THE BANKRUPTCY SAFE HARBOR IN LIGHT OF GOVERNMENT BAILOUTS: REIFYING THE SIGNIFICANCE OF BANKRUPTCY AS A BACKSTOP TO FINANCIAL RISK

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If the recent financial crisis was a test of the bankruptcy system and its ability to deal with the risks posed by modern finance, then the bankruptcy system failed. Well-designed financial networks have circuit breakers, but the exemption of securitized assets and derivatives trades from the bankruptcy process left bankruptcy law unable to stop runs on financial contracts held by financial institutions. The more effective the bankruptcy law, the greater the ability to build from it to create specialized resolution regimes or to use it to resolve even financial firms, which would increase certainty among creditors and the public. This Article emphasizes the importance of effective bankruptcy law as a backstop to systemic risk. The Article represents the first part of a two-part study; part two will investigate prerequisites to the development of securities and derivatives markets in emerging economies.

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Introduction

The recent financial crisis begins and ends with bankruptcy. Securitizing assets and collateralizing derivatives trades has insulated assets from the bankruptcy process, and the protection from bankruptcy appeared to contribute to high volumes of investments in securities and derivatives by financial institutions.[1] When the value of the securities fell, derivatives counterparties reacted to losses at the institutions holding the securities by seizing additional collateral from the institutions, which pushed the institutions closer to insolvency.[2] Because the counterparties were exempt from bankruptcy law, the ordinary rules of bankruptcy could not preserve the assets within the institutions, and the resolution of distressed financial institutions within bankruptcy became impossible.[3]

Government bailouts, outside of the bankruptcy system, lacked the efficiency, fairness, and transparency characteristic of bankruptcy.[4] The bailouts socialized losses, while benefiting the directors and shareholders of institutions that had undertaken excessive risk.[5] Political actors had discretion to decide outcomes for individual institutions and their creditors, outside of a public, judicial forum.[6]

Solving the deficiencies in the response to the recent crisis would therefore appear to require a more robust bankruptcy law.[7] Legislation

1. *See infra* Sections III.A, III.B.1.
2. *See infra* Section III.B.2.
3. *See infra* Section III.B.2.
4. *See infra* Part II.
5. *See infra* Section II.A.
6. *See infra* Sections II.B, II.C.
7. *See infra* Section IV.C.

to establish a new resolution authority has continued to rely on the existing bankruptcy system in most instances, and other recent proposals have suggested additions to the existing bankruptcy code.[8] Because a mostly successful bankruptcy law exists already, minor updates could realign the bankruptcy law with the realities of modern finance.[9] While the law has exempted derivatives, in order to prevent losses from spreading from one institution to the counterparties to its derivatives trades, the exemption instead appeared to propagate risk throughout the financial system.[10] The more similar the special resolution authority to the bankruptcy system, and the more ability to resolve institutions within bankruptcy, the more certainty creditors will have in regard to their likely treatment and recoveries.[11]

A circuit breaker that prevents runs on financial contracts held by financial institutions, which can destabilize the economic system, is necessary.[12] This Article emphasizes the importance of effective bankruptcy law as a circuit breaker to systemic risk. Part I first anchors bankruptcy law in its underlying theory.[13] This Part explains how the goals of efficiency, fairness, and transparency animate provisions of the bankruptcy code.[14]

Part II compares the resolutions that occurred outside of bankruptcy, during the recent crisis, with the characteristics of the traditional bankruptcy process.[15] This Part argues that government bailouts sacrificed the efficiency, fairness, and transparency that the bankruptcy system has achieved.[16]

Part III explores the reasons why regulators circumvented bankruptcy procedures during the crisis, in light of the shortcomings of the alternative response.[17] This Part argues that the insulation from bankruptcy of securities and derivatives trades made the insolvency of fi-

8. *See infra* Section IV.A.
9. *See infra* Section IV.C.
10. *See infra* Sections III.A, III.B.2.
11. Stephen J. Lubben, *Transaction Simplicity*, 112 COLUM. L. REV. SIDEBAR 194, 197 (2012) [hereinafter Lubben, *Transaction Simplicity*] (arguing that proceedings under the Dodd-Frank Act and Chapter 11 should be harmonized); *see, e.g.*, Stephen J. Lubben, *Financial Institutions in Bankruptcy*, 34 SEATTLE U. L. REV. 1259, 1274 (2011) [hereinafter, Lubben, *Financial Institutions*] (noting that the Dodd-Frank Act creates uncertainty through its use of standards that differ from Chapter 11).
12. *See, e.g.*, Joseph E. Stiglitz, *Contagion, Liberalization, and the Optimal Structure of Globalization*, J. GLOBALIZATION & DEV., Dec. 2010, at 1, 4 (noting that circuit breakers prevent the failure of one area from affecting the entire system).
13. *See infra* Part I.
14. *See infra* Sections I.A–I.C.
15. *See infra* Part II.
16. *See infra* Sections II.A–II.C.
17. *See infra* Part III.

nancial institutions more likely, while simultaneously rendering their resolution in bankruptcy impossible.[18] The bankruptcy exemption incentivized the accumulation of securitized assets and derivatives trades on the balance sheets of institutions.[19] When mortgage defaults caused losses at institutions holding mortgage-backed securities, the bankruptcy exemption prevented the bankruptcy law from blocking "runs" on the institutions by their derivatives counterparties to claim assets.[20] The "runs" decreased liquidity at the institutions, leaving insufficient assets to support their restructuring.[21]

Part IV examines the necessity of strong bankruptcy law in preventing and improving responses to future crises.[22] The government has proposed a new resolution authority that builds on the existing bankruptcy regime, rather than replacing it.[23] Others have advocated reforming the bankruptcy law to make it possible to resolve financial institutions solely within bankruptcy.[24] The bankruptcy system provides an established set of tools for dealing with distressed institutions and their creditors.[25] It can easily be updated to account for the development of securitization structures and derivatives trades that has taken place.[26]

A strong bankruptcy law could contribute to the avoidance of insolvency among financial institutions, in the first instance, and contribute to the ability to prepare for bankruptcy, in the second.[27] Without the bankruptcy exemption, counterparties to derivatives trades would become more likely to monitor their trading partners, and more likely to enter fewer and less precarious trades.[28] Corporate directors would no longer have to postpone bankruptcy, in order to prevent mass termination of derivatives contracts.[29] If the law prevented derivatives counterparties from dismembering economically viable institutions, and from causing reductions in the value of assets held by other institutions, alternative resolution schemes would become less neces-

18. *See infra* Section III.B.
19. *See infra* Sections III.A–III.B.
20. *See infra* Section III.B.
21. *See infra* Section III.B.
22. *See infra* Part IV.
23. *See infra* Section IV.A.
24. *See infra* Section IV.B.
25. *See infra* Section IV.C.
26. *See infra* Section IV.C.
27. *See infra* Section IV.C.
28. *See, e.g.*, *ABI Members Testify on Medical Debt and "Bailouts vs. Bankruptcy*,*"* 18 AM. BANKR. INST. J., Dec. 2009–Jan. 2010, at 10, 72; *see also infra* Section III.A.
29. *Compare infra* Section III.B, *with* the corresponding textual statement above.

sary.[30] Certainty for creditors would increase if they did not risk participation in more than one resolution scheme.[31]

I.
The Bankruptcy System

The modern, credit-based economy requires effective processes for resolving failed firms.[32] The risk that firms that have assumed debts will become unable to repay their creditors cannot be eliminated. Bankruptcy law codifies a distribution system that can determine which creditors insolvent companies will repay and in what amounts, in accordance with clear and predictable rules.[33] The bankruptcy system operates to impose the costs of firm failures on the private actors involved, and prevents the costs from becoming socialized.[34]

Scholars, however, have long debated the purposes of bankruptcy law.[35] They have disagreed over how to balance the enforcement of private rights with the management of that enforcement in the public interest.[36] Those in the "contractualist" school argue that maximizing returns to creditors, and preserving the contractual rights for which the creditors originally bargained, should be paramount.[37] To accomplish these goals, the bankruptcy process substitutes one coordinated distribution of assets for multiple individual enforcement actions that would waste resources and potentially deplete the value of distressed firms.[38] Other scholars view the scope of bankruptcy law more broadly, and would task it with mitigating the societal consequences of firm fail-

30. *See infra* Section IV.C.

