step in and generally arrange an immediate sale—which is set up in secret, often over a weekend—of the bank’s assets to another bank.¹¹⁶ While deposits are guaranteed, other liabilities are not.¹¹⁷ The immediate sale guarantees

112. The TED spread is the difference between 3-month LIBOR (an interest rate at which banks lend to each other) and the 3-month U.S. Treasury Bill rate. See InvestorWords.com, TED spread Definition, http://investorwords.com/5820/TED_spread.html (last visited Mar. 10, 2010).

113. Daily Treasury Bill Rates, U.S. Treasury, http://www.ustreas.gov/offices/domestic-finance/debt-management/interest-rate/daily_treas_bill_rates_historical_2008.shtml (last visited Mar. 9, 2010).

114. John Taylor has often offered additional, complementary evidence that Lehman’s role in the credit crisis has been seriously distorted. See, e.g., *Bankruptcy and Antitrust Law and Financial Regulation: Hearing Before the H. Judiciary Subcomm. on Commercial and Admin. Law*, 111th Cong. 2 (2003) (statement of John B. Taylor, Professor, Stanford University) (citing JOHN B. TAYLOR, *GETTING OFF TRACK* (2009) and finding that the biggest jump in the Libor-OIS spread came after the Treasury announced its plan to propose the major rescue funding that eventually provided \$700 billion in TARP funds).

115. For a suggestion along these lines, see Oliver Hart & Luigi Zingales, *Economists Have Abandoned Principle*, WALL ST. J., Dec. 3, 2008, at A17.

116. For a good overview of bank insolvency regulation, and a comparison to Chapter 11, see Robert R. Bliss & George G. Kaufman, *U.S. Corporate and Bank Insolvency Regimes: A Comparison and Evaluation*, 2 VA. L. & BUS. REV. 143 (2007).

117. When Washington Mutual was merged with J.P. Morgan Chase through FDIC receivership, the depositors and secured debt were assumed by J.P. Morgan. The senior unsecured and subordinated debt was not assumed and will presumably be paid from the sale proceeds. The FDIC announced that subordinated debt investors should not expect to recover anything. See Press Release, FDIC, Information for Claimants in

liquidity, assuring that depositors never lose access to their funds, and minimizes the systemic disruption of the bank's default. The rules also are designed to avoid any possibility of a disruption to the payment system.¹¹⁸ In theory, the same approach might be used to resolve the financial distress of investment banks or hedge funds, which have similar characteristics.¹¹⁹

In comparing the two options side-by-side, it is crucial to understand that the prompt corrective action approach requires several elements to make it function effectively that are not needed for Chapter 11. It requires a pool of taxpayer money to cover depositor losses, persistent *ex ante* regulatory oversight of bank assets and liabilities to limit the magnitude of these losses, and the power of a regulator to trigger the resolution unilaterally.¹²⁰ As a result, the chief benefits of this approach are most valuable in the commercial bank context. As guarantor of bank deposits, which are the vast majority of a bank's liabilities, the government (and taxpayers) has an enormous stake in the health of banks. The depositors into whose shoes the government steps, by contrast, have little incentive to monitor, because they are fully protected. Given the government's stake and its role as the principal creditor, it is sensible to couple deposit insurance with *ex ante* regulatory oversight and the power to determine how to resolve distress.

Important downsides exist to the prompt corrective action approach, in addition to the need for taxpayer funds to back it. The system is designed to assure early closure of troubled banks, and it relies on regulators to determine when and how to intervene, rather than the parties with the best information—the bank's managers and investors.¹²¹ Guaranteeing promptness of the resolution procedure requires denying the rights of the bank's unprotected investors (unsecured creditors and shareholders) to affect the terms and timing of the resolution. To use bankruptcy terminology, the FDIC must have the immediate authority to “cram down” a plan to resolve distress, over any objection by

Washington Mutual Bank (Sept. 29, 2008), available at <http://www.fdic.gov/news/news/press/2008/pr08085b.html>. The terms of the original Wachovia merger with Citigroup, by contrast, involved taxpayer rescue money to shield investors from losses. See Press Release, FDIC, CitiGroup Inc. to Acquire Banking Operations of Wachovia (Sept. 29, 2008), available at <http://www.fdic.gov/news/news/press/2008/pr08088.html>.

