

**Bankruptcy's Financial Crisis Accelerator:
The Derivatives Players' Priorities in Chapter 11**

Mark J. Roe

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Abstract

Chapter 11 stops bankrupts from immediately repaying their creditors, so that the court can reorganize the debtor without creditors shredding the bankrupt firm's business. Not so for the bankrupt's derivatives counterparties, who can seize and liquidate collateral, net out gains and losses, terminate their contracts with the bankrupt, and keep both preferential eve-of-bankruptcy payments and fraudulent conveyances they obtained from the debtor in ways that favor them over other creditors. Their right to jump to the head of the bankruptcy repayment line, ahead of even ordinary secured creditors, warps their pre-bankruptcy incentives to monitor the pre-bankruptcy debtor and adjust their investments to better account for counterparty risk, since they do well in any resulting bankruptcy. If they bear less risk, other creditors bear more risk and have more incentives to monitor the debtor. But the other creditors — such as the United States of America — are poorly positioned to provide that monitoring. Moreover, the policy justification for the super-priorities — reducing financial contagion risk — is difficult to maintain today: contagion is as likely to be propagated by the priorities as it is to be stifled, the priorities did not prevent contagion in the 2007-2008 financial melt-down and may have spread it, and we use alternate resolution mechanisms anyway. Bankruptcy policy was made in the erroneous belief that it could contain contagion and that there were no other ways to do so. The best regulatory reaction to this monitoring disconnect is for Congress to repeal the extensive de facto priorities now embedded in chapter 11 for these derivatives counterparties. Repeal would induce the derivatives market to better recognize the risks of counterparty financial failure, which in turn should better stabilize the financial system and dampen the possibility of another AIG/Bear/Lehman financial melt-down, thereby helping to maintain financial stability. Yet the major financial reform packages now in Congress do not contemplate the needed repeal.

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INTRODUCTION

The AIG, Bear Stearns, and Lehman Brothers failures were at the heart of the 2008-2009 financial crisis and economic downturn. Some said the failures sparked a financial panic and exacerbated the consequent economic downturn. Some said they transmitted financial troubles emanating elsewhere in a way that brought the underlying economic damage to a head.¹ Here, I show that the Bankruptcy Code's favored treatment of these firms' massive derivatives and financial repurchase contracts magnified the consequences of these firms' failures.

The Bankruptcy Code did so by sapping the failed firms' derivatives counterparties' incentives to account well for counterparty risk — the risk that their financial trading partner would fail (as AIG, Bear, and Lehman eventually did). Each failed firm likely had more super-priority debt than they would have had otherwise, if that debt did not enjoy the strong, better-than-secured-creditor priorities that the Code gives them. The Code thereby weakened financial resiliency.

Were those super-priorities not in the Bankruptcy Code, the failed firms' financial trading partners would have lowered their exposure to a potential failure of Lehman, AIG, or Bear. Were they not in the Code, each of the three failed firms would have been incentivized to substitute away from what turned out to be risky, often overnight, financing and toward a stronger balance sheet. Were the super-priorities not in the Code, the three firms' counterparties would have had reason to substitute away from some trades with the failed firms, into trades with the next tier of financial firms. Together, those results would have made each of these three firms *less* financially central and *less* inter-connected, reducing their failures' impact and reducing the odds that regulators would view such firms as too big and too interconnected to fail. The players' would have had greater incentives to ease the concentration here of American finance. Because trades in these securities now flow mainly through five firms, decentralization should reduce institutional risk, as the system would be better able to handle the failure of any one of a larger number of financially-interconnected firms, each of which would be less financially central if trades were spread further.

These bankruptcy-induced problems are not small. When Bear failed, a quarter of its capital came from the “repo” market via short-term, frequently overnight

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¹ Compare Thomas Ferguson & Robert Johnson, *The God that Failed: Free Market Fundamentalism and the Lehman Bankruptcy*, THE ECONOMIST'S VOICE, Jan. 2010, with John Cochrane & Luigi Zingales, *Lehman and the Financial Crisis*, WALL ST. J., Sept. 15, 2009. Cf. John Taylor, *The Financial Crisis and the Policy Responses: An Empirical Analysis of What Went Wrong*, NBER working paper, available at <http://www.nber.org/papers/w14631>.

borrowings.² Without the Code's priorities, such a precarious capital structure would not have been viable. When AIG failed, its excessive credit default swap derivatives exposure destabilized it further. Without the Code's derivatives swap priorities, such a precarious position for a financially central firm would not have been so easily viable. These are not just local financial structures that unfortunately failed: As the financial crisis opened in June 2007, we had \$2.5 trillion in overnight repos, when the aggregate insured bank deposits were only twice as much.³ At the same time, \$4 trillion of collateral backed up the derivatives market.⁴ Combine the overnight repo market with the collateralized portion of the derivatives markets and we have a financial market bigger than the FDIC-insured banking system. If there's a failure in these markets, the first set of governing rules come from the Bankruptcy Code.

* * *

A roadmap for this Article: In Part I, I describe the derivative and repo counterparties' Code-based advantages. Although several are conceptually sound, most go far beyond sound bankruptcy and financial policy.

In Part II, I show how the Code's advantages sap counterparties' incentives to closely monitor the weak debtor. This is the central defect in the Code's rules, one that discourages financial resiliency. In Part III, I analyze why creditors' contractual adjustments cannot resolve the Code-induced defect. True, since the Code priorities reduce the derivatives counterparties' risks, they thereby raise risks the firm's other creditors face. Ordinarily, those creditors can react contractually to reduce their exposure to a risky debtor. But the relevant players are poorly informed and poorly skilled at reducing resulting risks because they are not derivatives and repo professionals. The largest affected creditor is the United States as de facto guarantor of weak, too-big-to-fail financial debtors. But the United States has no contract, unless we conceptualize the Bankruptcy Code rules as its de facto contract.

In Part IV, I analyze the major arguments favoring derivatives and repo priorities. The best proffered macro-policy reason is that their priority reduces systemic contagion risk of multiple financial firm failures. But, the priorities are as likely to increase systemic risk as to contain it. Here, however, we have a rare instance of being able to have our cake and eat it too: We can get the systemic advantages of ex ante counterparty monitoring by ending the super-priorities and we can do so without having to fully bear the concomitant systemic costs (if any) because of government

² Bear Stearns, Form 10-Q (Feb. 29, 2008), at 4, *available at* <http://sec.gov/Archives/edgar/data/777001/000091412108000345/be12550652-10q.txt>.

Repos and derivatives are not financially identical, but they enjoy the same super-advantages under the Code. A repo is a sale of assets, often over-night, with the seller promising to buy the assets back. Repos are typically used to finance a firm. Derivatives trade financial outcomes such as those of changing currency rates or of long-term for short-term interest rates. Derivatives typically transfer risks.

³ Adam Ashcraft, Federal Reserve Bank of N.Y. discussion paper, *available at* <http://imf.org/external/np/res/seminars/2009/arc/pdf/ashcraft1.pdf>.

⁴ INT'L SWAPS AND DERIVATIVES ASS'N. ISDA MARGIN SURVEY (2009). Much larger numbers are often quoted for the derivatives market. When a party swaps a floating interest rate for a fixed on, say, \$100 million of debt that neither party has borrowed or lent, the \$100 million "notional" amount is often reported as reflecting the market's size. However, the smaller interest rate is being swapped and an even smaller amount is given by one side or the other as collateral. It's the collateral amount that goes into the text's still-big \$4 trillion number.

agencies' ex post resolution authority. That ex post authority can be made to interact with enhanced ex ante monitoring incentives to strengthen the financial system.

Finally, I conclude. The Bankruptcy Code's safe-harbor, super-priorities for derivatives and repurchase agreements are ill-conceived. Several new considerations need to be brought to analysis of their position in bankruptcy: First, the priorities decrease the derivatives players' ex ante monitoring incentives. However, second, that result heightens the monitoring incentives of other financial players in the subject firms. But these players are incapable of reacting well contractually or otherwise, either because they are poorly informed or because they, like the United States, are distant and contingent. The combination of weakly-incentivized and poorly-informed players encourages risky, knife's edge financing. Third, priority proponents promote potential contagion effects from derivatives and repo failures to justify the priorities they have, while opponents correctly point to run potential as a resulting harm of those priorities. But these two risky outcomes are largely opposite sides of the same coin and, in this contagion dimension, we must be unsure whether super-priority hurts or helps the financial system. It's the monitoring misalignment that's central. Fourth, bankruptcy and financial regulatory policy here is made too often in two separate silos, one for bankruptcy and one for financial regulation. Combining the two wisely would allow us to build a stronger system, one with better bankruptcy ex ante rules that maximize financial resiliency in light of the ex post financial regulation potential. With the interaction in mind we can get the strengths of both run-avoidance and improved monitoring without putting up the full offset of contagion potential.

Overall, although several of the bankruptcy derivatives and repo advantages are functional and ought to be kept, the full range is far too broad. Most are more likely to destabilize financial markets than to stabilize them and most need to be repealed.

I. DERIVATIVE COUNTERPARTIES' CHAPTER 11 SUPER-ADVANTAGES

A. The Code

A failing firm's bankruptcy filing affects its creditors: First, the Bankruptcy Code bars its creditors from suing the debtor for repayment, bars them from trying to otherwise collect debts due from the bankrupt, and, if secured, bars them from immediately seizing or liquidating their security. Second, creditors who are repaid in the 90 days before bankruptcy must return those payments to the bankrupt, thereby allowing all creditors to share in that value. Third, ordinary creditors do not have an unlimited right to set-off their own debts due *to* the debtor against debts due *from* the debtor. Fourth, bankrupts can recover pre-bankruptcy fraudulent conveyances — whereby the debtor sells its own assets for less than their fair value — for the benefit of all of the bankrupt's creditors. Fifth, the Code limits creditors' and suppliers' rights to terminate contracts with the bankrupt. Sixth, creditors cannot terminate their contracts with a bankrupt just because the firm files for reorganization via chapter 11.⁵

⁵ First: Bankruptcy Code, § 362(d) (automatic stay); second: § 547 (preferences must be returned); third: § 362(a)(7) (set-off requires judicial permission); fourth: § 548 (fraudulent conveyance liability for mismatched consideration); fifth: § 365(e)(1) & § 541(c)(1); and sixth: § 365.

For creditors holding derivatives and repurchase agreements with the bankrupt, each of these rules is reversed in their favor. These counterparties can collect on their debts and seize collateral while other creditors wait for the bankrupt to reorganize. They need not return eve-of-bankruptcy preferential payments on old debts and preferential collateral calls that other creditors must return. They have strong set-off rights that allow them to escape handing over money they owe to the debtor. They are exempt from most fraudulent conveyance liability. Finally, derivatives counterparties can terminate contracts; and they need not suffer the debtor's option to assume or reject the underlying contract.⁶ The total impact of these exemptions and special rules is to give the favored a super-priority.