31. *See infra* Section IV.C.

32. *See, e.g.*, World Bank, Principles and Guidelines for Effective Insolvency and Creditor Rights Systems 1 (2001), http://www.worldbank.org/ifa/ipg_eng.pdf.

33. *See* Charles W. Mooney, Jr., *A Normative Theory of Bankruptcy Law: Bankruptcy as (Is) Civil Procedure*, 61 Wash. & Lee L. Rev. 931, 953 (2004) (noting that bankruptcy law provides a procedural means for determining and distributing value to rightsholders).

34. *See, e.g.*, Donald R. Korobkin, *The Role of Normative Theory in Bankruptcy Debates*, 82 Iowa L. Rev. 75, 91 (1996) (citing Elizabeth Warren, *Bankruptcy Policymaking in an Imperfect World*, 92 Mich. L. Rev. 336, 341–73 (1993) and describing the four principal goals of business bankruptcy law).

35. *See, e.g.*, *id.* at 121; Mooney, *supra* note 33, at 953.

36. Robert K. Rasmussen, *An Essay on Optimal Bankruptcy Rules and Social Justice*, 1994 U. Ill. L. Rev. 1, 2–3 (noting that some scholars view bankruptcy law in purely economic terms whereas others view bankruptcy law as an instrument of social justice).

37. David A. Skeel, Jr., *Markets, Courts, and the Brave New World of Bankruptcy Theory*, 1993 Wis. L. Rev. 465, 470.

38. Alan Schwartz, *A Normative Theory of Business Bankruptcy*, 91 Va. L. Rev. 1199, 1200–01 (2005).

ures.[39] These scholars advocate a bankruptcy regime that would operate to preserve jobs for the employees of bankrupt firms, support suppliers and other businesses in the community dependent on the firms, and maintain the provision of products and services to customers.[40]

In actuality, bankruptcy law has become infused with normative values that extend beyond allocative efficiency.[41] Bankruptcy law, for example, offers firms a chance at rehabilitation, even though doing so increases costs to creditors.[42] The central task of bankruptcy, the distribution of assets to creditors, moreover, takes place in accordance with normative principles considered to achieve fair results.[43] The law strikes a bargain between privileging contractual rights and promoting other priorities for repayment: secured creditors have first priority over asset distributions because they negotiated property rights in secured collateral prior to the bankruptcy.[44] Employees rank second in the distribution hierarchy, ahead of other unsecured creditors, because the law is sensitive to their inability to charge interest to protect themselves against the bankruptcy risk of the firms that employ them and their inability to diversify the bankruptcy risk among multiple employers.[45] To legitimate these distributional choices, the law has also in-

39. Christopher W. Frost, *Asset Securitization and Corporate Risk Allocation*, 72 TUL. L. REV. 101, 140–41 (1997).

40. Mooney, *supra* note 33, at 956–57 (noting that the interests of debtors and employees are the primary goals of the bankruptcy system).

41. *See, e.g.*, Robert E. Scott, *Sharing the Risks of Bankruptcy:* Timbers*,* Ahlers*, and Beyond*, 1989 COLUM. BUS. L. REV. 183, 189 (recognizing that the bankruptcy system has multiple objectives).

42. *Id.* at 189 (noting that the rehabilitation goal of the bankruptcy system may require the redistribution of the burdens of insolvency among both debtors and creditors).

43. Philip R. Wood, *The Bankruptcy Ladder of Priorities and the Inequalities of Life*, 40 HOFSTRA L. REV. 93, 94 (2011) (recognizing that the bankruptcy system's priorities are dictated by notions of fairness).

44. Jean Braucher, *A Guide to Interpretation of the 2005 Bankruptcy Law*, 16 AM. BANKR. INST. L. REV. 349, 394 (2008) (recognizing that lenders with personal property collateral receive priority in Chapter 7 and 13 proceedings); Wood, *supra* note 43, at 96 (noting that secured creditors often receive high priority in bankruptcy proceedings); *Exploring Chapter 11 Reform: Corporate and Financial Institution Insolvencies; Treatment of Derivatives: Hearing Before the Subcomm. on Regulatory Reform, Commercial & Antitrust Law of the H. Comm. on the Judiciary*, 113th Cong. 17 (2014) [hereinafter *Sontchi Hearing*] (statement of Christopher Sontchi).

45. Donald R. Korobkin, *Employee Interests in Bankruptcy*, 4 AM. BANKR. INST. L. REV. 5, 6 (1996) (describing the unique circumstances of employees and their inability to possess sufficient information to protect themselves from the risk of their employer's default).

corporated procedures that increase the openness and transparency of the bankruptcy process.[46]

The themes of efficiency, fairness, and transparency animate many of the provisions of the bankruptcy code, even as disputes over the meaning and content of the three themes persist.[47] This Part explains how the code achieves aims related to each theme.

A. Efficiency

Chapter 11 of the bankruptcy code sets out efficiency-enhancing rules for resolving failed firms because efficient outcomes in bankruptcy support economic growth.[48] Creditors that recover more assets in bankruptcy face fewer costs when firms default.[49] The lower the risk of providing credit, the lower the interest rates that creditors will charge.[50] Cheaper credit, in turn, increases investment into productive activities.[51] This Section describes how the code seeks to achieve efficiency.

Chapter 11 increases efficiency primarily by replacing a race among creditors to seize assets before others can claim them with an orderly, collective process.[52] Otherwise, individual creditors could dismantle the firm, taking assets away from other creditors.[53]

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46. *See, e.g.*, David I. Cisar & Christopher J. Stroebel, *A Private Moment in the Fishbowl: Filings Under Seal in Bankruptcy Court*, 2012 AM. BANKR. INST. J. 38, 73 (noting that transparency promotes integrity in the bankruptcy system).

47. *See, e.g.*, Diane Lourdes Dick, *The Chapter 11 Efficiency Fallacy*, 2013 BYU L. REV. 759, 760–61 (2013) (noting that while efficiency has been the traditional concern of the bankruptcy system, fairness and transparency have also become primary goals).

48. Whitney Travis, *Stripping Down the Subprime Crisis*, 10 TRANSACTIONS 51, 68 (2008).

49. Adam Feibelman, *Consumer Bankruptcy as Development Policy*, 39 SETON HALL L. REV. 63, 93 (2009) (recognizing that a functioning bankruptcy system allows creditors to collect debt from insolvent debtors).

50. Schwartz, *supra* note 38, at 1203 (noting that an efficient bankruptcy system can lower interest rates and increase investment incentives).

51. *See* DANIEL FITZPATRICK, NATHAN ASSOCS., BANKRUPTCY LAW: INTRODUCTION TO BANKRUPTCY LAW AND OVERVIEW OF OPTIONS FOR MOZAMBIQUE 9 (2005), http://pdf.usaid.gov/pdf_docs/PNADC674.pdf (analyzing fictional scenarios to demonstrate how an efficient bankruptcy system increases investment in various industries).

52. Skeel, *supra* note 37, at 470 (recognizing that the collective process prevents creditors from dismembering a debtor in an effort to recover their investments).

53. Barry E. Adler, *Bankruptcy and Risk Allocation*, 77 CORNELL L. REV. 439, 444 (1992) ("Because the debtor lacks sufficient assets to pay all creditors in full, each creditor has an incentive to collect its debt before the other creditors.").

An essential tool for preventing inefficient creditors' races is the automatic stay codified in the bankruptcy law.[54] Upon filing for bankruptcy, the stay blocks individual actions by creditors to enforce their claims against the firm.[55] Protecting firms against individual actions by creditors forces the creditors to act within a single proceeding.[56] The assets of the firm remain together to maximize collective distributions, and the firm enjoys a breathing spell in which to devise a plan for restructuring.[57] Where the assets of a firm have a higher value in the aggregate than separately, rehabilitation would be more efficient than liquidation.[58]

The stay applies to secured creditors, in spite of the property rights that they hold in their secured collateral.[59] The general suspension of the ownership rights of secured creditors reflects the importance of maintaining the collateral assets within the bankrupt firm for the viability of the bankruptcy process.[60] Allowing secured creditors to remove the collateral would harm other creditors and potentially destroy firm value.[61] Secured creditors, therefore, may only claim the collateral if a court finds that the collateral is not adequately protected or that it is not necessary to support the bankruptcy process.[62]

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54. Yaad Rotem, *Pursuing Preservation of Pre-Bankruptcy Entitlements: Corporate Bankruptcy Law's Self-Executing Mechanisms*, 5 BERKELEY BUS. L.J. 79, 91 (2008) (recognizing that "[f]or a collective approach to be possible at all, individual debt collection actions must be halted").