118. See, e.g., Bliss & Kaufman, *supra* note 116, at 147–49.

119. The Obama administration's financial reform proposals would extend bank regulators' powers to all systemically important financial institutions, but would focus less on early intervention than on regulatory authority. We assess the proposals *infra* in Part VIII.

120. When the FDIC arranges for the disposition of a troubled bank, it usually pays another bank to assume the deposits, often as part of a transaction in which the acquirer also receives some of the troubled bank's assets. See, e.g., FDIC, RESOLUTIONS HANDBOOK 29–35 (2003), available at <http://www.fdic.gov/bank/historical/reshandbook/ch3pas.pdf> (describing “purchase and assumption” transactions). In the less frequent case in which a troubled bank is simply liquidated, the FDIC pays depositors directly. *Id.* at 41–46.

121. Regulators' track record on closing commercial banks during the current crisis has been checkered, with IndyMac (which was not closed until well after its financial distress was obvious and is expected to cost taxpayers \$8.5–9.4 billion) and Wachovia (where regulators arranged a lowball sale to Citigroup that was quickly trumped) each involving significant miscues. See, e.g., VERN MCKINLEY & GARY GEGENHEIMER, BRIGHT LINES AND BAILOUTS 18–19 (2009) (describing the Wachovia sale); Binyamin Applebaum, *FDIC Agrees to Sell IndyMac to Investor Group*, WASH. POST, available at <http://www.washingtonpost.com/wp-dyn/content/article/2009/01/02/AR2009010202228.html> (IndyMac). One of the authors of this Article has argued elsewhere for an incentive system that would encourage managers of troubled banks to initiate insolvency proceedings as a supplement to FDIC oversight. See generally David A. Skeel, Jr., *The Law and Finance of Bank and Insurance Insolvency Regulation*, 76 TEX. L. REV. 723 (1998).

unprotected investors who are subject to bearing losses. While this is defensible with commercial banks, because the vast majority of their liabilities are deposits, it is far more problematic with other firms. The relative slowness of Chapter 11 resolutions is driven in large part by the attempt to guarantee that the firm's stakeholders have some control over the firm's fate, so that the value of the estate is preserved for investors. Thus, the "prompt corrective action" model has some attractive features (namely, speed) that are more appropriate to limiting systemic risk. On the other hand, this system may create serious firm-specific costs that Chapter 11 does not.¹²²

VII. SYSTEMIC CONCERNS WITHIN BANKRUPTCY

To this point, we have assumed that bankruptcy itself is essentially neutral with respect to systemic risk—that it neither addresses systemic risk issues nor exacerbates them. The most important exceptions to this agnosticism are derivative contracts and other new financial instruments.¹²³ In an effort to counteract systemic risk, lawmakers have excepted derivatives and other financial contracts from several key bankruptcy rules. Although the purpose of these provisions is reducing systemic risk, their efficacy is subject to serious question.

Although most bankruptcy lawyers and bankruptcy judges do not know a great deal about derivatives, the industry trade group and regulators who deal with them have long insisted that these instruments must be exempted from the automatic stay and several other core bankruptcy provisions so that a debtor's counterparties can close out their contracts after the debtor files for bankruptcy. The International Swaps and Derivatives Association (ISDA) has argued, with the support of the Federal Reserve and Treasury, that the bankruptcy of a company that has entered into a significant number of derivatives could snarl the financial system if the automatic stay applied.¹²⁴ According to ISDA, a

122. Another alternative that lies between a government-controlled, fast resolution like receivership and a decentralized, investor-driven resolution like Chapter 11 would be a distress resolution mechanism that is pre-arranged contractually. For example, key financial institutions could be required to issue securities that automatically convert from debt to equity under pre-specified conditions. One such proposal and the difficulties in its implementation are discussed in Barry E. Adler, *Financial and Political Theories of American Corporate Bankruptcy*, 45 STAN. L. REV. 311 (1993). Several commentators have explored a similar approach—the use of distress contingent bonds—for financial institutions. See, e.g., Mark J. Flannery, Market-Valued Triggers Will Work for Contingent Capital Instruments (unpublished manuscript, Nov. 6, 2009) (solicited submission to U.S. Treasury Working Group on Bank Capital); Darrell Duffie, *Contractual Methods for Out-of-Court Restructuring of Systemically Important Financial Institutions*, in KENNETH SCOTT, GEORGE SHULTZ & JOHN TAYLOR, ENDING GOVERNMENT BAILOUTS AS WE KNOW THEM (forthcoming 2010).