Bankruptcy sticklers may object to calling these *priority* provisions and they are formally correct. The Code sets forth priorities in §§ 507 and 726, which are unaffected by derivative status. The derivatives and repos benefits operate by exempting them from baseline rules (such as the stay, allowing them to liquidate collateral), insulating them from others (such as fraudulent conveyance and preference rules), and giving them more rights (to set-off mutual debts and to terminate unfavorable contracts). But because these rules' total impact is to pay them first, or pay them more, they have in substance super-security. Hence, it is legitimate to call these exemptions short-hand quasi-priorities, which we will here. Those favored by the Code's exemptions, insulations, and special treatment do better and get more.

The normative point here is not that the ordinary rules are uniformly wise; several could be done better if Congress overhauled the Code. The point is that we have two sets of bankruptcy rules — one for derivatives counterparties and one for everyone else — and having two sets of rules here is unwise.⁷ One set limits creditors' seizures from the bankrupt firm. The second set exempts seizures and accords extra priorities to creditors holding financial contracts called "derivatives" or "repurchase agreements." It is no surprise that sophisticated finance players seek this favored framework because it protects them. By doing so, the super-prioritized counterparties' incentives to monitor and to ration their dealings with financially weak debtors decline.

These negative incentives can perniciously affect the debtor itself, its other creditors, and, ultimately, the economy. The best result would be to repeal most priorities in any financial reform package that emerges from Congress. Doing so would reduce the possibility of another AIG-Bear-Lehman melt-down.

⁶ First: Bankruptcy Code, §§ 362(b)(17), (27), 560 (can liquidate collateral in their possession); second: § 546(g), (j) (exempt from preference rules); third: §§ 553(a), 560 (automatic option to set-off); fourth: § 546(g), (j) (exempt from constructive fraudulent conveyance liability); fifth and sixth: §§ 555, 559, 560, 561 (can terminate repos, swaps, and master netting agreements). These apply in both chapter 7 liquidations and chapter 11 reorganizations.

Termination rights can be quite valuable if the counterparty is secured. If it is, it can combine two derivatives exemptions, by terminating the contract and then seizing the security to satisfy any damages that the bankrupt owes it upon termination. Other creditors can neither terminate the contract nor seize the security. Two-thirds of the derivatives contracts were collateralized in 2007. René Stulz, *Financial Derivatives: Lessons from the Subprime Crisis*, MILKEN INST. REV., 1ST Q., 2009, at 58, 65.

⁷ There may be reason to make some basic rules more creditor-friendly than they are (I offer no view on that here) but little reason and much cost to doing so only for a favored group of creditors.

B. The AIG, Bear, and Lehman Failures in Light of the Code

This is not the place to describe the full breadth of the financial crisis and the role the collapse of AIG, Bear, and Lehman played in extending and reflecting the crisis. Good narratives can be found elsewhere.⁸ Instead, we cull core features of the three mega-collapses to see how derivatives' super-advantages in chapter 11 contributed to monitoring disincentives and to the firms' eventual collapse.

1. *AIG*. Consider AIG, the huge insurer. AIG was a big player in the credit default swap market, by which it assured others that it would pay up if another firm's financial product failed. When AIG failed in September 2008, it was obligated on \$400 billion of credit default obligations. Some of these credit default swaps, which functioned as guarantees, were on other companies. Some guaranteed performance of mortgage pools, including those infamous sub-prime housing mortgages.⁹

Goldman was one of AIG's major counterparties. It had protected other investors in the mortgage market on about \$14 billion of securities, then purchased credit protection from AIG at a lower rate, profiting from the \$50 million difference. According to a former chief of AIG's financial products unit, in a post-mortem: "It seems shocking to me that Goldman would become so exposed to AIG and kept doing deals with them and laying on the risk."¹⁰ This is suggestive of Goldman paying insufficient attention to the creditworthiness of its counterparty, AIG, an action consistent with it expecting to have the derivatives priority in bankruptcy. Its Code priorities plausibly distorted Goldman's incentives as it dealt with AIG.¹¹ On the eve of its failure, AIG insisted that Goldman return several billion dollars of what AIG thought to be its own overpayments to Goldman of collateral obligations, as front-page newspaper headlines tell us.¹² Had Goldman lacked the derivatives exceptions for preferences and fraudulent conveyances, its bargaining position would have been weaker, as AIG could have been anticipated to recover the funds from Goldman. Instead, Goldman did not have to, and in fact did not, return the money.¹³

2. *Bear, Stearns*. Consider Bear, the huge investment bank and securities trader. Prior to its failure, it financed itself largely in the "repo" market. Banks like Bear need cash; Bear obtained much of its liquidity by selling its securities, promising to buy

⁸ E.g., WILLIAM D. COHAN, *HOUSE OF CARDS* (2009); LAWRENCE MACDONALD, *A COLOSSAL FAILURE OF COMMON SENSE: THE INSIDE STORY OF THE COLLAPSE OF LEHMAN BROTHERS* (2009); HENRY M. PAULSON, *ON THE BRINK: INSIDE THE RACE TO STOP THE COLLAPSE OF THE GLOBAL FINANCIAL SYSTEM* (2010); GILLIAN TETT, *FOOL'S GOLD* (2009).

⁹ Ben Levisohn, *AIG's CDS Hoard: The Great Unraveling*, *BUS. WK.*, Apr. 6, 2009; Matthew Phillips, *The Monster that Ate Wall Street*, *NEWSWEEK*, Oct. 6, 2008.

¹⁰ Serena Ng & Carrick Mollenkamp, *Goldman Fueled AIG Gambles: Wall Street Firm's Role Shown in Journal Analysis; It Says Problems Hidden*, *WALL ST. J.*, Dec. 12-13, 2009, at B1, B4. The AIG executive had left AIG before its mortgage-backed purchases began in earnest. *Id.*

¹¹ OFFICE OF THE SPECIAL INSPECTOR GEN'L FOR THE TROUBLED ASSET RELIEF PROGRAM, *FACTORS AFFECTING EFFORTS TO LIMIT PAYMENTS TO AIG COUNTERPARTIES*, SIGTARP-10-003, Nov. 17, 2009. But cf. Carrick Mollenkamp & Serena Ng, *Report Rebutts Goldman's Claim on AIG*, *WALL ST. J.*, Nov. 17, 2009.

¹² Gretchen Morgenson & Louise Story, *Testy Conflict With Goldman Helped Push A.I.G. to Precipice*, *N.Y. TIMES*, Feb. 7, 2010, at 1.

¹³ *Id.*

them back later, often the next day. Bear's sale with an obligation to repurchase turned the transaction into a short-term loan to Bear. And, because the overnight loans were typically rolled over, Bear's repo financing became de facto long-term financing, until Bear, in trouble, could no longer roll over its overnight borrowings. This kind of financing was common for securities firms and was "repeated day after day for some thirty years ... leaving Morgan Stanley, Merrill Lynch, Lehman Brothers, and Bear Stearns ... always just twenty-four hours away from a funding crisis."¹⁴

Bear's short, largely overnight borrowing was at the \$100 billion level. With \$400 billion in assets when it failed, a quarter of it was in the repo market, an amount eight times Bear's total equity capital at risk.¹⁵ This level was a sharp increase from 1990, when Bear's net repo financing was only 7 percent of its total liabilities and only twice its equity. Congress has added derivatives priorities to the Code over the decades, expanding them in major ways in 1982, 1994, and 2005. It's plausible to wonder whether Bear's financing counterparties would have so heavily participated in Bear's short-term repo financing were they unable to enjoy the Code's advantages.¹⁶ Bear was not alone: the portion of total investment bank assets financed by overnight repos doubled between 2000 and 2007.¹⁷ Bear failed, but the entire sector financed itself similarly.

Because Bear's repo counterparties could seize and sell their security, they were even less concerned with Bear's viability and liquidity than ordinary secured creditors, who are themselves Code-favored but not as extensively. It's plausible that absent the super-priorities, Bear would not have been able to finance a quarter of its total assets in the repo market for as long as it did. Instead, Bear's borrowings would have likely had to go longer-term, thereby better stabilizing the firm against reversals.

3. *Lehman*. Consider Lehman Brothers, the long-lived investment bank. Prior to its collapse, Lehman owed JP Morgan about \$20 billion. Four days before Lehman's bankruptcy, Morgan froze \$17 billion of Lehman cash and securities that Morgan had and demanded \$5 billion more in collateral.¹⁸ Creditors cannot ordinarily seize and liquidate their collateral in chapter 11, but instead must wait for the bankruptcy court

¹⁴ COHAN, *supra* note 8, at 4-5, 32. Short-term financing can make all concerned more alert. But there is no public policy reason to subsidize that advantage via favored bankruptcy status.

¹⁵ Bear Stearns, Form 10-Q (Feb. 29, 2008), *supra* note 2, at 4, <http://sec.gov/Archives/edgar/data/777001/000091412108000345/be12550652-10q.txt>; COHAN, *supra* note 8, at 32, 94. While this is the number reported in the media, Bear's net repo position is more relevant, as it also bought securities subject to sale-back. But its net position parallels its liability position alone. When it failed, its net repo position was nearly 20% of total liabilities and six times its equity; in 1980, the net had been only 7 percent of liabilities and only twice its equity.

¹⁶ When Bear failed, it had been using non-prime collateral for its repos. It lost access to repo financing when the market would only take government securities for repos. Peter Hördahl & Michael R. King, *Developments in repo markets during the financial turmoil*, BIS Q. REV., Dec. 2008, at 37, 46. Prior to the 2005 Code amendments, only repos of Treasuries and similar securities could obtain super-priority.

¹⁷ Markus K. Brunnermeier, *Deciphering the Liquidity and Credit Crunch 2007-2008*, 23 J. ECON. PERS. 77, 79-80 (2009).