55. 11 U.S.C. § 362 (2014) (listing situations in which the automatic stay applies); Mooney, *supra* note 33, at 952 (noting that the automatic stay prevents uncoordinated efforts and enforcement actions brought by creditors).

56. Rotem, *supra* note 54, at 82–83 (recognizing that collective proceedings allow problems emanating from financial distress to be managed by a single entity: the bankruptcy court).

57. Steven L. Schwarcz & Ori Sharon, *The Bankruptcy-Law Safe Harbor for Derivatives: A Path-Dependence Analysis*, 71 WASH. & LEE L. REV. 1715, 1719 (2014); *see also* Kathryn R. Heidt, *Is "Incorporation Venue" a Good Thing? Yes*, 7 BUS. L. TODAY 26, 28 (1998) (recognizing that saving costs and fees through a collective proceeding will ultimately maximize distribution).

58. Schwartz, *supra* note 38, at 1200–01 (arguing that social welfare is maximized when "financially distressed firms are continued").

59. Chrystin Ondersma, *Shadow Banking and Financial Distress: The Treatment of "Money-Claims" in Bankruptcy*, 2013 COLUM. BUS. L. REV. 79, 106–07 (explaining that secured creditors are subject to the automatic stay and can only seize the property in limited circumstances).

60. Franklin R. Edwards & Edward R. Morrison, *Derivatives and the Bankruptcy Code: Why the Special Treatment?*, 22 YALE J. ON REG. 91, 107 (2005) (emphasizing that the stay prevents creditors from seizing collateral that may be essential to the firm's viability).

61. Withdrawal of collateral would eliminate any possibility of a firm's turnaround and would destroy any going concern value that existed.

62. Ondersma, *supra* note 59, at 106–07.

B. Fairness

In addition to establishing efficient mechanisms to maximize the value of assets available for distributions to creditors, the bankruptcy law emphasizes fairness in distributing the assets to creditors.[63] According to the Supreme Court, "equality of distribution among creditors is a central policy [of bankruptcy law]."[64] The code includes provisions intended to prevent special treatment of individual creditors and, instead, promote predictable and just allocation of assets to classes of creditors with similar rights.[65] This Section describes how the code advances a specific conception of fairness both within classes of creditors and among them.[66]

As a collective process, bankruptcy deals with creditors by class, rather than as individuals.[67] Assets must be distributed equally within classes of creditors.[68] To reinforce the equal treatment of each class of creditors, any creditor that receives more assets outside of bankruptcy must return the assets to the bankruptcy estate.[69] The bankruptcy code empowers bankruptcy courts to reverse transfers that have occurred within ninety days of a firm filing for bankruptcy.[70]

The bankruptcy law also maintains inequality among classes of creditors and distributes assets to each class in a defined hierarchy devised to promote fair outcomes.[71] The rule of absolutely priority requires that classes of creditors be paid in a set order.[72] Before one class of creditors can receive a distribution of assets, the class that ranks above it must have already been repaid in full.[73] Lower classes of creditors are entitled to nothing until the claims of the higher classes are satisfied.[74] The law protects the property rights that secured

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63. *See* Rasmussen, *supra* note 36, at 3.

64. Begier v. IRS, 496 U.S. 53, 54 (1990).

65. *See* Ondersma, *supra* note 59, at 105; Scott, *supra* note 41, at 187.

66. *See, e.g.*, Rotem, *supra* note 54, at 93 (describing differing standards of equality within a class of creditor and between classes of creditors).

67. Skeel, *supra* note 37, at 469–70.

68. Brian McCarthy, *Imprevedibilita!: An Analysis of Italy's Failure to Create or Maintain a Stable and Efficient Insolvency System*, 25 CONN. J. INT'L L. 153, 156 (2009) (emphasizing that creditors in similar positions are treated similarly).

69. Schwarcz & Sharon, *supra* note 57, at 1720 (noting that during bankruptcy proceedings, debtors can revoke transfers that prefer some creditors over others).

70. *Id.*

71. Rotem, *supra* note 54, at 93.

72. Schwartz, *supra* note 38, at 1202.

73. Philippe Aghion et al., *Improving Bankruptcy Procedure*, 72 WASH. U. L.Q. 849, 852 (1994).

74. Rotem, *supra* note 54, at 93.

creditors bargained for and paid for, for example, by awarding secured creditors priority in distribution.[75]

The bankruptcy court has additional, discretionary powers to correct injustices.[76] The court can equitably subordinate one creditor to the others, and place that creditor last in the distribution line, in order to protect the rest of the creditors from the unfair conduct of one creditor.[77] In addition, a resolution plan may only take effect if the court determines that it is "fair and equitable" to any class of creditors that voted against it.[78]

C. *Transparency*

Finally, to increase public buy in to the outcomes of bankruptcy proceedings, the bankruptcy code includes transparency-enhancing provisions.[79] In bankruptcy, distressed firms are resolved in public view, in an open process guided by a bankruptcy judge.[80] Transparency strengthens the integrity of the process by showing how and why distributions of assets are made.[81] This Section describes the procedural and structural provisions that the bankruptcy code includes to support transparency.

Mandatory disclosures create an open arena for working towards negotiated decisions.[82] The bankruptcy process, for example, commences with a petition, a public document.[83] The petition makes known the assets and liabilities of the firm, information which may previously have remained private.[84] If the firm requires financing to support its operations during bankruptcy, it must submit additional in-

75. The law also distinguishes employees from other unsecured creditors and gives them second ranking. Bankruptcy provides employees with a greater opportunity for repayment than other unsecured creditors because of their inability to charge interest to reflect the bankruptcy risk of the firm that employs them, and because of their inability to diversify the bankruptcy risk among other employers.

76. *See, e.g.*, Pamela Foohey, *Chapter 11 Reorganization and the Fair and Equitable Standard: How the Absolute Priority Rule Applies to All Nonprofit Entities*, 86 St. John's L. Rev. 31, 35–36 (2012).

77. Jonathan Carson, *Pre-Petition Capital Contributions: The Road to Equitable Treatment in Bankruptcy*, 1999 Colum. Bus. L. Rev. 403, 416.

78. 11 U.S.C. § 1129 (2014).

79. Jonathan C. Lipson, *The Shadow Bankruptcy System*, 89 B.U. L. Rev. 1609, 1618 (2009) (comparing the "shadow banking" system to traditional banking).

80. *See, e.g.*, Travis, *supra* note 48, at 63 (discussing open access afforded to debtors and creditors).

81. Cisar & Stroebel, *supra* note 46, at 38.

82. The Second Circuit Court of Appeals has said that the "key" to bankruptcy is disclosure. *In re* Lionel Corp., 722 F.2d 1063, 1070 (2d Cir. 1983).

83. 11 U.S.C. § 301(a).

84. Lipson, *supra* note 79, at 1621.

formation to the court and obtain court approval.[85] The sale of firm assets also may not take place without notice and a public hearing at which the sale price of the assets and competing bids for them are scrutinized.[86] Confirmation of a final plan for restructuring requires a vote of the creditors and shareholders, and the creditors and shareholders receive court-approved disclosures that set out the provisions of the plan prior to the vote.[87]

Committees of creditors also promote transparency.[88] Once a committee discloses the circumstances of its formation, and information regarding the claims of its members against the bankrupt firm, committees of creditors have the opportunity to review and object to proposals of the firm, for example, to obtain financing, or sell assets.[89] The bankruptcy code also provides the committees with investigatory powers.[90]

Transparency is built into other structures of the bankruptcy process. When a bankruptcy case encounters problems, the bankruptcy code responds with additional transparency to encourage resolution. The court can appoint a trustee to make known more about the circumstances of the bankrupt firm;[91] alternatively, the parties can ask for a court-appointed examiner.[92] The trustee has the power to investigate the "acts, conduct, assets, liabilities, and financial condition of the debtor, the operation of the debtor's business and the desirability of the continuance of such business."[93] The examiner "conducts such investigation of the debtor as is appropriate."[94] The Office of the U.S. Trustee, a governmental body, also monitors the bankruptcy process and has the authority to file civil enforcement actions to protect the integrity of the bankruptcy system and refers suspected bankruptcy crimes to the U.S. Attorneys.[95]

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85. *Id.* at 1621–22.