123. A derivative is a contract with payment terms based on the change in value of something else, such as an interest rate, a national currency, or a stock index. The bankruptcy laws give special treatment to five categories of derivatives and other financial contracts: repurchase agreements, commodity contracts, forward contracts, swap agreements, and securities contracts. See, e.g., Shmuel Vasser, *Derivatives in Bankruptcy*, 60 BUS. LAW. 1507, 1511–25 (2005) (outlining the treatment of each).

124. "Participants in the swap market," an ISDA representative testified in 1989, "are concerned that, if a counterparty files for bankruptcy, the automatic stay and other provisions of the Bankruptcy Code could be interpreted to bar [termination] These bankruptcy-related issues create uncertainty among potential participants in [derivatives markets], creating a risk that, particularly in periods of volatility, the liquidity of the market will be restricted" *Hearing Before the Subcomm. on Courts and Administrative Practice of the Comm. on the Judiciary*, 101st Cong. 16 (Apr. 11, 1989) (testimony of Mark C. Brickell, Chairman, ISDA) [hereinafter *1989 Swap Hearing*]. See also *id.* at 18 (noting Federal Reserve support for the proposed

solvent counterparty's inability to immediately terminate its contract could interfere with its efforts to hedge and possibly even jeopardize the counterparty's solvency.¹²⁵ The counterparty's instability could, in a worst case scenario, have a similar effect on its own counterparties as the contagion worked its way through the market. Exempting derivatives from the automatic stay minimizes the risk of these ripple effects, ISDA and other proponents argue, because it enables counterparties to close out their contracts and to quickly re-hedge their risks. Based on this reasoning, Congress has amended the bankruptcy laws four different times—most recently and sweepingly in 2005—to provide increasingly expansive protection for derivatives.¹²⁶

Although the special provisions could reduce systemic risk in some cases, they may throw oil on the fire in others. Counterparties' ability to jettison their contracts when a debtor files for bankruptcy can create a run on the debtor's assets, as numerous counterparties terminate their contracts and seize any collateral securing the contracts.¹²⁷ If the debtor is one of the handful of major derivatives counterparties, the debtor's failure could itself cause marketwide damage, since the glut of terminated contracts may overwhelm the market's ability to provide replacements.¹²⁸

Recent developments show that this concern is not simply hypothetical. When Lehman filed for bankruptcy, its counterparties canceled more than 700,000 of its over 900,000 derivatives contracts.¹²⁹ The simultaneous closing out of 700,000 contracts threatened to create chaos both in the Lehman bankruptcy and in the derivatives market generally. The effects were diminished somewhat by netting and by the inability of many counterparties to retrieve assets to satisfy their claims.¹³⁰ Counterparties whose contracts

amendments).

125. See, e.g., *id.* at 12 (warning that “the nondefaulting party could suffer unexpected and perhaps substantial losses” if not allowed to terminate).

126. The original exclusion, which was included in the 1978 Code, applied only to commodities and futures. The bankruptcy laws were subsequently amended to protect securities contracts in 1982, repurchase transactions in 1984, swaps in 1990, and, among other things, cross-product netting in 2005. 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, 644 (2005). The 2005 changes were designed to ensure that any transaction that can plausibly be construed as a derivative is protected. As Edward Morrison and Joerg Riegel have pointed out, the derivatives provisions now insulate entire markets, rather than just particular counterparties as before 2005. *Id.* at 641, 652. See also Rhett G. Campbell, *Financial Markets Contracts and BAPCPA*, 79 AM. BANKR. L.J. 697 (2005) (outlining the 2005 changes).

127. Franklin R. Edwards & Edward R. Morrison, *Derivatives and the Bankruptcy Code: Why the Special Treatment?*, 22 YALE J. ON REG. 91, 94 (2005).

128. For an analysis of this risk that now looks prescient, given the Lehman and AIG crises, see Robert R. Bliss & George G. Kaufman, *Derivatives and Systemic Risk: Netting, Collateral, and Closeout*, 2 J. FIN. STAB. 55, 67–68 (2006). As Bliss and Kaufman note, the advent of master agreements that provide for cross-product netting may have magnified the concentration of the derivatives industry, since the ability to net contracts entered into with a particular counterparty creates an incentive to deal with a single counterparty. By explicitly protecting these netting agreements, the 2005 bankruptcy changes reinforced the competitive advantage of the biggest counterparties.