¹⁸ See Darrell Duffie, *The Failure Mechanics of Dealer Banks*, 24 J. ECON. PERS. 51, 67 (2010) (describing JPMorgan-Lehman eve-of-bankruptcy dealings); Susan Craig & Robin Sidel, *Crisis on Wall Street: J.P. Morgan Made Dual Cash Demand*, WALL ST. J., Oct. 8, 2008, at C2; Iain Dey & Danny Fortson, *JP Morgan 'Brought Down' Lehman Brothers*, THE SUNDAY TIMES, Oct. 5, 2008; David Teather, *Lehman Brothers: JP Morgan Accused over Bank's Downfall*, THE GUARDIAN (London), Oct. 6, 2008.

to decide whether the assets are needed for a successful reorganization, protecting the secured creditors otherwise.¹⁹ But because of the exception from the Code's automatic stay for favored counterparties,²⁰ Morgan could liquidate the collateral rightaway in the bankruptcy. Standard secured creditors could not and would have risked that the bankrupt could recovery their pre-bankruptcy benefits.²¹ But the Code super-priority exemptions put Morgan in a better position.²²

The Reserve Fund, the nation's oldest money market fund, owned Lehman commercial paper. It failed shortly after Lehman, attracting widespread media attention and exacerbating the panicked atmosphere of that moment. Money market funds, like the Reserve Fund, invest in short-term securities and seek to maintain an asset value of \$1.00 per share to indicate their financial stability and near-bank-like safety. "Breaking the buck" is considered a shocking event in that financial sector and when the Reserve Fund broke it, the Treasury felt compelled to guarantee all money market funds for a time during the financial crisis.²³

The Reserve Fund held \$785 million of Lehman commercial paper — effectively a short-term IOU that ran from Lehman to the Reserve Fund. That loss accounted for about \$.12 of asset value per \$1.00 share, enough to induce a run of redemption requests and the fund's collapse.²⁴ Because Lehman's derivatives counterparties could grab value out from Lehman ahead of Lehman's other creditors, those other creditors, like the Reserve Fund, lost more than they otherwise might have.²⁵

While the Reserve Fund's collapse has been linked to Lehman,²⁶ it is not so much the ex post problem of that fund's collapse that's central, but the ex ante problem of monitoring disincentives that is critical. Someone had to lose money when Lehman failed. But had the super-priorities not been in place when Lehman built its capital

¹⁹ Bankruptcy Code §§ 361, 362.

²⁰ Bankruptcy Code §§ 362(b)(17), (27), 560.

²¹ Bankruptcy Code § 546(g), (j). If an asset is transferred for less than full value from a bankrupt in the two years before bankruptcy, it is a fraudulent conveyance, which the bankrupt estate can recover.

²² As of this writing, in March 2010, the Lehman bankruptcy examiner had filed a sealed report on the transactions, with the report expected in time to become public. Shortly after the report was filed, Lehman and Morgan settled claims from these transactions, favorably to Morgan, with Lehman paying Morgan a cash settlement and Morgan returning some unused, unsold, difficult-to-value collateral. Linda Sandler, *Lehman Brother Examiner Files Sealed Report on Banks*, BLOOMBERG.COM, Feb. 9, 2010, available at <http://www.bloomberg.com/apps/news?pid=20601103&sid=awa8w7ZOIhbY#>; *Lehman Settles Collateral Claims With JPMorgan*, N.Y. TIMES DEALBOOK, Feb. 26, 2010, available at <http://dealbook.blogs.nytimes.com/2010/02/25/lehman-settles-collateral-claims-with-jpmorgan>.

²³ U.S. Dep't of the Treasury, Office of Domestic Finance, Treasury's Temporary Guarantee Program for Money Market Funds, <http://www.treas.gov/offices/domestic-finance/key-initiatives/money-market-fund.shtml> (accessed Nov. 13, 2009).

²⁴ The Reserve Fund, Press Release, Sept. 16, 2008, available at http://www.reservefunds.com/pdfs/Press%20Release%202008_0916.pdf; Marcin Kacperczyk & Philipp Schnabl, *When Safe Proved Risky: Commercial Paper during the Financial Crisis of 2007-2009*, 24 J. ECON. PERS. 29, 40-41 (2010); Jeffrey N. Gordon & Christopher Muller, *Avoiding Eight-Alarm Fires in the Political Economy of Systemic Risk Management* (working paper, Nov. 9, 2009) (MS at 11, 31 n.131).

²⁵ The Reserve Fund could have faced problems just from the other creditors being secured, although the sequence suggests a \$5 billion eve-of-bankruptcy preference to JP Morgan Chase that benefited from the derivatives' exemption from preference law.

²⁶ *Id.*

structure and derivatives portfolio, the incentives for Lehman's derivatives and repo counterparties' to want a more stable Lehman would have been greater. And Lehman itself would have been incentivized to keep to a safer capital structure, in order to encourage the counterparties to keep dealing with them.

This monitoring incentive problem is the problem we focus on next.

II. CODE-INDUCED DISINCENTIVES TO PRIVATE MONITORING

A. The Code-Created Mismatched Monitoring Incentives

The Bankruptcy Code's core negative consequence of favoring derivatives contracts and repurchase agreements is that doing so encourages investors in these instruments to slacken their efforts to contain the risk of counterparty failure.²⁷

1. *Derivatives counterparties have knowledge, but limited incentives.* The super-priorities reduce the counterparties' risks, inducing them to accept a higher, perhaps even imprudently higher, level of derivatives and repo financing with the weak counterparty. If the strong players were made to bear more of the risk of a weaker player's failure, then the stronger ones would have reason to reduce their exposure to weaker players. That would make the weaker player less financially central, which in turn would make its failure less likely to be systemically important.

2. *Exposed unsecured creditors have incentives, but limited knowledge.* Because the derivatives and repo counterparties bear less risk of debtor failure, the debtor's other creditors correspondingly bear more risk. One could mistakenly believe that the total level of incentives to monitor and ration risk here are kept the same, as a sort of Modigliani-Miller irrelevance proposition, but this is not the case.²⁸

The Code's priority modulation is unlikely to leave the total monitoring incentives unaffected, because the other players in the failing financial firm's capital structure are poorly positioned to monitor that firm. They typically have been commercial paper holders with little monitoring capability, insurance premium payers with no monitoring capacity, or the United States of America as contingent guarantor of the liabilities of firms that are too big to fail.

a. *Commercial paper (Lehman).* Lehman had issued \$4.8 billion in commercial paper prior to its collapse.²⁹ The unwillingness of the commercial paper market to roll-

²⁷ On monitoring incentives and disincentives for secured creditors in general, compare Richard Squire, *The Case for Symmetry in Creditors' Rights*, 118 YALE L.J. 806, 818-19 (2009), with Saul Levmore, *Monitors and Freeriders in Commercial and Corporate Settings*, 92 YALE L.J. 49, 56 (1982).

²⁸ Modigliani and Miller showed that a firm's risks emanated from its underlying operations, not from how it sliced up its capital structure, absent transactions costs. Here, the risk of counterparty failure emanates from the counterparty's underlying business; if one creditor bears less risk, another takes on more. But, as the text shows, the transaction costs decline if the creditor bearing the risk is best-positioned to monitor the debtor. The original M-M paper is Franco Modigliani & Merton H. Miller, *The Cost of Capital, Corporation Finance, and the Theory of Investment*, 48 AM. ECON. REV. 261 (1958); a synopsis is at Merton H. Miller, *The Modigliani-Miller Propositions After Thirty Years*, 2 J. ECON. PERS. 99 (1988).

²⁹ Lehman Bros. Holdings Inc., Form 10-Q (May 31, 2008), available at <http://www.secinfo.com/d11MXs.t1C1k.htm#1stPage>.

over Lehman's obligations was the proximate cause of Lehman's failure.³⁰ Commercial paper players (like the Reserve Fund) operate on very small margins. They invest very short-term, do not write financial covenants into their investments, and are not positioned to monitor their debtors in the fine-textured manner that bank loan officers might try.

Unlike the derivatives counterparties, the commercial paper buyers do not typically participate in the derivatives market. They should not be expected to understand it well, and they do not. Indeed, the monitoring potential for all involved is made hard because of the derivative market's opacity. Even the aggregate level of a financial firm's derivatives exposure is not easy to uncover.³¹

Commercial paper buyers do ultimately react, but not in a finely gauged way and typically not until it's too late for the failing firm to recover. When the commercial paper market comes to understand that the firm is failing, they refuse to roll-over their purchases of commercial paper when the paper comes due. As happened for Lehman, the refusal to roll-over then becomes the proximate cause of the firm's failure.

b. Unsecured policyholders (AIG). A large portion of an insurance company's creditors are unsecured policyholders. The Code's super-priorities put them at risk if the insurance firm's affiliated financial products subsidiary fails and the counterparties pull value out from the insurer. Cross-guarantees are (and were) common and the businesses are hard to fully separate.³² But policyholders are not well-positioned to monitor the insurer's derivatives portfolio, because the policyholders are too often small, retail insurance consumers, who lack the financial expertise to understand the insurer's underlying investment portfolio.

c. Unsecured depositors and bank creditors (Citicorp). Big banks, as custodians of the nation's payments system, are the quintessential systemically vital financial institutions. Lowering their counterparties' risks raises the risks to depositors (or to the depositors' guarantor): if the bank lacks enough assets to pay off all of its creditors, the counterparties come first and the depositors second. But retail depositors are poorly placed to monitor a commercial bank's assets at all, much less understand and monitor a complex derivatives portfolio.³³

The central firms that failed in the financial panic were not commercial banks, but other financial institutions, although the potential for Citibank and its affiliated holding company, Citicorp, was quite real. Still, this mismatch between counterparty monitoring and the exposure of the depositors' eventual guarantor (the United States)

³⁰ INT'L MONETARY FUND, BANK FOR INT'L SETTLEMENTS, AND SECRETARIAT OF THE FINANCIAL STABILITY BOARD, GUIDANCE TO ASSESS THE SYSTEMIC IMPORTANCE OF FINANCIAL INSTITUTIONS, MARKETS AND INSTRUMENTS: REPORT TO THE G-20 FINANCE MINISTERS AND CENTRAL BANK GOVERNORS 19-22 (Oct. 2009), available at <http://www.imf.org/external/np/g20/pdf/100109a.pdf>.

³¹ Frank Partnoy & David A. Skeel, *The Promise and Perils of Credit Derivatives*, 75 U. CIN. L. REV. 1019, 1036 (2007). Better disclosure rules could help. But even with better disclosure, the incapacity of players like commercial paper buyers to assess the meaning of the exposure would persist.

³² See Richard Squire, *Shareholder Opportunism in a World of Risky Debt*, 123 HARV. L. REV. 1151, 1187-89 (2010).

³³ To be sure here, ordinary secured creditors would come ahead of depositors as well. Exemptions from ordinary bankruptcy practice make it easier for derivatives and repos holders to come ahead more often and in greater amounts. Commercial banks do not reorganize in chapter 11 of the Bankruptcy Code. But their affiliates do, thereby making the Code's derivatives exceptions relevant for banking structures.

helps to justify what's now called the Volcker proposal — to separate proprietary trading (such as in derivatives) from government-guaranteed deposits.³⁴

d. The United States of America (All). The most basic, most important mismatch of monitoring incentives and capacity is that of the United States, as lender of last resort to the too-big-to-fail financial institution. Compare the United States to the financially central firm's derivatives counterparties. It is distant from the scene, has diffuse incentives, can face difficulties in hiring those with the relevant expertise, and is often politically constrained from being aggressive. It is not well-positioned to monitor risk successfully on a firm-by-firm basis day-to-day.