86. *Id.*

87. *Id.* at 1623.

88. *Id.* at 1624.

89. 11 U.S.C. § 2019 (2014); Lipson, *supra* note 79, at 1623 (discussing voting rights of stakeholders).

90. Lipson, *supra* note 79, at 1624.

91. 11 U.S.C. § 1106(a)(3).

92. 11 U.S.C. § 1104(c).

93. 11 U.S.C. § 1106(a)(3).

94. 11 U.S.C. § 1104(c).

95. *See, e.g.*, *About the Program*, U.S. DEP'T JUST., http://www.justice.gov/ust/eo/ust_org/index.htm (last visited Oct. 2, 2015).

II.
Bankruptcy Not Bailout

Many of the high-profile firm failures during the recent financial crisis did not end in bankruptcy.[96] Instead, failing financial institutions were resolved through government interventions.[97] The interventions evolved as the crisis progressed, and ended in the U.S. government providing roughly $4.76 trillion in liquidity to individual firms.[98] While the response appeared to prevent the collapse of the financial markets, it suffered from inefficiency, unfairness, and opacity, in comparison to bankruptcy. This Part explains in detail why the government actions could be viewed as less efficient, fair, and transparent than the traditional bankruptcy process.

A. Efficiency

The government substituted a series of ad hoc responses for the orderly, collective bankruptcy process.[99] Reacting to emergency conditions as they arose, government officials moved within a few weeks from contributing over $100 billion to creditors of the government-sponsored enterprises Fannie Mae and Freddie Mac,[100] to imposing losses on creditors of Lehman Brothers without enough collateral securing their claims,[101] to demanding that Congress appropriate $700 billion to buy up distressed assets from other distressed firms at artificially high prices.[102] The ex post quality of these varying choices increased the uncertainty of market participants, while failing to promote efficient outcomes.[103] This Section explains why the bailouts appeared less efficient than bankruptcy.

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96. *See, e.g.*, Steven M. Davidoff & David Zaring, *Regulation by Deal: The Government's Response to the Financial Crisis*, 61 Admin. L. Rev. 463, 509–12 (2009) (discussing the resolution of Wachovia and Morgan Stanley's difficulties).

97. *Id.* at 528–29; David A. Skeel, Jr., *Institutional Choice in an Economic Crisis*, 2013 Wis. L. Rev. 629, 633–34.

98. *See, e.g.*, Davidoff & Zaring, *supra* note 96, at 465; *Total Wall Street Bailout Cost*, Source Watch, http://www.sourcewatch.org/index.php?title=total_Wall_Street_Bailout_Cost (last visited Oct. 2, 2012).

99. Kenneth Ayotte & David A. Skeel, Jr., *Bankruptcy or Bailouts?*, 35 J. Corp. L. 469, 470 (2010).

100. W. Scott Frame et al., Fed Reserve Bank of N.Y., Staff Report No. 719, The Rescue of Fannie Mae and Freddie Mac 16 (2015), http://www.newyorkfed.org/research/staff_reports/sr719.pdf.

101. Ayotte & Skeel, *supra* note 99, at 470.

102. Cheryl D. Block, *A Continuum Approach to Systemic Risk and Too-Big-to-Fail*, 6 Brook. J. Corp. Fin. & Com. L. 289, 315 (2012); *see also* Davidoff & Zaring, *supra* note 96, at 465.

103. Ayotte & Skeel, *supra* note 99, at 471–72.

The government response did not always maximize the amount of assets distributed to creditors, as bankruptcy has sought to do in order to minimize the cost of credit.[104] A competitive process to buy assets often did not occur, and large institutions instead were sold to buyers in privately negotiated deals.[105] For example, although the CEO of Bank of America tried to back out of acquiring Merrill Lynch, the Fed and the Treasury discouraged him, and the acquisition was arranged within forty-eight hours.[106] Bank of America then received $20 billion from the U.S. Treasury and an additional $118 billion in government backstops.[107] The Fed also encouraged the acquisition of Bear Stearns by JP Morgan by lending JP Morgan $30 billion to buy credit insurance for Bear's toxic assets.[108]

Politics also influenced outcomes in inefficient ways.[109] Political symbolism constrained the actions that government officials could take, and congressional decisions sometimes also dictated their actions.[110] The bailout of AIG, for example, was tied to the replacement of the CEO, to create the impression that taxpayer money would not reward wrongdoing, even though governance decisions are ordinarily left to shareholders because of their ownership stake in a firm.[111]

In addition to governance distortions, the bailouts often shielded firm directors and creditors from the consequences of destabilizing actions, which subsidized high-risk firm decisions and discouraged creditors from monitoring and disciplining firm directors.[112] Owners and creditors of firms took the benefit of the rescue, while taxpayers paid the costs.[113] The government intervention in AIG, for example, extended $180 billion to its creditors and swap counterparties without

104. *See* Lubben, *Financial Institutions*, *supra* note 11, at 1267.

105. BIPARTISAN POLICY CTR., FAILURE RESOLUTION TASK FORCE, TOO BIG TO FAIL: THE PATH TO A SOLUTION 43 (2013), http://bipartisanpolicy.org/wp-content/uploads/sites/default/files/TooBigToFail.pdf.

106. FIN. CRISIS INQUIRY COMM'N, THE FINANCIAL CRISIS INQUIRY REPORT 383–84 (2011).

107. *Id.* at 384–86.

108. Perry Mehrling, Credit Default Swaps: The Key to Financial Reform 4–5 (Mar. 13, 2009) (unpublished manuscript), http://economics.barnard.edu/sites/default/files/inline/mehrling_financial_reform_final_edit1.pdf.

109. *See, e.g.*, Davidoff & Zaring, *supra* note 96, at 465.

110. *See id.* at 493–94.

111. Ayotte & Skeel, *supra* note 99, at 486–86 (citing the example of AIG CEO Robert Willumstad).

112. *See, e.g.*, *Panel 3: Bankruptcy & Restructuring of Financial Institutions*, 6 N.Y.U. J.L. & BUS. 241, 242–43 (2010) (discussing how bailouts create moral hazards).

113. *See* Davidoff & Zaring, *supra* note 96, at 475 (describing the government bailouts as creating an environment of free riding, in part based on the inability to fully penalize shareholders).

requiring them to accept any losses.[114] Bankruptcy, by contrast, imposes costs on firms and their creditors, which acts as a disincentive to excessive risk taking.[115]

B. Fairness

The bailouts did not conclude with the fair outcomes that the public, as well as creditors, expect from bankruptcy. Taxpayers absorbed losses, and creditor recoveries depended on government discretion, rather than rules of distribution known in advance.[116] Some firms gained market advantages ahead of others.[117] This Section explains why some have considered the bailouts unfair, relative to bankruptcy.

The socialization of losses, while private gains remained, seemed less fair than bankruptcy, and the appearance of corporate executives benefiting at the expense of the public caused a public outcry.[118] While bankruptcy distributes assets to classes of creditors in a defined hierarchy and imposes losses on creditors, the bailouts held taxpayers responsible for the cost of rescuing private industry.[119] European banks, for example, received $60 billion of AIG rescue funds.[120]

The government interventions also appeared discretionary, rather than fair.[121] Federal officials acted without clear legal constraints established through a record of judicial opinions and scholarly commentary.[122] The bailouts that resulted seemed idiosyncratic to specific firms, which made creditors and shareholders less certain of the status

114. FIN. CRISIS INQUIRY COMM'N, *supra* note 106, at 352.

115. *ABI Members Testify on Medical Debt and "Bailouts vs. Bankruptcy," supra* note 28, at 72.

116. *See, e.g.*, CONG. OVERSIGHT PANEL, JUNE OVERSIGHT REPORT: THE AIG RESCUE, ITS IMPACT ON MARKETS, AND THE GOVERNMENT'S EXIT STRATEGY 9 (2010), http://cybercemetery.unt.edu/archive/cop/20110402010341/http://cop.senate.gov/documents/cop-061010-report.pdf (observing that, in the bailout of AIG, the taxpayers, not the shareholders, bore the cost of the bailout).