129. See, e.g., Debtor's Motion for an Order Pursuant to Sections 105 and 365 of the Bankruptcy Code to Establish Procedures for the Settlement or Assumption and Assignment of Prepetition Derivative Contracts 4, *In re Lehman Brothers Holdings Inc. et al.*, No. 08-13555 (Bankr. S.D.N.Y., Nov. 13, 2008) (“Debtors are party to approximately 930,000 Derivative Contract transactions of which approximately 733,000 are purported to have been terminated.”).

130. After establishing a protocol and netting out many of the contracts, ISDA and the derivatives industry

were collateralized could terminate their contract and use the collateral to satisfy Lehman's obligations. Counterparties that did not have collateral, on the other hand, could close out the contract but they could not take further steps to collect what they were owed.¹³¹ If the counterparties had been able not only to close out their contracts, but also to insist on immediate payment, Lehman would have been forced to liquidate many of its assets, which would have seriously complicated the orderly resolution of the case.

From the perspective of Lehman's counterparties, who were forced to stand in line with other unsecured creditors, the uncertainty about the status of their claim could have made it difficult to re-hedge their risk. But this was not an insurmountable problem in most cases. The counterparty could use the standard procedure for establishing its damages, which generally involves determining the cost of an alternative transaction.¹³² The counterparty could then purchase the alternative hedge. The principal cost is uncertainty as to when and how much the counterparty will be paid in the debtor's bankruptcy case. If the contract is unusually large, the cost of re-hedging could be prohibitive. But for other contracts, the delay in recovering is less problematic (and is no different than of other creditors in a bankruptcy case).

The current framework—in which counterparties can terminate their contract but are vulnerable if they do not have collateral—gives counterparties a strong incentive to assure that they are fully collateralized. The pressure to grab collateral was a central feature of the AIG collapse. When AIG's fortunes deteriorated, its counterparties forced the insurer to begin posting collateral. To continue satisfying these demands, the company would have been forced to liquidate assets to generate collateral, perhaps destroying going concern value in the process.¹³³ The risk of value destruction is magnified by the potential consequence of the bankruptcy filing itself. Because it is an event of default under existing derivatives contracts, bankruptcy effectively terminates all of the debtor's contracts at the same time.¹³⁴ To avoid this massive termination event, a company's managers can be expected to take extraordinary steps to avoid bankruptcy. The powerful bankruptcy avoidance incentive makes it even more likely that managers will destroy going concern value as they liquidate assets to post sufficient collateral to avoid bankruptcy.

claimed credit for reducing the confusion. *See, e.g.*, Press Release, International Swaps and Derivatives Association, ISDA Applauds \$25 Trillion Reductions in CDS Notionals, Industry Efforts to Improve CDS Operations (Oct. 31, 2008), *available at* <http://www.isda.org/press/press103108.html>.

131. *See, e.g.*, INTERNATIONAL SWAPS AND DERIVATIVES ASSOCIATION, BANKRUPTCY CODE SAFE HARBOR OVERVIEW 2 (Jan. 2010) ("It is important to note that the solvent party's unsecured claim . . . will be treated the same as other, non-swap unsecured claims and will be paid only at the same time as other, non-swap unsecured claims as determined by a bankruptcy court.")

132. *See, e.g.*, LEHMAN BROTHERS GUIDE TO EXOTIC CREDIT DERIVATIVES 4–6 (2005), *available at* <http://www.investingbonds.com/assets/files/LehmanExoticCredDerivs.pdf> (describing the settlement options).

133. Ordinarily, if a debtor posted new collateral within three months of bankruptcy, this value could be retrieved from the counterparty as a preferential transfer. 11 U.S.C. § 547(b) (2006). But this is one of the provisions that has been waived for derivatives counterparties. *See, e.g.*, § 546(e) (protecting margin arrangements).

134. *See, e.g.*, Jean S. Chin, Joseph P. Collins, Pamela J. Sackmann & Andres E. Aguila, The 2002 ISDA Master Agreement, <http://www.thefreelibrary.com/The+2002+ISDA+Master+Agreement.-a097426052> (describing tightening of bankruptcy default provision in standard agreement) (last visited Mar. 10, 2010).