The United States can best control its risk exposure not by contract but by fixing the rules governing bankruptcy distributions. Conceive of the Bankruptcy Code adjustments I recommend as the way a regulator who is also a guarantor adjusts to a market that is putting a heavy risk load on the government's shoulders.

* * *

Derivatives lawyers advise their clients to be wary that a counterparty might fail. In a leading derivatives lawyer's guide for derivatives-dealing managers, the author implored firms to develop a derivatives risk management program.³⁵ That program should include having senior people responsible and accountable,³⁶ with manuals that indicate tasks and risk management. But those manuals presumably need not overly emphasize the fundamentals of counterparty risk, because, says the guide in a lawyer's sequence on "What the Pros Recommend" for risk management, counterparty risk is best handled by being *sure that the bankruptcy super-priorities have been obtained*.³⁷

In the derivatives market's early days, before super-priorities were achieved, "it would be quite rare to see a ... derivatives transaction that did not involve Fortune 500 firms or top-tier financial institutions. Indeed, ... commercial and investment banks even formed AAA-rated subsidiaries to handle derivatives..."³⁸ It's plausible to wonder whether derivatives' explosive growth during the past quarter-century depended in large part on the expanding exemptions from normal bankruptcy practice.

B. Counterparties' Reactions to Repeal: Reduce Exposure to Counterparty Risk

Repeal of the super-priorities should make strong counterparties more vividly recognize the risk that weak counterparties could fail. Strong counterparties should react by reducing their exposure to weak counterparties, by more aggressively building stronger financing structures, and by seeking more stable derivatives trading platforms, as exchange trading has been thought to be.

³⁴ Tom Braithwaite & Alex Barker, *Volcker rule sent to Congress*, FIN. TIMES, Mar. 4, 2010, at 3.

³⁵ PHILIP MCBRIDE JOHNSON, DERIVATIVES: A MANAGER'S GUIDE TO THE WORLD'S MOST POWERFUL FINANCIAL INSTRUMENTS 47 (1999). Johnson wrote as a partner in a major law firm with a derivatives practice and as a former chair of the Commodity Futures Trading Commission, the derivatives' markets main regulator.

³⁶ *Id.* at 49.

³⁷ *Id.* at 115-16. The lawyer-author so advised even before all of super-priorities were in place.

³⁸ *Id.* at 56.

1. *By substituting other financing structures.* Most basically, raising the expected private costs to the strong counterparties will press them to substitute away from the investments that repeal would make more costly.

(a) *From overnight repos to more stable financing — going long.* A quarter of Bear's assets came from repurchase agreements that were regularly rolled over, until Bear got into trouble.³⁹ These overnight sale and repurchase contracts were effectively loans, with the difference between the repurchase price and the sale price being the interest on the loan.

Because the Code's priorities made these repos safer for Bear's counterparties, the Code enabled Bear to substitute short-term hot money for safer financing for Bear, like equity and longer-term loans. A primary attraction for Bear's overnight lenders was that the de facto loans would get the Code's super-priorities, enabling those lenders to charge Bear a bit less than otherwise. Other parties — in the end, the United States of America — accordingly took more risk.

If counterparty risk for repos was raised back to normal secured creditor levels, by returning the counterparties to no more than the same strengths secured creditors have, then counterparties in a future Bear-type setting would have more reason to want a more stable counterparty than they have now. And firms like Bear would have more reason to keep themselves more stable, because they could not lower their cost of capital by using the overnight repo Code priorities, which would be gone. They could then better lower capital costs by having a more equity and a more stable base of liabilities. And a more stable base of liabilities would have more longer-term and less overnight hot money. Such shifts would make future financial failures less likely and, by making some key financial institutions more stable and steady the financial system.

(b) *Does the Code encourage knife's-edge, systemically dangerous financing?* We can generalize. It's plausible to suspect that the Code's super-priorities rendered the financial system less stable, by encouraging borrower and lender to engage in riskier behavior than they would otherwise have deployed. With the repos golden under the Code, Bear and its lenders had reason to use them. With derivatives players knowing that they enjoyed super-priority, they could pay less attention to one major cost of trading — the risk that their counterparty could fail and default on its obligations. By minimizing counterparty risk, the Code could well have magnetized this kind of financing, pulling financing from systemically better vehicles into repos.

In 1990, 7 percent of Bear's capital structure was in Code-protected repos. In 1994, 11 percent. And, in 2008, 19 percent.⁴⁰

2. *By reducing exposure to a single counterparty.* The derivatives market is strongly centralized, according to the Comptroller of the Currency, with five firms accounting for nearly 90 percent of the industry's net credit exposure.⁴¹ But if the Code

³⁹ Bear Stearns Form 10-Q (Feb. 29, 2008), *supra* note 2, at 4.

⁴⁰ From Bear Stearns Annual and Quarterly Reports on Forms 10-K and 10-Q. The numbers are net numbers, subtracting Bear's repo assets from its repo liabilities.

⁴¹ OFFICE OF THE COMPTROLLER OF THE CURRENCY, OCC'S QUARTERLY REPORT ON BANK TRADING AND DERIVATIVES ACTIVITIES, 2d.Q. 2009, *available at* <http://www.occ.treas.gov/ftp/release/2009-114a.pdf>; David A. Skeel, *Bankruptcy Boundary Games*, 4 BROOK. J. CORP. FIN & COM. L. 1, 10-11 (2010) (summarizing legislative history skeptically).

were altered so that the counterparties were made to bear more of counterparty risk, stronger firms would have more reason to further diversify their range of counterparties. This should further reduce systemic risk, because there would be more players with a smaller stake in this financial market. One firm could fail without an out-sized negative impact on the economy.

The following is the hoped-for sequence from weakening the super-priorities: Knowing they bear some more counterparty risk, strong players diversify their counterparties. More counterparties would mean less risk that any single counterparty becomes systemically vital. Thereafter, the strong counterparty should view a weakened counterparty as less likely to be too big to fail, because it would be smaller than before. That recalibrated expectation should then motivate it to go another round of diversification to bear even less significant counterparty risk. The cycle should reduce systemic risk.

C. Runs and Contagion

Regulators justly feared that one financial failure could induce others to fail. This fear justified treating derivatives and repos favorably.⁴² Less understood when the Code was built is that the derivatives exceptions also *increase* the incentive of the failing firm's derivatives counterparties to close out their positions, thereby *starting or spreading* financial failure. Indeed, the Code's super-priorities may well have accelerated recent financial difficulties by pushing derivatives and repo creditors of failing financial firms to rush to cash in their claims, which others could not do. These cash-outs are familiar as bank runs, which deepen and extend bank failure. These demands are also familiar in bankruptcy as higher-ranking creditors seek immediate repayment in ways that can halt an otherwise viable firm from reorganizing.⁴³

The run perspective is straightforward: Just as banks with illiquid assets are vulnerable to massive, near-simultaneous requests to cash in deposits, leveraged firms with illiquid assets are susceptible to runs. If creditors sense a weakening debtor and understand that they can rush the debtor to repay and if the creditor can keep that repayment, then creditors have an incentive to rush the debtor to repay. In doing so, they may dismember a firm that is otherwise valuable intact or whose value could be better preserved if partially restructured over time.

Bankruptcy preference and automatic stay rules normally stymie such runs: creditors who were repaid in the 90 days before bankruptcy are subject to a bankruptcy recall of their payments. And creditors often negotiate contractual stand-still agreements, under which each major creditor agrees not to pursue its remedies against the firm, so that a peaceful workout can be negotiated. Derivatives counterparties need not feel so encumbered under the Code, because they are not restricted.

⁴² See sources cited *infra* note 61-62.

⁴³ THOMAS H. JACKSON, *THE LOGIC AND LIMITS OF BANKRUPTCY LAW* 7-19, 125 (1986).

The derivatives' safe harbors from preference law and the automatic stay increase the incentives for the failing firm's counterparties to start a run.⁴⁴ If the failing firm is financially central, these possibilities thereby enhance systemic risk.⁴⁵ Finally, the Code's derivatives and repo exceptions are based on old economic thinking, failing to account for the powerful potential of informational contagion.

1. *AIG: Collateral calls, the run, and private lenders' unwillingness to lend.* The derivatives priorities hastened AIG's failure. As AIG weakened, its derivatives counterparties could, and did, demand collateral from AIG, sapping AIG of liquidity.⁴⁶ Chapter 11 ordinarily bars such collateral grabs, stopping them via either the automatic stay or via preference law, which forces the grabbed collateral back into the bankrupt's estate to benefit all creditors.

The Code's prospect of preference recovery is designed to stymie runs such as AIG's.⁴⁷ Eliminating the Code's stay for one key class—derivatives counterparties—recreates the bankruptcy run problem. It reduces the potential for firms like AIG to raise new money to stabilize themselves, as the potential new investors want to wait until the run is over to see what value, if any, is left in the firm.

Stephen Lubben describes the situation:

Once it became clear that the [AIG] financial products division would have to pay out on [some credit default swap] contracts ... AIG's credit rating fell, ... its counterparties ... demand[ed] that AIG post cash or other assets as collateral to back up the swaps. This converted the previously unsecured claims on the swaps into secured claims.

It also became self-reinforcing — as AIG posted more collateral, it began to develop liquidity problems, which led to the threat of further downgrades and collateral calls. There was no end in sight [A] run on AIG had commenced.⁴⁸

A difficulty with the run analysis is how hard it is to fully evaluate how incentives would change if the rules differed. True, if the priorities and exceptions were unavailable, the weak firm's decline might be slower and softer. But their absence might just start the run-induced decline earlier. In contrast, strong counterparties might see a weakening debtor but, because the strong player benefits from the super-priority, it might forgo collecting immediately. If denied that priority, it might act sooner, starting a run and collapsing the weak firm even earlier. It's hard to predict whether the priorities make us worse off in run terms or whether they just change the timing of the weak firm's decline.

⁴⁴ Stephen J. Lubben, Repeal the Safe Harbors (working paper, 2009), available at <http://ssrn.com/abstract=1497040> (MS at 2). See also Stephen J. Lubben, *Derivatives and Bankruptcy: The Flawed Case for Special Treatment*, 12 U. PA. J. BUS. L. 61 (2009).

⁴⁵ Franklin Edwards & Edward R. Morrison, *Derivatives and the Bankruptcy Code: Why the Special Treatment?*, 22 YALE J. REG. 91, 101, 107-09 (2005); Partnoy & Skeel, *supra* note 31, at 1049.

⁴⁶ Stulz, *supra* note 5, at 64.

⁴⁷ JACKSON, *supra* note 43, at 125.

⁴⁸ Lubben, *supra* note 44 (MS at 2). Cf. Duffie, *supra* note 19, at 68-69.

2. *Contagion.* A related view—focused on contagion potential, as counterparties, unable to get their collateral, themselves fail—has justified the derivatives priorities. But properly analyzed, the contagion effect, and the purported need for super-priority, is also indeterminate. Super-priorities could stop the spread of the contagion or they could hasten its spread. Policymakers have focused on the first possibility, not the second.