117. BIPARTISAN POLICY CTR., *supra* note 105, at 4 (noting that some have characterized the bailout as an implicit government subsidy).

118. Davidoff & Zaring, *supra* note 96, at 499–500; Lipson, *supra* note 79, at 1615; *see also, e.g.*, Adam J. Levitin, *In Defense of Bailouts*, 99 GEO. L.J. 435, 438 (2011) (observing the lack of loss-sharing by AIG's creditors fueled public outrage).

119. *See supra* Section I.B; Ayotte, & Skeel, *supra* note 99, at 471–72 (observing that bailouts are taxpayer funded while bankruptcy offers an effective exit option for creditors with reduced moral hazard concerns).

120. Davidoff & Zaring, *supra* note 96, at 500.

121. *Panel 3: Bankruptcy & Restructuring of Financial Institutions*, *supra* note 112, at 244.

122. *See, e.g.*, Randall D. Guynn, *Are Bailouts Inevitable?*, 29 YALE J. ON REG. 121, 137 (2012) (observing that the FDIC had little clear guidance in carrying out Orderly Liquidation Authority resolutions).

of their claims.[123] The AIG bailout, for example, did not require the financial products business to return $165 million in bonuses that could otherwise have been distributed to creditors.[124]

The firm-specific interventions, furthermore, caused market distortions.[125] The government injections of public money advantaged certain firms over others.[126] Mitigating losses at some, but not all, firms introduced follow-on competitive effects.[127] In addition, government facilitation of the sale of large institutions in a market with few buyers served to make dominant firms even more dominant.[128] JP Morgan, for example, surpassed the asset holdings of its rivals by taking over Bear Stearns and Washington Mutual.[129]

C. Transparency

Finally, because the bailouts lacked the transparency of bankruptcy, they sacrificed public trust. The bailouts did not offer the public disclosures and opportunities for judicial review that the bankruptcy process ordinarily provides.[130] The public, consequently, did not always understand the factors that motivated firm outcomes and creditor recoveries, and secrecy damaged public confidence in the financial markets.[131] This Section describes the opacity of the bailouts.

The bailouts took place largely outside of court and without a public process.[132] As a result, the adversarial system did not function.[133] The bailouts lacked oversight through due process, the application of judicial precedent, and judicial review.[134]

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123. Block, *supra* note 102, at 333.

124. Davidoff & Zaring, *supra* note 96, at 499–500.

125. *See Panel 3: Bankruptcy & Restructuring of Financial Institutions*, *supra* note 112, at 244 (noting that firm-specific support exacerbates the "too big to fail" problem).

126. BIPARTISAN POLICY CTR., *supra* note 105, at 44.

127. *Id.*

128. David Skeel, *Making Sense of the New Financial Deal*, 5 LIBERTY U. L. REV. 181, 190 (2011).

129. *Id.*

130. Richard J. Herring, *The Central Role of Resolution Policy in Dealing with Systemically Important Financial Institutions* 35 (Wharton Fin. Insts. Ctr., Working Paper No. 11-71, 2011), http://fic.wharton.upenn.edu/fic/papers/11/11-71.pdf.

131. *See, e.g.*, Davidoff & Zaring, *supra* note 96, at 485 (observing that financial institutions' shareholders were reluctant to recapitalize in fear of equity-destroying bailout and that people withdrew deposits despite the government's guarantee).

132. Block, *supra* note 102, at 348 (noting the private nature of government bailouts and the concomitant need for sensitivity).

133. *Panel 3: Bankruptcy & Restructuring of Financial Institutions*, *supra* note 112, at 254.

134. Davidoff & Zaring, *supra* note 96, at 496–97.

A federal resolution authority instead had the power to make decisions that were not transparent.[135] It remains unclear, for example, why the Fed issued shares in AIG to a trust for the benefit of the Treasury Department, rather than issuing interest directly to the Fed.[136]

The lack of transparency contributed to a feedback loop that worsened conditions.[137] Rumors became reality as market participants lost confidence in the economic system and demanded collateral or halted doing business with troubled institutions, setting off a "contagious panic."[138] The government, for example, seized IndyMac Bank and placed it into FDIC conservatorship, in order to ensure the protection of consumer deposits, but deposit-holders nevertheless queued to withdraw their money.[139] Investors, furthermore, retreated from offering new credit in part because of uncertainty over whether the institutions they might have invested in would later become nationalized.[140]

III.
Reasons Bankruptcy Not Used

Why was the principal legal system for addressing business failure not used during the recent financial crisis?[141] A primary reason appears to derive from the fact that securitization and derivatives trading has taken assets essential for restructuring outside of the legal definition of the bankruptcy estate.[142] The legal tool that prevents a race to claim assets by individual creditors, the automatic stay, applies only to

135. *Panel 3: Bankruptcy & Restructuring of Financial Institutions*, *supra* note 112, at 254.

136. Davidoff & Zaring, *supra* note 96, at 496–97.

137. *Id.* at 476.

138. *Id.*; *Financial Institution Bankruptcy Act of 2014: Hearing Before the Subcomm. on Regulatory Reform, Commercial & Antitrust Law of the H. Comm. on the Judiciary*, 113th Cong. 13 (2014) [hereinafter *Bernstein Hearing*] (statement of Donald Bernstein).

139. Davidoff & Zaring, *supra* note 96, at 485.

140. *Id.* at 486.

141. Lipson, *supra* note 79, at 1612–13.

142. *See* William Choslovsky, *Five Things Every Lawyer Should Know About Bankruptcy and Reorganization Law*, Chi. B. Ass'n Rec., Apr. 2004, at 40, 40 (noting that some code provisions apply only to property of the estate); Saule T. Omarova, *The Quiet Metamorphosis: How Derivatives Changed the "Business of Banking*,*"* 63 U. Miami L. Rev. 1041, 1044 (2009) (noting how regulatory determinations of coverage enabled greater and more complex financial risks); Dov Solomon, *The Rise of a Giant: Securitization and the Global Financial Crisis*, 49 Am. Bus. L.J. 859, 879 (2012) (describing the transfer of uncovered assets when the originator becomes insolvent). Additional reasons might include faulty risk model, faulty regulatory oversight, and faulty monetary policy. *See* Mehrling, *supra* note 108, at 1.

property deemed part of the bankruptcy estate.[143] The limits on the definition of the bankruptcy estate contributed to the proliferation of financing mechanisms that would not be subject to bankruptcy,[144] and the increase in these forms of financing rendered the bankruptcy process ineffectual.[145] The government, therefore, offered bailouts to failed firms to avoid bankruptcy and the systemic instability that the exemption to bankruptcy would have caused.[146] This Part sets out how the exemption works.[147] It then describes in a general way the actions that it encouraged that made insolvency more likely and traditional bankruptcy procedures problematic.[148] It closes with a more specific analysis of the consequences of the exemption in the cases of Bear Stearns, AIG, and Lehman Brothers.[149]

A. *Exemptions*

Securitization removes assets from the balance sheets of firms and insulates them from the bankruptcy of the firms, and derivatives trades qualify for a statutory exemption in the bankruptcy code that enables derivatives investors to circumvent the bankruptcy process.[150] Courts and regulators have, in most cases, endorsed the technical separation of securitized assets from the bankruptcy estate and shielded them from distribution to the rest of the creditors.[151] In addition, while ordinarily counterparties to contracts with bankrupt firms must continue the contracts while the firms choose whether to assume or

143. Choslovsky, *supra* note 142, at 53.

144. *See, e.g.*, Stephen D. Adams, *Swap Safe Harbors in Bankruptcy and Dodd-Frank: A Structural Analysis*, 20 STAN. J.L. BUS. & FIN. 91, 100–01 (2014) (describing the automatic stay exemption and the risk it will lead to mass sales of collateral).

145. *See, e.g.*, *Panel 3: Bankruptcy & Restructuring of Financial Institutions*, *supra* note 112, at 250.

146. Ayotte & Skeel, *supra* note 99, at 484.

147. *See infra* Section III.A.

148. *See infra* Section III.B.

149. *See infra* Section III.C.