Lawmakers could address these concerns in a variety of ways. Most sweepingly, they could simply reverse the special protections altogether. Applying bankruptcy's automatic stay and avoidance provisions to derivatives contracts would diminish the danger of a run on a major derivatives counterparty. This benefit would come at the cost of slowing the resolution of derivatives contracts in cases that did not threaten to shake the markets to the same extent. A more nuanced response might be to invalidate the provisions in derivatives contracts that make bankruptcy an event of default, as is done with most other contracts, so that the bankruptcy filing itself would have less dramatic consequences.¹³⁵ Lawmakers might also distinguish among different kinds of derivatives contracts. The case for imposing a stay on termination of credit default swaps, for instance, is stronger than the case for halting termination of an interest rate or currency swap.¹³⁶

Overall, however, we favor the simplest solution—a blanket reversal of the exemption of derivatives and other financial contracts from the automatic stay. In addition to curbing the systemic problems we have described by enabling a debtor to halt asset grabs by filing for bankruptcy, the prospect of a stay would strengthen counterparties' incentives both to carefully monitor the debtor, and to avoid overexposing themselves to a single counterparty. Moreover, the costs of the stay, such as costs due to the uncertainty whether the debtor will assume or reject a contract, could be reduced by setting tight deadlines on the debtor's decision whether to retain the contract.¹³⁷

The current framework is far from perfect. Given the systemic concerns outlined in this Part and the last, rescue loans may sometimes be defensible as an alternative to bankruptcy. But in most cases, either a traditional bankruptcy filing or a bankruptcy filing backed by government financing or a government guarantee of vulnerable assets will be a superior mechanism for resolving financial distress.

VIII. NEW RULES FOR SYSTEMICALLY IMPORTANT FIRMS?

With the initial wave of financial institution failures and bailouts now behind us, the locus of debate over the government's bailout policy has shifted to the legislative sphere. The principal reform proposals would extend bank regulators' resolution authority to include systemically important nonbank financial institutions such as investment banks and insurance holding companies.¹³⁸ In the discussion that follows, we briefly describe

135. See 11 U.S.C. §§ 541(c)(1)(B), 365(b)(2) (over-riding such provisions). For an argument along these lines, see Partnoy & Skeel, *supra* note 4.

136. As proponents of the 1990 amendments that extended special treatment to swaps frequently pointed out, the interest rate protection provided by an interest rate swap will generally not be essential to a bankruptcy debtor, because debtors are not required to make interest payments during the bankruptcy case. See, e.g., *1989 Swap Hearing*, *supra* note 124, at 70 (statement of John J. Jerome) ("The need for interest rate protection is a fiction because you don't pay, for the most part, postpetition interest."). Credit default swaps, by contrast, are more likely to play an important role.

137. Many derivatives could not be assumed by the debtor in any event. Under 11 U.S.C. § 365(c), a debtor cannot assume contracts such as repos that are designed to provide financing.

138. The administration released a lengthy white paper outlining its financial reform proposals in June 2009. TREASURY WHITE PAPER, *supra* note 11. The resolution proposal discussed in this part can be found at 76–79. As of this writing, a version of this proposal introduced by Congressman Frank has been passed by the House. See *Frank Bill*, *supra* note 11.

and assess the new proposals.

Under current law, bank and insurance regulators resolve the financial distress of banks and insurance companies, the FDIC does so for commercial banks and thrifts, and state insurance regulators do so for insurance companies.¹³⁹ The holding company of a bank or insurance company, on the other hand, is subject to the ordinary bankruptcy laws, as are investment banks, hedge funds, and other entities.¹⁴⁰ The proposed reforms would shift these boundaries, giving bank regulators resolution authority over any financial institution holding company deemed “systemically important.”¹⁴¹ If the Fed, Treasury, or FDIC designated an institution such as Citigroup or Bank of America as systemically important, it would be subject to the new resolution regime.¹⁴² In the event of financial distress, the Treasury, in consultation with the President and after two-thirds approval of the Federal Reserve and the FDIC board, would designate a regulator—usually the FDIC according to the government’s White Paper—to step in as conservator or receiver.¹⁴³ Much like the FDIC with commercial banks, the regulator would have sweeping authority to rehabilitate, sell, or liquidate the bank, and to determine the payouts to its creditors and shareholders.¹⁴⁴

The proposal is billed as filling in the gaps in regulatory authority that undermined the government’s response to the Bear Stearns, Lehman Brothers, and AIG failures.¹⁴⁵ When these entities ran into trouble, according to former Treasury Secretary Paulson and other Treasury officials, regulators had only the carrot of bailout money at their disposal; they did not have any sticks. In particular, they did not have the power to intervene and to force the institutions to wind down. “In the absence of [a statutory framework for avoiding the disorderly failure of nonbank financial firms],” as the White Paper puts it, “the government’s only avenue to avoid the disorderly failures of Bear Stearns and AIG was the use of the Federal Reserve’s lending authority.”¹⁴⁶ The new resolution authority would give them the tools they lacked.