Focus first on the costs of priority lost, the derivatives industry will say, as it did when obtaining the priorities from Congress. If one derivatives contract fails, then the counterparty will be out of pocket the underlying cash. That counterparty will, having lost on a set of contracts with a sinking debtor, in turn fail on its own financial contracts. Failure would cascade through American (and world) financial institutions and then break out into the real economy.⁴⁹

The contagion possibility is real, but the directionality of the impact of the super-priorities is uncertain. We do not know, even now, whether priority that leads to collateral calls is a primary source of contagion or whether it's part of the cure. It's telling that the Federal Reserve was unwilling to let Long-Term Capital Management fail in 1998, *because* it concluded that the derivatives priority could, contagion-like, spread through the financial system. That is, the LTCM contagion risk was due *to* the counterparties being *exempted* from the Bankruptcy Code's automatic stay from collection and contract termination.

The Fed thought that a considered reaction from the financial market, with LTCM's portfolio staying in place, unliquidated, would have allowed the financial system to stabilize naturally. But due to LTCM's counterparties having Code priorities and exemptions, that option wasn't available to the Federal Reserve. Had the Code priorities not been in place, the contagion potential would, given the Fed's conclusions at the time, have been *less*, not more.⁵⁰

Similarly, we today still do not know whether the derivatives exceptions dampened or accelerated a contagion emanating from Lehman and AIG. Lehman's failure induced the Reserve Fund to break the buck (and put other money market funds at similar risk).⁵¹ This observation has been made to indicate that the Reserve Fund's failure was one of the reasons governmental authorities erred by not bailing out Lehman, as the Reserve Fund break accelerated the financial panic.⁵² But what we do not know is whether the priorities *exacerbated* contagion, to the detriment of Lehman's ordinary creditors, such as commercial paper holders like the Reserve Fund. If the

⁴⁹ See H.R. REP. NO. 97-420, 97th Cong., 2d Sess., at 1, *reprinted in* 1982 U.S.C.C.A.N. 583 (1982); Philippe Jorion & Gaiyan Zhang, *Credit Contagion from Counterparty Risk*, 64 J. FIN. 2053 (2009).

⁵⁰ Cf. Edwards & Morrison, *supra* note 45, at 100-01.

⁵¹ Gordon & Muller, *supra* note 25.

⁵² Cf. Office of the Special Inspector General for the Troubled Asset Relief Program, Factors Affecting Efforts to Limit Payments to AIG Counterparties, SIGTARP-10-003, Nov. 17, 2009, at 10-11:

After Lehman filed for bankruptcy, the Reserve Primary Fund ... "br[oke] the buck," which further aggravated the credit crisis. The resulting market anxiety contributed to a run on the Reserve Primary Fund in which investors attempted to withdraw their money quickly. In addition, large-scale redemptions caused money market mutual fund companies to hoard cash rather than invest in funding markets

derivatives parties were at the same priority level as the Reserve Fund, perhaps the fund would not have broken the buck.⁵³

Lastly, the Code's derivatives and repo thinking did not reflect modern economic thinking on signaling and information contagion. The Code focuses on linkage contagion—one firm fails and brings down its counterparty, inducing a chain reaction—but did not consider information contagion.

Consider the effects of failure when creditors are poorly informed about their counterparties' financial health. Creditors rely primarily on collateral and the Code super-priorities that give them immediate access to the collateral. Next, an unexpected economic shock tells them that their collateral is worth less than they had thought, so they suddenly must rely on counterparty financial quality. But they are not well-informed about counterparty financial quality, because, until the shock, they had little reason to pay attention to that. So, when Bear, Lehman, and AIG failed, creditors reevaluated their priors about their collateral and about their *other* borrowers' solvency. If they had a deeper stock of direct information about their counterparties' portfolios, they would not have re-pegged downward the quality of all counterparties. But, they lacked enough counterparty-specific information. They faced an informational black hole, into which they wished not to enter. Hence, they stopped lending, until they could acquire better information about their counterparties. This suddenly made more of their counterparties more illiquid.⁵⁴

This result is a panic, with lending markets freezing up. "A panic [occurs when] informationally-insensitive debt [suddenly] becomes informationally-sensitive. It is a switch because it becomes profitable to produce private information about the debt."⁵⁵

Or about the debtor. That description resembles American financial markets in September 2008. Had the players considered counterparty risk to be nontrivial in the ordinary course of running their business, which a better Code could have prodded, they would have been generating information about their counterparties. Failures such as those of Bear, Lehman, or AIG, would not necessarily have made the entire financial market resemble a black hole, because creditors would have had glimmers of understanding of the color, depth, and shape of the other financial players' firms.

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⁵³ Michael Mackenzie & Helen Thomas, *Repo dealers fear legislation will drain liquidity*, FIN. TIMES, Dec. 7, 2009 (as "investors became worried about the health of Bear Stearns and Lehman Brothers, those institutions suffered a run on their repo positions, which contributed to their eventual demise").

The run's defect is in how the financial market deals with a single company's derivatives; the contagion defect is in how multiple companies deal with one another's derivatives. A run at a single weak bank (exacerbated by the Code's priorities) could induce contagion at a stronger counterparty (with that contagion, Code defenders assert, dampened by the Code's priorities). Which Code effect is greater is not a priori known or maybe even knowable. Recent experience suggests that policymakers underestimated the run effect, perhaps because the industry highlighted to Congress and regulators the contagion effect.

⁵⁴ See Gary Gorton, *Slapped in the Face by the Invisible Hand: Banking and the Panic of 2007*, available at <http://www.frbatlanta.org/news/Conferen/09fmc/gorton.pdf> (MS at 5, 35). See generally Brunnermeier, *supra* note 17; Douglas W. Diamond & Raghuram G. Rajan, *Liquidity Risk, Liquidity Creation and Financial Fragility: a Theory of Banking*, 109 J. POL. ECON. 2897 (2001); FRANKLIN ALLEN & DOUGLAS GALE, *UNDERSTANDING FINANCIAL CRISES* (2007); Franklin Allen & Douglas Gale, *Financial Intermediaries and Markets*, 72 ECONOMETRICA 1023 (2004).

⁵⁵ Gorton, *supra* note 54, at 35.

The contagion argument is a doubled-up policymaker's nirvana fallacy. First, its view is that we need rules favoring one set of financial claimants who are important. Somehow, though, this favoring of one set of financial claimants miraculously does not damage any other important set of financial claimants, but spreads through the system at negligible cost. Finance economists such as Modigliani and Miller have shown parallel arguments to be fallacious:⁵⁶ There is a fixed amount of risk; the structure spreads it, transfers it, or concentrates it, but does not directly reduce it. That fixed amount of risk emanates from the underlying operational situation — such as the fragility of the subprime mortgage market. One needs a strong transaction cost story on why shifting the contagion risk from one place to another reduces overall contagion risk. To the extent there's a transaction cost story here, it goes in the opposite direction, as the rules disincentive monitoring and encourage knife's-edge financing.

Relieving a party of counterparty risk does not in itself alleviate contagion risk. Someone, somewhere pays for that shift and bears that risk.

As Edwards and Morrison have insightfully pointed out about the justifications for the derivatives counterparty priorities, “systemic risk is a red herring,”⁵⁷ although the stated justification for the derivatives' exceptions was that Congress sought to prevent the “insolvency of one commodity firm from spreading to other brokers ... and possibly threatening the collapse of the market.”⁵⁸ “[T]he Code can do little to mitigate it...”⁵⁹ In fact, the Code may exacerbate systemic risk by facilitating a run by derivatives counterparties, such as that feared for Long-Term Capital Management at the time of its collapse.⁶⁰ Second, on top of that, the Code does not effect the possibility of information contagion, which is increasingly understood by economists to be central. In fact, the Code heightens its possibility.

Lastly here, Congress analyzed the institutional tools that contain contagion incorrectly. It assumed that if derivatives counterparties lacked super-priority, contagion was likely.⁶¹ But the government apparatus has arrested similar contagion via FDIC or Federal Reserve resolution of the affected firm or via their guaranteeing the underlying payouts. Congress analyzed derivatives' treatment under the Code in a silo, as if there were no FDIC or Federal Reserve authority to arrest a contagion if and when it arose. Instead, it went too far, not realizing, first, that ex ante shifting value does not itself reduce contagion, and, second, that the transactional disincentives the shifts created were as likely to create both contagion risk and run risk. Lastly,

⁵⁶ Modigliani & Miller, *supra* note 28; Miller, *supra* note 28.

⁵⁷ Edwards & Morrison, *supra* note 45, at 94. For an analogous point, see Squire, *supra* note 32, at 1200.

⁵⁸ H.R. REP. NO. 97-420, 97th Cong., 2d Sess., at 2 (1982). Closely related is the enhanced liquidity of the financial market. “Enhanced liquidity is undoubtedly a social good It is less obviously a social good when it is the product of a government subsidy, paid for by other creditors.” Edwards and Morrison, *supra* note 45, at 119.

⁵⁹ Edwards & Morrison, *supra* note 45, at 94.

⁶⁰ *Id.* at 94, 100-01.

⁶¹ 128 CONG. REC. S15981 (daily ed. July 13, 1982) (statement of Senator Dole) (“It is essential that stockbrokers ... be protected from the issuance of a court ... order which would stay [seizure], because ... the insolvency of one party could trigger a chain reaction of insolvencies...”). And, when the safe harbors were expanded: 135 CONG. REC. S1414 (daily ed. Feb. 9, 1989) (statement of Senator DeConcini upon introduction of S. 396).

Congress did not account for the fact that there were ex post means to contain contagion if it in fact arose and that no Code rule could eliminate contagion costs, but with ex post resolution available, we could harness ex ante monitoring and financing incentives to reduce the frequency that the ex post authorities would be called upon. (We need not pin the analytic blame solely on Congress. The derivatives association's lobbying arm, the International Swap Dealers Association (ISDA), the Securities Industry Association, and others strongly supported the exemptions, proffered the contagion theory as determinative, and did so without opposition.⁶²)

3. *Ex post vs. ex ante.* Still, the best macro-justification for the bankruptcy super-priorities is the belief that priority dampens contagion effects and systemic risk. The strategy is an ex ante one: if counterparties do well, they will be less likely to fail and less likely to spread financial failure throughout the economy.

But, as we've seen, there is reason to believe that the super-priorities *increase* systemic risk. They can strongly do so in two ways: by facilitating runs and by disincentivizing monitoring for counterparty failure risk.

While the Bankruptcy Code operates here via ex ante rules, the regulatory apparatus does not. Ex post, when a crisis appears, government authorities can decide whether a financial firm really is systemically vital. If it is (or if part of its portfolio is), the authorities can intervene and subsidize, ex post. If it is not vital, the government can stay away. The Code in effect bails out *all* derivatives counterparties when only some will turn out to be systemically vital.