150. Edwards & Morrison, *supra* note 60, at 113; Schwarcz & Sharon, *supra* note 57, at 2.

151. Kenneth Ayotte & Stav Gaon, *Asset-Backed Securities: Costs and Benefits of "Bankruptcy Remoteness,"* 24 REV. FIN. STUD. 1299, 1301, 1303 (2011); Lois R. Lupica, *Circumvention of the Bankruptcy Process: The Statutory Institutionalization of Securitization*, 33 CONN. L. REV. 199, 200, 210 (2000). Courts can decide, however, not to recognize the transfer of assets to the special purpose vehicle. *See, e.g.*, Kenneth Kettering, *Securitization and Its Discontents: The Dynamics of Financial Product Development*, 29 CARDOZO L. REV. 1553, 1581 (2008) (observing that the sale of securitized assets by an originator to a special purpose entity may be deemed property of the estate of the originator if the court characterizes the sale as a loan by the special purpose entity to the originator).

reject them, the law treats derivatives contracts differently.[152] Policymakers feared that if derivatives investors could not close out their trading positions, the problems of the bankrupt firm would spread to others and cause a series of bankruptcies that would threaten the stability of the financial markets.[153] A statutory exemption, often referred to as the "safe harbor," has therefore extended special treatment to derivatives investors and permitted them to terminate their agreements, liquidate their positions, net their contracts, and seize their collateral, without participating in the traditional bankruptcy process.[154] This Section describes how securitization protects assets from bankruptcy and explains the operation of the safe harbor for derivatives traders.

1. Securitization

Securitization intentionally removes assets from the remit of the bankruptcy system.[155] Assets transfer to a separate legal entity, which in turn sells rights to the assets to investors.[156] Securitizing a mortgage, for example, includes three principal steps. First, the originator of the mortgage transfers assets in the form of future loan repayments to a special purpose vehicle, a separate legal entity.[157] Second, the special purpose vehicle sells rights to the assets to outside investors in exchange for capital.[158] Third, the mortgage originator takes the money that the special purpose vehicle earned from the sales as compensation for the original transfer of the assets.[159]

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152. Vail Cloar, *Safely Subsidized: Derivative and Repo Financing Under the U.S. Bankruptcy Code*, 45 ARIZ. ST. L.J. 1663, 1677 (2013).

153. Mark J. Roe, *The Derivatives Market's Payment Priorities as Financial Crisis Accelerator*, 63 STAN. L. REV. 539, 564 (2011).

154. *See, e.g.*, Timothy P.W. Sullivan, *Swapped Disincentives: Will Clearinghouses Mitigate the Unintended Effects of the Bankruptcy Code's Swap Exemptions?*, 80 FORDHAM L. REV. 1491, 1511 (2011) (discussing the exemption from automatic stay of contractual rights for participants in swap agreements).

155. Lynn M. LoPucki, *A Team Production Theory of Bankruptcy Reorganization*, 57 VAND. L. REV. 741, 756 (2004); *see also* Kettering, *supra* note 151, at 1556–57 (highlighting securitization's goal of isolating assets from bankruptcy).

156. *See* Edwards & Morrison, *supra* note 60, at 113 (briefly explaining the transfer of assets and associated rights in the securitization process).

157. *See, e.g.*, Ryan E. Scharar, *The Limits of Securitization: Why Bankruptcy Courts Should Substantively Consolidate Predatory Sub-Prime Mortgage Originators and Their Special Purpose Entities*, 2008 MICH. ST. L. REV. 913, 918–19 (describing the pooling and sale of mortgage assets to a separate legal entity).

158. *See, e.g.*, Gabriella Chiesa, *Bankruptcy Remoteness and Incentive-Compatible Securitization* 2 (Univ. of Bologna Dep't of Econ., Working Paper No. 928, 2014) (providing a general overview of the securitization process).

159. *See, e.g.*, LoPucki, *supra* note 155, at 756 (describing the contractual arrangement involved in a "typical" securitization).

The introduction of the special purpose vehicle in between the originator and the investors accomplishes a legal fiction that protects assets from bankruptcy.[160] If the originator enters bankruptcy, the bankruptcy estate will no longer contain the assets over which the special purpose vehicle took ownership.[161] The investors transacted only with the special purpose vehicle, not the originator, and so the investors have claims only against the special purpose vehicle.[162] They do not participate in the bankruptcy of the originator.[163]

By eliminating the risk to investors that would ordinarily flow from the possibility of the originator entering bankruptcy, securitization lowers the cost of capital below the cost of secured financing.[164] Investors in securities do not need to price the bankruptcy risk of the originator into the interest rates that they charge.[165] Only the quality of the payment stream from the assets underlying the securities affects returns to the investors.[166] Securitization makes other risks associated with the originator, such as how market fluctuations affect it, irrelevant.[167]

Court decisions and regulatory rules have affirmed the protection of securitized assets from bankruptcy, even though, functionally, securitized assets differ little from secured credit.[168] Despite the legal fiction of the securitization structure, the originator uses the securitized assets in the same way that it would use secured credit.[169] Nevertheless, secured collateral remains part of the bankruptcy estate, available to support restructuring, while securitized assets do not.[170]

160. Gary B. Gorton & Nicholas S. Souleles, *Special Purpose Vehicles and Securitization*, *in* THE RISKS OF FINANCIAL INSTITUTIONS 549, 557 (Mark Carey & René M. Stulz eds., 2007); Solomon, *supra* note 142, at 879.

161. Lois R. Lupica, *Asset Securitization: The Unsecured Creditor's Perspective*, 76 TEX. L. REV. 595, 634 (1998).

162. Frost, *supra* note 39, at 103.

163. *See id.* at 121 (explaining that creditors of the separate entity can "opt out of the reorganization process").

164. Lupica, *supra* note 151, at 231.

165. *See, e.g.*, Ronel Elul, *The Economics of Asset Securitization*, BUS. REV., Q3 2005, at 16, 22.

166. Kettering, *supra* note 151, at 1556.

167. *See* Lupica, *supra* note 151, at 210–11 (listing various types of risk on the origination side from which investors in securitized products are shielded).

168. *See id.* at 200, 210; Ayotte & Gaon, *supra* note 151, at 1301, 1303. Courts can decide, however, not to recognize the transfer of assets to the special purpose vehicle. *See, e.g.*, Kettering, *supra* note 151, at 1581.

169. The special purpose vehicle leases back to the originator the assets that the special purpose vehicle bought from it, securitized, and resold. LoPucki, *supra* note 155, at 756.

170. *See* Solomon, *supra* note 142, at 873–74.

2. *Derivatives*

Securitized assets packaged into derivative trades benefit from a different and more explicit exemption from bankruptcy.[171] Referred to as the "safe harbor," the bankruptcy code offers investors in derivatives transactions immunity from bankruptcy.[172] Over time, amendments have broadened the exemption, creating a growing class of creditors that can seize assets outside of bankruptcy, and thereby derail the success of the bankruptcy process.[173]

The bankruptcy code provides investors in derivatives transactions with special rights and immunities so that the bankruptcy of one firm does not spread to the entities with which it traded and propagate instability throughout the financial system.[174] Consequently, the investors are exempt from general provisions of the bankruptcy law including: (1) the avoidance rules, which require creditors that receive assets from firms that file for bankruptcy within ninety days to return the assets to the bankruptcy estate;[175] (2) the ban on ipso facto clauses, which prohibits contractual provisions that make entry into bankruptcy automatically terminate contracts;[176] (3) the automatic stay, which prevents creditors from filing individual enforcement actions against firms undergoing bankruptcy;[177] and (4) the permission requirements for netting claims and liabilities, which make court ap-

171. *See* Edwards & Morrison, *supra* note 60, at 96 (detailing how derivatives contracts are treated differently from other contracts in bankruptcy); Michael Simkovic, *Secret Liens and the Financial Crisis of 2008*, 83 AM. BANKR. L.J. 253, 281 (2009) ("Derivatives counterparties . . . enjoy far better treatment under the Bankruptcy Code than even secured creditors.").

172. Schwarcz & Sharon, *supra* note 57, at 1717.

173. *See, e.g.*, Edward R. Morrison & Joerg Riegel, *Financial Contracts and the New Bankruptcy Code: Insulating Markets from Bankrupt Debtors and Bankruptcy Judges*, 13 AM. BANKR. INST. L. REV. 641, 644 (2005) (noting the expansion of the safe harbor to other contracts, agreements, and swaps); Sullivan, *supra* note 154, at 1511 (describing the special rights that participants in swap agreements have in bankruptcy proceedings).