In theory, the expanded resolution authority might enable regulators to intervene early in a crisis, but there is reason to be skeptical. When systemically important banks have stumbled, bank regulators have invariably bailed them out rather than letting creditors take losses and risking a contagion effect. Regulators bailed out Continental

139. See Skeel, *supra* note 121, at 727–33 (describing the bank and insurance insolvency frameworks).

140. See, e.g., 11 U.S.C. § 109(b) (excluding insurance companies, banks, and savings and loans from bankruptcy, but not excluding their holding companies or other financial institutions). The brokerage operations of an investment bank can file for Chapter 7 but not Chapter 11. § 109(d) (excluding “stockbroker” and “commodity broker” from Chapter 11).

141. TREASURY WHITE PAPER, *supra* note 11, at 74.

142. *Id.* at 75. If the largest subsidiary is a broker–dealer or securities firm, the SEC would take the FDIC’s place as the final regulatory decision maker and presumptive conservator or receiver. *Id.*

143. *Id.* Other pending proposals would provide somewhat different rules for intervention, but each contemplates a similar expansion of bank regulators’ authority. See, e.g., *Frank Bill*, *supra* note 11 (summarizing the bill as giving the Treasury authority to “appoint the FDIC as receiver for one year to resolve, liquidate, or take other specified emergency stabilization actions with respect to a financial company whose imminent or actual default would have serious adverse effects on financial stability”).

144. TREASURY WHITE PAPER, *supra* note 11, at 75; *Frank Bill*, *supra* note 11.

145. TREASURY WHITE PAPER, *supra* note 11, at 74 (“The federal government’s responses . . . were complicated by the lack of a statutory framework for avoiding the disorderly failure of nonbank financial firms”).

146. *Id.*

Illinois in 1984, for instance, and provided open bank assistance to Citigroup and Bank of America more recently.¹⁴⁷ If the decision making structure were to give the President and multiple regulators a say, as in the original administration proposal,¹⁴⁸ it would reinforce these proclivities by putting the bailout decision in the hands of a consortium of politically sensitive decision makers. Anticipating this protection, investors will provide credit to systemically important institutions more readily, and at lower cost, than with their non-systemically-important peers, just as they did with Fannie Mae and Freddie Mac in the 1990s and 2000s.¹⁴⁹ In addition to institutionalizing the recent bailout policy, the expanded resolution regime would thus spur the continued creation of institutions that are too big and interconnected to fail.

IX. CONCLUSION

If one mentions bankruptcy as a mechanism for addressing a financial institution's default, the usual reaction is incredulity. Those who favor the rescue of troubled financial institutions, and even those who prefer that their assets be promptly sold to a healthier institution, treat bankruptcy as anathema. Everyone seems to agree that nothing good can come from bankruptcy.

In this Article, we have tried to complicate that assumption. We do not wish to go to the opposite extreme and suggest that bankruptcy is always and everywhere the optimal solution to financial institution distress. But bankruptcy has been surprisingly effective in most cases, and it avoids many of the distortions and taxpayer commitments required from the standard, more popular strategy of last-minute rescue lending. With a handful of simple changes, it also could be adjusted to better handle the financial distress of systemically important firms.

147. For a succinct history of these and other bank bailouts, see MCKINLEY & GEGENHEIMER, *supra* note 121, at 1, 5–6 (discussing Continental Illinois), 19–21 (discussing Citigroup and Bank of America).

148. *See supra* note 143 and accompanying text.

149. *See, e.g.*, Peter J. Wallison, *Too Big to Fail, or Succeed*, WALL ST. J., June 18, 2009, at A13 (arguing that “the administration’s plan would create what are essentially government-sponsored enterprises like Fannie Mae and Freddie Mac in every sector of the financial economy”).