This thus becomes one rare area where we can have our cake and eat it to. We can repeal the over-extended super-priorities and thereby both (1) *reduce* the systemic risks they *create* and (2) *increase* the monitoring incentives to *reduce* systemic risks. Yet, we need not watch helplessly if there are still resulting systemic failures; ex post the regulatory authorities can save the systemically vital portfolio or its firm.

* * *

In short, although the normative impact of run and contagion analysis is ambiguous, the policy bottom line is not. Contagion proponents are correct that a financial firm's failure could spread through the financial system. But it is indeterminate whether the priorities reduce contagion, increase it, or net, do nothing at all. The priorities mean that the strong counterparty survives, but also mean that weaker lenders to the failing firm, like the Reserve Fund, do not. Which failures are more systemically costly is not at all obvious. Even if contagion risk is real, the risk of a run on the weak institution is in play, ex ante offsetting contagion risks. The AIG and Bear situations looked like runs of a type that the super-priorities made possible.

Thus, it's hard to know whether without the super-priorities we would have more contagion (but fewer runs) and whether with the priorities we have less contagion (but more runs). In contrast to this uncertainty, the monitoring disincentives stemming

⁶² Shmuel Vasser, *Derivatives in Bankruptcy*, 60 BUS. LAW. 1507, 1510 (2005). An earlier expansion of the super-priorities, coordinated by the President's Working Group on Financial Markets in the 1990s was described by an FDIC player as "an outstanding example of regulatory and industry cooperation and coordination." Michael Krimminger, *The evolution of U.S. insolvency law for financial markets contracts*, 18 FIN. FACTORY 79, 83 (2006). That relationship might be seen more cynically as industry capture of policymaking.

from the derivatives priorities are as close as we usually get to being unambiguously and perniciously inefficient. Repealing the derivatives priorities would, ex ante, enhance monitoring and diversification incentives. And an ex post strategy from outside the Bankruptcy Code would still permit regulators to handle systemic, contagion risks that nevertheless arise.

III. WHY CONTRACT CANNOT SOLVE COUNTERPARTY RISK

When one creditor's risks in an enterprise decline, another's rise. Once that other party understands it has been made to bear more risk, it should react by raising its interest rate, by seeking to reduce the risk it faces, or by improving its contract terms. Such contract reaction is possible in the derivatives priority situation we are analyzing, but it's ultimately incomplete — and seriously so.

A large slice of the risk is transferred to parties that cannot, or will not, react contractually. The other contract parties are poorly positioned and too weakly informed to monitor the debtor's overall riskiness in general and its derivatives portfolio in particular. The new risk-bearers are insurance policyholders, depositors, ordinary commercial paper buyers, and similar players who are not well informed about the derivatives market. In this dimension, we need not identify the precise, primary reason for the big firms' failure in the 2008 financial crisis. Whatever the impetus for failure,⁶³ the derivatives and repo exceptions put risk on the shoulders of parties poorly-positioned to monitor the firms.

The second reason why contractual reaction is necessarily incomplete is that the major creditor who receives the transferred risk is the United States of America as guarantor of too-big-to-fail firms. The United States cannot react contractually in any grounded real sense of contract. It can instead react by changing the rules of the game to account for its weak monitoring position. For the United States, changing the Code's priority structure is its way of reacting quasi-contractually.

A. Contractual Reaction and Its Limits

1. Financial covenants as partial solution. Once burnt, twice shy. Ordinary creditors of financial firms in future could take the debtor's derivatives exposure into account. A simple way to do so would be to limit the total derivatives exposure by an appropriate formula. This is common in financial contracting: the lender lends, but requires that the debtor maintain a debt-to-equity ratio of no more than, say, \$2 of debt

⁶³ While the conventional wisdom is that credit derivatives were central in bringing down AIG and others, some analysts show the riskiness of AIG's core portfolio to have been more central. Squire, *supra* note 32, at 1183-87, 1203-04. Cf. Viral V. Acharya et al., *Manufacturing Tail Risk: A Perspective on the Financial Crisis of 2007-09*, 4 FOUNDATIONS AND TRENDS IN FINANCE (2010, forthcoming) (excessive risk-taking in large financial institutions). This would extend the monitoring story: super-priorities reduced the incentives to monitor counterparty risk, with that counterparty risk emanating from both the immediate trades and the firm's overall portfolio.

for every dollar of equity.⁶⁴ Derivatives could be folded into these kinds of financial covenants. Thus, contract can help.

But it cannot help fully, because derivatives counterparties can also react and, one expects, will. Some derivatives counterparties did well due to their bankruptcy benefits, but others did not anticipate the financial crisis and, hence, did not take full advantage of the privileges that the Code offers them. In the next financial crisis, one would expect that more counterparties will be prepared for the crisis and, hence, will, if the Code still permits it, demand collateral sooner, be sure that their set-off positions are advantageous, and demand repayments that would otherwise be voidable transfers absent the exemptions.

Contractual reaction may be an arms race going forward. Non-derivatives creditors seek better contract protection, knowing the story of AIG, Bear, and Lehman. But derivatives counterparties know that they are exposed unless they take care to get their bankruptcy super-priorities. In a typical contractual setting, without spill-over effects, the best policy is usually to let the private players find their *modus vivendi*. But here, spill-over effects and systemic risks make that kind of reaction not ideal.⁶⁵

2. *The necessary incompleteness of contractual reaction: The United States as de facto guarantor.* The principal problem with relying on contractual adjustment to ameliorate the monitoring mismatch is that financial institutions have a very large, passive creditor that cannot readily adjust contractually. The United States is a *de facto* creditor as it pays up to rescue too-big-to-fail financial institutions. Even if the private parties adjusted, there would be suboptimal contractual adjustment overall, because one of the creditors — the U.S. Treasury — is not adjusting its contracts. Moreover, some of the private lenders may under-adjust contractually if they conclude that a derivatives failure is likely to be enmeshed in a financial crisis and, in a financial crisis, the Treasury will likely rescue the firm.

The U.S. Treasury's equivalent to contractual adjustment for the fire next time is regulatory adjustment now. And that regulatory reaction is best handled by changing the Bankruptcy Code.

This is not a small point: contractual reaction to super-priorities now that financial players know the priorities are valuable is *necessarily* going to be grossly incomplete, because the biggest creditor is the United States. And it can only react by changing the regulatory framework, not by writing another clause into its bond

⁶⁴ AMERICAN BAR FOUNDATION, CORPORATE DEBT FINANCING PROJECT, COMMENTARIES ON MODEL DEBENTURE INDENTURE PROVISIONS 326-469 (1971).

⁶⁵ Some arms race proponents posit that counterparties would react to repeal by grabbing collateral earlier, seeking to get the collateral 91 days before bankruptcy instead of a few days before. Doing so would, they'd assert, put them outside the bankruptcy preference recovery period, thereby putting the financial system approximately where it was when they had an eve-of-bankruptcy preference safe harbor. But positing this scenario misunderstands the way bankruptcy preference law works. Goldman, with a safe harbor, might grab its collateral 91 days before it initially *expects* a bankruptcy instead of on its eve. Cf. *supra* notes 10-12. But Goldman cannot assuredly succeed in doing so without the preference super-priority exception. That early seizing of collateral is typically a public event, allowing other creditors to consider acting, by demanding repayment from the debtor, and even forcing an early bankruptcy, turning the seizure of collateral day into Day 7 before the debtor's bankruptcy instead of Day 91. Goldman, well-advised that creditors will so react, would, if it lost that favored status, have less reason to seize collateral and more to pursue a collective remedy among creditors. This process is well understood by bankruptcy players. Consult any bankruptcy textbook or treatise, or see JACKSON, *supra* note 43, at 7-19, 122-50.

indenture or loan agreement, because it has no bond indenture or loan agreement. It is exposed and its equivalent to a bond indenture here is the Bankruptcy Code, which is now quite unfavorable to the United States.

B. Real Regulatory Reaction

The most sensible regulatory reaction is to repeal the super-priorities.

1. *Changing the Bankruptcy Code.* The changes are simple but far-reaching. The derivatives parties' ability to seize collateral would be folded into the secured creditors' strong, but not all-encompassing, power to do so. The strong counterparties would be subject to ordinary preference and fraudulent conveyance law. The parties could continue to net obligations due to the bankrupt with those due from it, but only if the two are economically a single transaction and not if they are unrelated transactions.

This does not mean that derivatives players would be thrown cold and naked into the street, unpaid. As long as the debtor is solvent, they would be paid. That will induce the derivatives players to deal with solvent debtors who remain solvent.

2. *Changing the Code's coverage: The Resolution Authority.* The congressional financial reform bills⁶⁶ and the Administration's proposals⁶⁷ contemplate expanding governmental powers to resolve failed financially central firms. Congress and the Administration are reacting to shortfalls in the AIG, Bear, and Lehman failures — either discovering real gaps in regulatory authority or finding that it's better to explain their shortfalls in results on a lack of authority than to explain them on the difficulty of reacting to momentous events under great time pressure. The resolution proposals may have merit,⁶⁸ but the better first, or simultaneous, reform step is to enhance private incentives to monitor counterparties and build stronger financial structures.

Resolution authority and Code super-priorities interact, as we have seen. The Code provisions quite plausibly create more systemic risk than they eliminate, by disincentivizing monitoring and possibly incentivizing runs. But the presence of an ex post back-stop makes the contagion downside, if any, from repeal less important, or even irrelevant, to reducing systemic risk. If it happens, the regulatory authorities can react in a targeted way. In the meantime, the Code could encourage pre-bankruptcy private monitoring and discourage pre-failure collateral grabs, by repeal.

3. *Justified exceptions for the derivatives market.* While I focus here on the substantially over-broad nature of the counter-party derivatives and repo priorities, not every priority lacks merit. I next point to two of the more important justified priorities.

Consider the netting rules. The Code allows derivatives players to net obligations to the bankrupt with obligations from the bankrupt. Netting can be very valuable even if the obligations are identical in size. If the counterparty owes the

⁶⁶ THE WALL STREET REFORM AND CONSUMER PROTECTION ACT OF 2009. H.R. No. 4173, 111th Cong., 1st Sess., which passed the House of Representatives in December 2009.

⁶⁷ UNITED STATES DEPT. OF TREASURY, FINANCIAL REGULATORY REFORM: A NEW FOUNDATION (June 17, 2009).