174. Stephen J. Lubben, *The Bankruptcy Code Without Safe Harbors*, 84 AM. BANKR. L.J. 123, 130–31 (2010).

175. Adams, *supra* note 144, at 7–8; Roe, *supra* note 153, at 547.

176. *See* Stephen J. Lubben, *Repeal the Safe Harbors*, 18 AM. BANKR. INST. L. REV. 319, 322–23 (2010) [hereinafter Lubben, *Repeal*] (describing the nature of ipso facto clauses); *see also* Stephen J. Lubben, *Systemic Risk & Chapter 11*, 82 Temp. L. Rev. 433, 441 (2009) [hereinafter Lubben, *Systemic Risk*] (positing that the ban on ipso facto clauses prevents "a general fear of bankruptcy" from creating "socially inefficient breaches of agreements").

177. *See, e.g.*, *The Bankruptcy Code and Financial Institution Insolvencies: Hearing Before the Subcomm. on Regulatory Reform, Commercial & Antitrust Law of the H. Comm. on the Judiciary*, 113th Cong. 94, 97 n.1 (2013) [hereinafter *Roe Hearing*] (statement of Mark J. Roe, Law Professor, Harvard Law School) (describing the automatic stay exemption for safe-harbored financial instruments).

proval necessary before creditors can subtract money that they owe to bankrupt firms from the amounts that the firms owe to them, so that they can make a smaller claim against the bankruptcy estate.[178]

Following a series of amendments, the safe harbor now appears to include investors trading in every instrument currently used in the derivatives markets and any instruments that might be developed in the future.[179] These investors have the unique right to grab assets from the firms they have traded with when the firms appear to be on the verge of bankruptcy.[180] Generally, in derivatives trades, the firms set aside margin.[181] The margin operates similarly to a deposit and pays out assets to investors in response to changes in the value of derivatives contracts. If insufficient margin remains available, the investors can call for additional margin, forcing firms to offer more assets.[182] Without the operation of the avoidance rules, the investors do not risk having to return the assets if the firm files for bankruptcy, as other creditors would.[183] Upon the entry of firms into bankruptcy, investors in derivatives can also cancel their contracts, using ipso facto clauses that would not be available to other creditors.[184] In addition, the automatic stay does not operate to prevent derivatives investors from terminating their trades and claiming assets outside of the bankruptcy process.[185]

The unrestricted right that derivatives investors have to close out their trading positions makes coordinated resolution in bankruptcy im-

178. *See, e.g.*, Sean J. Griffith, *Governing Systemic Risk: Towards a Governance Structure for Derivatives Clearinghouses*, 61 EMORY L.J. 1153, 1169 (2012) (noting that derivatives counterparties have the ability to net positions); Lubben, *Repeal*, *supra* note 176, at 329–30 (discussing the lack of court approval needed for derivatives investors to net positions when faced with a bankruptcy counterparty).

179. Stephen J. Lubben, *Derivatives and Bankruptcy: The Flawed Case for Special Treatment*, 12 U. PA. J. BUS. L. 61, 67 (2009); Lubben, *Systemic Risk*, *supra* note 176, at 443–44.

180. *See* Edwards & Morrison, *supra* note 60, at 96 (highlighting the ability of counterparties to seize margin posted by an insolvent firm).

181. *See, e.g.*, Anupam Chander & Randall Costa, *Clearing Credit Default Swaps: A Case Study in Global Legal Convergence*, 10 CHI. J. INT'L L. 639, 651 (2010) (discussing the insufficiency of the margin posted to AIG by its CDS counterparties).

182. *See, e.g.*, *id.* (noting that firms can demand variation margin from counterparties in times of market stress).

183. *See* Morrison & Riegel, *supra* note 173, at 645–46 (explaining the rules that protect certain eve-of-bankruptcy payments by derivative counterparties).

184. *See* Lubben, *Repeal*, *supra* note 176, at 322 (noting that derivative counterparties can contract for automatic termination in the event of a bankruptcy filing).

185. Morrison & Riegel, *supra* note 173, at 641–42.

possible.[186] The investors have the unique ability to dismantle firms in a piecemeal way by seizing assets outside of bankruptcy, and therefore have no incentive to participate in the collective bankruptcy process.[187] The assets they remove from the bankruptcy estate become unavailable to support restructuring.[188]

B. *Exemptions Make Insolvency More Likely and Bankruptcy Impossible*

High volumes of bankruptcy-exempt transactions leading up to the recent financial crisis made it more likely for firms to become insolvent, while also making the traditional bankruptcy process unworkable.[189] The protection from bankruptcy that securitization structures offered encouraged the propagation of increasing numbers of mortgages.[190] Lending standards for mortgages fell, and institutions accumulated holdings in mortgage-backed securities.[191] The ability to shift the risk that the securities carried onto other investors through derivatives trading had freed firms from discipline in the debts they undertook.[192] Investors in derivatives also had less need to monitor the stability of the firms they traded with, because the bankruptcy exemption would protect their recoveries even if the firms entered bankruptcy.[193] As the value of mortgage-backed securities fell and the risks that the firms held became apparent, derivatives investors forced the

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186. *See, e.g.*, *Roe Hearing*, *supra* note 177, at 95 (using the "chaotic" bankruptcy of Lehman Brothers as an example of how "the safe harbors make an effective resolution in a bankruptcy without regulatory support difficult").

187. *See, e.g.*, Lubben, *Repeal*, *supra* note 176, at 323 (explaining that the derivative exemption from the automatic stay, in particular, interrupts the bankruptcy process).

188. *See, e.g.*, Lupica, *supra* note 161, at 634; Roe, *supra* note 153, at 35; Solomon, *supra* note 142, at 873.

189. *See* Edward R. Morrison, *Is the Bankruptcy Code an Adequate Mechanism for Resolving the Distress of Systemically Important Institutions?*, 82 TEMP. L. REV. 449, 452 (2009) ("[S]afe harbors may exacerbate the instability by permitting a counterparty 'run' on the failing institution."); Edwards & Morrison, *supra* note 60, at 92 (using the bailout of Long Term Capital Management as an example of an unworkable financial-institution bankruptcy).

190. *See infra* Section III.B.1.

191. *See, e.g.*, Kurt Eggert, *Held Up in Due Course: Predatory Lending, Securitization, and the Holder in Due Course Doctrine*, 35 CREIGHTON L. REV. 503, 550–51 (2002) (noting that securitization has led to "the decline of stringent underwriting"); Patricia A. McCoy et al., *Systemic Risk Through Securitization: The Result of Deregulation and Regulatory Failure*, 41 CONN. L. REV. 1327, 1327 (2009) (discussing securitization's effect on lending standards in the recent crisis); s*ee also infra* Section III.C.3 (discussing the AIG example).

192. *See* Roe, *supra* note 153, at 542 (identifying as examples the risky investment structures of Bear Sterns and AIG).

193. *See, e.g.*, Sullivan, *supra* note 154, at 1514–15 (arguing that the safe harbors for derivatives allow counterparties to take less care in monitoring credit risk).

firms to liquidate assets in order to provide additional margin, rather than compromising with other creditors to maintain the solvency of the firm.[194] Entry into bankruptcy would not have prevented derivatives investors from continuing to deplete the firms of assets necessary for restructuring and depressing the value of the assets held by other firms in the economy.[195] This Section sets out the reasons why the bankruptcy exemption encouraged increased investment in securities and derivatives and how the investment made it necessary to avoid bankruptcy.

1. Instability from Buildup of Trades

The bankruptcy advantages that securitization achieves may have contributed in part to the high volume of transactions in mortgage-backed securities, and derivatives based on them, and their accumulation on the balance sheets of financial institutions.[196] While mortgage securitization began in 1970, and by 1979 only 10% of mortgages had been securitized, by the close of 2008 $6.8 trillion in mortgage-backed securities were outstanding, representing a quarter of the entire U.S. bond market.[197] Derivatives experienced similar growth, with a few trades in the 1980s developing into an $11 trillion market by 1994 and a $430 trillion market by 2009, far larger than the regular debt market.[198] Credit default swaps, which accounted for $919 billion in trades in 2001, reached $62 trillion in 2007, and the repo market also doubled to $10 trillion.[199] Credit default swaps transfer the risk of default of an underlying loan from the buyer of the swap to its seller.[200] If the loan defaults, the seller of the swap will pay the buyer; if no default occurs, the seller earns a profit.[201] Repos offer a form of

194. *See, e.g.*, Adams, *supra* note 144, at 12–13 (describing the risk-shifting from derivatives counterparties to others in bankruptcy settings).