⁶⁸ For the view that they lack merit, see Peter J. Wallison, *The Meaning of the Lehman Bankruptcy*, Nov. 5, 2009, available at <http://www.aei.org/speech/100101> (Am. Bankr. Inst. speech) (Lehman's failure was not a systemic event, beyond the failure — minor in the author's view — of the Reserve Fund).

bankrupt \$100 million on one contract and is owed \$100 million on another, the typical result, without netting, is that it must write a check to the bankrupt for \$100 million, but it receives only a fractional return from the insolvent bankrupt. If the return to the bankrupt's creditors is only 10 cents on the dollar, a typical no-netting scenario yields the counterparty a \$90 million loss. Netting gets it that \$90 million. As between it and the debtor, this result is fair. But as between the counterparty and the debtor's *other* creditors it may not be. Regardless, it is not the general rule in bankruptcy.

The derivatives industry had reason to want Congress to clarify that typical, basic swap contracts were integrated economically and should be treated as a single unit in bankruptcy. The derivatives players' legitimate netting goal is to net two sides of an economically integrated single contract. Here's why: A swap arrangement exchanges risk. One side promises, say, to pay the London interbank interest rate, a benchmark rate that floats according to market conditions. The other side promises to pay a fixed rate of, say, 5 percent. (One side does not want to bear the risks of interest rate changes, while the other side can. So they trade.) An anti-netting rule could force the outsider to pay the full 5 percent, but only be able to collect a fraction of the floating rate obligation from the insolvent debtor. But this trade was economically a single contract, not two discrete deals. They should be netted and, even absent a Code safe-harbor, ought to have been seen to be single contract. As one well-informed derivatives player reported:

At one time, a trustee in bankruptcy could look over your counterparty's entire portfolio ..., disavow those with losses, and keep those that were profitable. This practice ... is no longer possible in the U.S. ...⁶⁹

That level of netting is sensible, but the Code goes much further. It allows the counterparty to net completely unrelated contracts, as long as they can be called derivatives or repurchase agreements. And its scope is so broad as to allow a party to net a winning position with the bankrupt against a losing contract (which the bankrupt would only pay fractionally) that the counterparty acquires *after* the debtor fails.

That is, strong counterparties can net strategically, by acquiring a flimsy obligation *from* the debtor and getting it de facto paid dollar for dollar by matching it with a nettable obligation *to* the debtor. Goldman and others did this with the failing Bear Stearns. Said one trader: "My shareholders ... said, 'You're crazy. Why are you guys taking [such a] credit risk without making money?' ... [But] it just nets you down and offsets, because you've made your money on the other side of the trade."⁷⁰

Consider preference law next. Bankruptcy's preference practice has the bankrupt recovering collateral that a creditor obtains or seizes in the 90 days before bankruptcy on an old (antecedent, as the Code calls it) debt. The concept is that the law should not encourage a race to the courthouse, in which aggressive creditors obtain value over the

⁶⁹ JOHNSON, *supra* note 35, at 47.

⁷⁰ COHAN, *supra* note 8, at 30. As before, this is fair when it's only the immediate players who are affected. But the results spill-over to other creditors, including the United States.

slower ones.⁷¹ If a creditor lent previously and seeks repayment or collateral on the eve of bankruptcy, bankruptcy policy does not allow it to jump ahead of other creditors.

Repurchase agreement financiers want to be sure that they will not be caught in a preference that the bankrupt debtor's creditors could claw back. They want to send cash into the weak firm, take the purchased asset back, and be able to keep the asset if it the selling firm fails. But this type of transaction *should* be exempt from preference law as a contemporaneous exchange. These should *not* be clawed back by the bankrupt estate, as it does not involve a truly antecedent debt.⁷² Clarification was appropriate and should not be repealed.

But the Code did more than clarify. It expanded the preference exceptions. Consider a typical derivatives transaction in which the party running a loss is required to put up collateral if its financial condition weakens. Again, as between the debtor and the counterparty, it's fair that it deliver the collateral. But if it delivers that collateral to shore up an antecedent debt on the eve of its bankruptcy, the value is coming not from the debtor's pocket, but from other creditors' pockets. Other creditors would have to give that collateral back; derivatives and repo creditors do not.

IV. COUNTER-ARGUMENTS FROM COUNTERPARTIES

Several strong and not-so-strong counter-arguments to the analysis thus far in this article are relevant, but not strong enough to reverse the analysis.

First, counterparties rely on the weak firm being too big to fail, regulatory proponents would say, making derivatives counterparties' ranking in the Code's priority structure unimportant. Changing the Code will not change outcomes. Second, classic bankruptcy-based justifications for limiting creditors collateral seizures do not apply to derivatives and repos, because the underlying asset is unconnected to the bankrupt's operation in the way that, say, the steel smelter is needed for the steel mill. Hence, the broad super-priorities are appropriate bankruptcy policy and ought not be changed. Lastly, priority proponents would say, derivatives and repos are valuable, possibly necessary, for the financial engineering needed to make today's financial system work. Without priority, the financial system will suffer.

A. Would Repeal Really Change Derivatives Market Incentives?

Critics of repeal might argue that strong counterparties fully expect that the government will bail out failed, weak counterparties. Accordingly, adjusting the Code priority exposure will only affect the strong parties' expectations and action in minor ways, if at all. They'll ignore counterparty risk regardless, because the government will always step in.

⁷¹ JACKSON, *supra* note 43, at 7-19, 122-50.

⁷² There's good reason to think that the Code should not claw back such payments, even without the derivatives and repo exemptions from preference law. See Bankruptcy Code § 547(b)(2) (to be a prohibited preference, a transfer must be "for or on account of an *antecedent* debt owed by the debtor *before* such transfer was made") (emphasis supplied).

However, firms are unlikely to entirely or even primarily rely on a government bail-out. Lehman failed in 2008 to the chagrin of its counterparties when the Treasury let it go under; Drexel failed two decades earlier. Governments typically say they will not bail out creditors next time. Although they often do not carry out their threats, there is genuine uncertainty about what the government will do, because their actual strategy is mixed.⁷³ Even financially central and interconnected firms are not always automatically bailed out.

Second, if repeal affects behavior even only marginally, the increasing number of counterparties will mean any one of them is less vital systemically. Once more, if smaller players are the weak counterparties, the strong players should further reduce their expectations of a government bailout. This process can induce a virtuous cycle of further diversification.

Third, a financial firm may be failing but not be too big to fail. If a financial firm's failure is localized and does not implicate systemic issues, the financial authorities are likely to let it fail. Drexel Burnham's collapse at the end of the 1980s comes to mind. In such a local collapse, priority matters to counterparties. Financial firms can fail. Some do. Counterparties lacking super-priorities would know this and will adjust. Two decades ago, a bankruptcy court holding that the stay applied to repos is said to have induced the repo market to shrink sharply,⁷⁴ until Congress exempted repos from the stay. If affirming the stay back then shrunk the market, that's evidence that repo players would again react if Congress put back the stay.

Moreover, even though some firms are systemically critical, financial players cannot be sure whether every counterparty is vital. As such, if they bear some counterparty risk because future rules are less favorable to them than today's, they will have reason to diversify their counterparty exposure. As they spread their counterparty exposure, fewer firms will be financially central. We would create a virtuous cycle.

Lastly, the financial players' actions indicate both that *they* are uncertain about what the United States will do and that *they* value super-priority. These players lobbied hard to get derivatives priorities in 1982, 1994, and 2005. If they did not care about priority because they fully expected United States bailouts, then they would not have lobbied for the super-priorities. Similarly, financial institutions have been lobbying hard now against *any* pull-back in their derivatives priority, thus far successfully. If the financial players fully expected the United States to bail them out, they would have had no reason to lobby so hard against even partial repeal.

Consider the derivatives industry's reaction to reform ideas. Some in Congress and the FDIC proposed that the derivatives overall priorities be limited to about 90 percent of the relevant debt. Reactions included: "Wall Street dealers are facing their worst fear ..."⁷⁵ "Banks have warned that the provision ... could have a chilling effect

⁷³ CHARLES P. KINDLEBERGER & ROBERT Z. ALIBER, *MANIAS, PANICS, AND CRASHES: A HISTORY OF FINANCIAL CRISES* 20 (5th ed. 2005).

⁷⁴ *Lombard-Wall, Inc. v. Columbus Bank & Trust Co.*, No. 82-8-11556 (Bankr. S.D.N.Y. Sept. 16, 1982); 5 COLLIER ON BANKRUPTCY 559 (Alan Resnick & Henry Sommer, eds.) (16th ed. 2009).

⁷⁵ Michael Mackenzie & Helen Thomas, *Repo dealers fear legislation will drain liquidity*, FIN. TIMES, Dec. 7, 2009.

on the 'repo' market and thus on broader creditor availability."⁷⁶ One financial player said: "The proposed legislation will certainly reduce leverage and liquidity in the repo market.... People who lend cash in [the] repo [market], will demand more collateral."⁷⁷ The chief executive of the Securities Industry and Financial Markets Association was more vociferous, saying the proposal "would negatively affect the efficient operations of the credit markets, increasing the cost of raising capital...."⁷⁸ "One head of repo [operations] at a leading bank was blunter, calling the proposed legislation 'nuclear' for the market. He said the industry is finally waking up to the threat, having assumed the legislation would never get this far."

The proposal's congressional proponent, Brad Miller, then indicated he might back down before the financial reform package goes to a vote, although he also indicated intuitions consistent with the thesis here: The proposal would "put[] pressure on anyone lending to a systemically significant firm to pay attention to what sort of shape the firm is in.... No one was paying attention to Lehman[.]"⁷⁹

The derivatives industry takes these priorities seriously and does not rely on an assured government bailout for protection.

* * *

A related comment should be made. It's tempting to imagine what would have happened if the super-priorities were not in place when AIG, Bear, and Lehman failed. One might mistakenly conclude that repealing the super-priorities would have no impact, because each would have failed anyway. Super-priorities or no super-priorities, the firms were doomed.

That, though, is not the right way to consider the situation. Instead, imagine the impact on the three failed firms' capital structure *if the super-priorities were not in place for years before their failure*. There's reason to believe that Bear would not have been so heavily financed with repos, that AIG's derivatives counterparties would neither have put so many derivatives eggs in the AIG basket nor tolerated AIG's risky portfolio overall, and that Lehman would have been more stable. We need to imagine what the *long-term ex ante* adjustment would have been.

B. The Unnecessary Asset: Does Basic Bankruptcy Theory Apply?

Classic justifications for the bankruptcy stay against creditors seizing security, against preferences that shred the firm, and similar limits on creditors are these: The firm is often worth more held together rather than shredded, so the Code's limits slow the shredding process down long enough for the judge and the parties to make a determination and to reorganize the firm. Assets that are critical to the firm need to be retained by the firm for the benefit of all the players and to maximize the total value of

⁷⁶ Tom Braithwaite & Michael Mackenzie, *Creditors to foot bill in US risk regulation*, FIN. TIMES, Dec. 2, 2009.

⁷⁷ Id.

⁷⁸ Id. See also Cheyenne Hopkins, *Creditors Fear New Resolution Process*, AM. BANKER, Dec. 7, 2009.

⁷⁹ Braithwaite & Mackenzie, *supra* note 76.

the bankrupt firm, with the affected creditor being compensated for its loss. Is the derivative or repo collateral that kind of vital asset?

1. *Holding complementary assets to the firms.* The interconnectedness of the bankrupt's assets is the standard justification for the stay, for preferences, and, indeed, for a bankruptcy process separate from ordinary contract enforcement. The bankrupt steel firm cannot continue its business without the steel mill, so bankruptcy bars the creditors with a security interest in the smelter from seizing the smelter while the chapter 11 process runs its course. The Code protects those creditors, assuring them that they will eventually get full value, but later. (Creditors often conclude that they are not getting full financial value, but the theory is clear: hold the asset to the firm, reorganize, and then pay the affected creditor in full.)

A powerful and insightful argument is in play here for financial firms, one that, if applicable, moots the stay's applicability for derivatives: The asset that the counterparty seeks to seize is *not* analogous to the steel company's smelter. It's just cash, not a critically-interconnected factory that fits tightly and of necessity with the bankrupt's other operations.⁸⁰ Hence, there's no rationale from bankruptcy policy to stay such financial seizures. Cash is generic; a steel mill is not.

2. *Liquidity as the financial firm's critical asset.* This is one of the most powerful counterarguments to repeal of the super-priorities.

But it may not apply. The financial firm sells, or builds, or trades using *liquidity*, and it is its liquidity that the Code's super-priorities destroy inside the bankrupt financial firm. The failing *financial* firm's cash or near-cash assets are critical for the financial firm, as critical for it as the smelter is for the steel manufacturer. If derivatives and repo counterparties seize enough value from the failing firm, the financial firm is sapped of liquidity. Dried out, it cannot operate and dies.

Hence, the classic justification for the stay and preference law seems to be as in play as ever for the financial firm.

C. Financial Necessity

The two foregoing considerations are serious ones to consider. Another is likely to arise in any major congressional and media-based debate. It should be rejected, but may prove more convincing in the media and the polity than the serious ones.

The argument takes the form that the derivatives industry requires priority in order to work. The persuasiveness of such arguments can be enhanced by the accurate statement that repurchase agreements and derivatives enhance liquidity and risk-management, with liquidity and risk-management important and sometimes vital to the economy. Just look at the depth and breadth of securities firms' financing via repos and the widespread use of credit derivatives to control risk. These are vital to a well-functioning economy. If Congress denies them their Code-based advantages they will damage the economy's financial arteries.

⁸⁰ Edwards & Morrison, *supra* note 45, at 114.

The problem with that view is not that the derivatives and repos do not provide vital benefits — they do. The problem is that there's no reason, on that assertion of importance alone, to favor derivatives and repos over other financial contracts. Restaurants need food deliveries to survive, and people need to eat food. Steel mills need iron, coal, and cobalt to make steel; the steel industry is economically important and, hence, priority for deliveries, their iron suppliers might say, is vital. Borrowers need capital; firms need labor. Everyone needs electricity and access to telecommunications. These are true statements about the economic importance of food, steel, energy, lending, working, and the telephone, but that vitality alone does not justify a priority for food deliveries to restaurants and for iron delivered to the steel mill. Each transaction needs to stand on its own. If repos and derivatives are valuable, people will pay for them.

The problem is not that the derivatives industry fails to provide benefits, but that the benefits come with costs if they obtain their super-priority — costs that come from transferring risk to other players. Those costs are hidden and, when widespread, pernicious. Many other credit arrangements are vital to economic activity, not just the liquidity and risk-management benefits of derivatives and repos.

Congress would need to be convinced that repos and derivatives provide some critical benefit with spillover effects. It's the *extra* benefit from *positive* spillovers that would justify jumping such financial contracts to the head of the bankruptcy queue. But to state their potential for spillover benefits is to state their costs: we may just as easily have been *over*-using these financial products, due to their favored bankruptcy status, thereby exacerbating a financial crisis and knife's-edge financing. Spillovers are as likely to be negative as positive. In the absence of compelling evidence either way, policy should be neutral. Derivatives should be treated like other financial obligations.

Overall, the problem with this counter-argument of necessity, despite the fact that it may prove convincing to policymakers, is that *many* economic and financial transactions are beneficial. There are, to make a discovery here, large gains from trade. But saying so does not justify prioritizing one side or the other of the trading relationship over the counterparties' other creditors and trading partners, whose trades also benefit the economy.

They all deserve priority. But, when the debtor lacks sufficient value to pay all its creditors, they cannot all have it.

V. WHAT THE PROPOSED FINANCIAL REFORMS DO AND FAIL TO DO

Three major bills to restructure the resolution of financial institutions are in Congress now. In their original form, two — the Dodd bill in the Senate⁸¹ and the Barney Frank bill in the House — would not alter derivatives' and repos' priorities. The latter would authorize a study of the issue.⁸² Proposals would allow regulators to

⁸¹ SENATE BILL, RESTORING AMERICAN FINANCIAL STABILITY ACT OF 2009, 111th Cong., 1st Sess. (proposed bill, sponsored by Sen. Dodd).

⁸² THE WALL STREET REFORM AND CONSUMER PROTECTION ACT OF 2009. H.R. No. 4173, 111th Cong., 1st Sess. § 1615.

force a haircut on derivatives players' repayments.⁸³ A third bill would bar bailouts, by building a new Chapter 14 to the Code for financially core firms.⁸⁴

This cut-down/haircut is a clumsy way to go about solving the incentives alignment problem. It keeps the powerful priorities in any non-bailout setting, and thereby keeps both the incentives of the parties to use these prioritized instruments and their disincentives to monitor counterparty risk well. Rather than giving the FDIC ex post authority to cut the counterparties' claims a bit — an authority that in crisis they may be reluctant to use — the better means would be to eliminate the priority up front.

Equally importantly, the proposals do not reflect how the Bankruptcy Code and the financial regulators' resolution authority interact. Code priorities can exacerbate contagion or contain it. While there's good reason to think that these priorities overall exacerbate it, particularly by reducing monitoring incentives, we cannot know for sure what the bottom line is here. But we do not need to know, as long we have a satisfactory ex post resolution mechanism in place. If we do, then we can have our cake and eat it too. We can get the monitoring incentives that ordinary priority induces, but we need not pay a price of extra systemic risk, because the financial authorities can deal with remaining contagion problems if and when they arise, ex post.

CONCLUSION

Chapter 11 automatically bars creditors from collecting on their loans from the bankrupt debtor, requires that creditors who seize security or repayment on the eve of bankruptcy return the assets seized, bars creditors from automatically offsetting their debts from a bankrupt with their debts to the bankrupt, requires that fraudulent conveyances be recaptured by the debtor, and allows the debtor, but not the creditor, to affirm or reject outstanding contracts.

None of these rules apply to a bankrupt's derivatives counterparties. Instead, derivatives market players can seize collateral, net out gains and losses, terminate contracts, and keep eve-of-bankruptcy preference payments from the debtor that favor them over other creditors. Their privileged capacity to jump to the front of the bankruptcy repayment line can induce a run on the failing financial institution and such a run may have hit AIG, Bear Stearns, and Lehman, deepening and extending the recent financial crisis.

Yet the run problem, although potentially serious, is not the most severe problem emanating from the derivatives exception. The most severe problem is that the derivatives players' super-advantages create a pre-bankruptcy monitoring reversal that accelerates and expands financial instability originating elsewhere in the financial system. That acceleration stems from the derivatives counterparties, with super-priority, having limited incentives to monitor the pre-bankruptcy debtor, since they do well in any resulting bankruptcy. Although ordinary financial creditors of the debtor correspondingly see their incentive to monitor the debtor rise, they have limited

⁸³ Mackenzie & Thomas, *supra* note 75 (FDIC could take a 20 percent derivatives "haircut").

⁸⁴ THE CONSUMER PROTECTION AND REGULATORY ENHANCEMENT ACT OF 2009, July 20, 2009, available at <http://www.scribd.com/doc/17607910/Section-by-Section-of-Republican-Plan>.

capacity to monitor the debtor's derivatives portfolio, as they typically are not well informed about that market.

Still, even poorly informed creditors' contractual reaction could eventually reduce these problems, because unsecured general creditors will in time anticipate the generality that they are bearing more risk, especially after they've suffered or seen others suffer from it once. But the biggest unsecured creditor for financial central firms like AIG, Bear, and Lehman is the United States, as de facto guarantor of too-big-to-fail financial institutions. For the United States, contractual reaction isn't plausible, since it has no contract. Instead, regulatory reaction is needed.

The most plausible regulatory reaction is to repeal the de facto derivatives priority in chapter 11. While clarifications are appropriate, such as affirming the integrated nature of an interest rate swap as not comprising two separate contracts for bankruptcy purposes, the derivatives super-priorities are far too strong, going much further than simple, principled clarifications. Repeal would push derivatives and repo counterparties to insist on doing business with a safer debtor. As weak debtors saw the costs of their repo financing and derivatives transactions rising, they would feel pressed to substitute toward longer-term, more stable financing. A derivatives exchange, such as those that have been proposed, would look more attractive to each side and could reduce failed trades and failed firms.⁸⁵ Derivatives counterparties have little incentive to set up such an exchange when they benefit from both the bankruptcy priorities and too-big-to-fail bailout expectations.

Overall, Congress needs to do better in drawing out the decision tree. The Code cannot prevent contagion and runs. It may in fact encourage them. Blanket exceptions and super-priorities are vastly over-broad and may in fact let counterparties drop their guard in terms of credit monitoring and financial stability. Given that ex post resolution cannot be fully avoided, we want a bankruptcy system that encourages as much market-based, ex ante market discipline as can be had, via more counter-party monitoring and more resilient financial structures. The Code does not do this.

Repeal now, in the current financial reform package, should dampen the possibility of another AIG/Bear/Lehman-type melt-down. Yet the major financial reform packages now in Congress do not contemplate the needed repeal. Amendments are being discussed, but they should be more than discussed. They should be an integral part of the reform: eliminating the derivatives priorities, nearly across the board.

⁸⁵ The likelihood that a clearinghouse is a cure-all may have been exaggerated in recent discourse. For sobering analyses, see Craig Pirrong, *The Economics of Clearing in Derivatives Markets: Netting, Asymmetric Information, and the Sharing of Default Rules Through a Central Counterparty* (SSRN working paper Jan. 8, 2009), available at www.ssrn.com/abstract/paper=1340660; Darrell Duffie, Ada Li & Theo Lubke, *Policy Perspectives on OTC Derivatives Market Infrastructure* (Jan. 2010 working paper), available at <http://ssrn.com/paper=1534981>; René Stulz, *Credit Default Swaps and the Credit Crisis*, 24 J. ECON. PERS. 73, 82, 88-89 (2010).