195. *See, e.g.*, Ondersma, *supra* note 59, at 111–12 (noting that derivatives counterparties “rush” to close out contracts with a failing firm, intensifying systemic distress).

196. *See, e.g.*, Sullivan, *supra* note 154, at 1515 (noting that the bankruptcy advantages could incentivize debtors with declining creditworthiness to use derivatives as a proxy for a loan).

197. Anna Gelpern & Adam J. Levitin, *Rewriting Frankenstein Contracts: Workout Prohibitions in Residential Mortgage-Backed Securities*, 82 S. CAL. L. REV. 1075, 1080 (2009); Adam J. Levitin, *The Paper Chase: Securitization, Foreclosure, and the Uncertainty of Mortgage Title*, 63 DUKE L.J. 637, 670–71 (2013).

198. Roe, *supra* note 153, at 543–44.

199. Margaret Blair, *Financial Innovation, Leverage, Bubbles and The Distribution of Income*, 30 REV. BANKING & FIN. L. 225, 247–50 (2011).

200. *See e.g.*, Mehrling, *supra* note 108, at 2.

201. *See, e.g.*, Blair, *supra* note 199, at 243; Lipson, *supra* note 79, at 1655–56.

short-term borrowing.[202] In a repo, or a repurchase agreement, one party sells securities to another with an agreement that the seller will later buy back the securities.[203] This Section explains how the bankruptcy exemption encouraged high volumes of trading in securitized assets and other derivatives including credit default swaps and repurchase agreements, increasing the likelihood of insolvency at financial institutions.

a. Increasing Securitization Volumes

Securitization increased the number of mortgages available to securitize for several reasons. First, because of the off-balance-sheet treatment of securitized assets, securitization made more money available for loans from financial institutions that owned mortgage-lending outfits, such as Deutsche Bank and Merrill Lynch.[204] The mortgage lenders did not have to price the risk of default into the mortgages they extended.[205] The lower cost of mortgage capital encouraged more home buying, which, in turn, fueled the pipeline of securitization.[206] Second, because other financial institutions that bought mortgages in the secondary market and securitized them, such as Lehman Brothers and Bear Stearns, earned fees from securitizing the mortgages, they could use the up-front fees generated from securitization to buy more mortgages to securitize.[207] Third, because securitization eliminated the disciplining effects of default risk, lending standards could fall.[208] Financial institutions passed the risk exposure of nonconforming mortgages to special purpose vehicles, which in turn sold it to downstream investors, insulating themselves from the consequences of default.[209]

In addition to securitizing increasing numbers of mortgages, financial institutions also bought mortgage-backed securities from each

202. BIPARTISAN POLICY CTR., *supra* note 105, at 18.
203. Nathan Goralnik, *Bankruptcy-Proof Finance and the Supply of Liquidity*, 122 YALE L.J. 460, 481 (2012).
204. Gelpern & Levitin, *supra* note 197, at 1084; Jason Lynch, *Reevaluating Bankruptcy Remoteness: Transfers of Risk, Implications of the GGP Reorganization*, AM. BANKR. INST. J., July–Aug. 2010, at 58, 59.
205. Gelpern & Levitin, *supra* note 197, at 1084.
206. *See e.g.*, Kenneth W. Dam, *The Subprime Crisis and Financial Regulation: International and Comparative Perspectives*, 10 CHI. J. INT'L L. 581, 623 (2010) (illustrating how home buying increased); Scharar, *supra* note 157, at 921 (explaining how lower capital cost increased liquidity for lenders).
207. Gelpern & Levitin, *supra* note 197, at 1080–82 (illustrating the structure of securitization and how lenders offset risk); McCoy et al., *supra* 191, at 1368 (summarizing the cyclical nature of risk deferral by large lenders).
208. Eggert, *supra* note 191, at 550–51; McCoy et al., *supra* note 191, at 1327–30.
209. Kathleen C. Engel & Patricia A. McCoy, *Turning a Blind Eye: Wall Street Finance of Predatory Lending*, 75 FORDHAM L. REV. 2039, 2041 (2007).

other, concentrating the risk of the securities.[210] By 2007, for example, Lehman Brothers had bought $111 billion of mortgage-backed securities, more than four times the total amount of equity that it owned.[211]

b. Increasing Derivatives Volumes

The legal and regulatory system also accommodated increased use of derivatives, often based on mortgage-backed securities.[212] The safe harbor, which eliminated the risk of bankruptcy, encouraged the use of credit default swaps that transferred the risk of the securities to other investors.[213] The protection from bankruptcy also incentivized firms to shift towards using derivatives to raise short-term financing.[214] Traditional warehouse loans, for example, were written as repo agreements in order to qualify for the safe harbor.[215] The law made derivatives trading rational for firms, though it led to more complexity and opacity in the overall financial system.[216]

The bankruptcy exemption incentivized precarious trades.[217] Investors in derivatives transacted with weak entities, knowing that the bankruptcy risk of their counterparties would not affect them:[218] They could protect themselves against default simply by calling for increased margin and taking collateral.[219] They had no reason to monitor their counterparties.[220] The counterparties also did not need to reduce risk to attract trading partners.[221]

210. *See, e.g.*, Hyun Song Shin, *Securitisation and Financial Stability*, VoxEU (Mar. 18, 2009), http://www.voxeu.org/article/securitisation-undermined-financial-stability (summarizing how re-sale of securities to peer banks concentrated the risk from said securities within the banking industry itself).

211. Fin. Crisis Inquiry Comm'n, *supra* note 106.

212. Cloar, *supra* note 152, at 1676 (describing the use of the safe harbor as a tool to accommodate increased derivative use).

213. *See, e.g.*, Sullivan, *supra* note 154, at 1515 (summarizing how the policy decision to endorse the safe harbor contributed to the failure of Bear Stearns and Lehman Brothers).

214. Zachary J. Gubler, *Regulating in the Shadows: Systemic Moral Hazard and the Problem of the Twenty-First Century Bank Run*, 63 Ala. L. Rev. 221, 265–66 (2012).

215. Lubben, *Repeal*, *supra* note 176, at 138–39.

216. Steven L. Schwarcz, *Regulating Shadows: Financial Regulation and Responsibility Failure*, 70 Wash. & Lee L. Rev. 1781, 1819 (2013) (framing the pre-Dodd-Frank environment as encouraging morally hazardous but rational activity).

217. *See* Roe, *supra* note 153, at 542.

218. *Id.*; Cloar, *supra* note 152, at 1676.

219. Lubben, *Repeal*, *supra* note 176, at 330–31.

220. *See, e.g.*, Sullivan, *supra* note 154, at 1505 (citing a Senate committee report noting that policy encouraged firms not to monitor counterparties and move forward with insufficient capital).

221. *See* Roe, *supra* note 153, at 555.

In addition, because credit default swaps enabled one party to pay another an insurance premium for assuming the risk that a mortgage holder would default, the swaps stimulated additional investment in mortgages.[222] Making the credit risk of the securitized mortgages tradable made them cheaper, which in turn made credit for the underlying mortgages cheaper.[223] The swap buyer, however, would remain exposed to the default risk if the counterparty insuring the risk were to fail.[224]

Financial institutions entered into both sides of derivatives transactions, in increasing numbers.[225] According to Vanderbilt Law professor Margaret Blair, "financial market participants were using derivatives not so much to offset other risks but to place bets with each other."[226] Citigroup, for example, paid more than $55 billion for products based on U.S. subprime mortgages.[227]

2. *From Bankruptcy Risk to Bankruptcy Impossibility*

High volumes of securitization and derivatives trading made resolution through bankruptcy impossible.[228] The bankruptcy exemption enabled the depletion from firms of assets that otherwise would have been available to support restructuring.[229] Securitization transferred assets out of the bankruptcy estate;[230] the buyers and sellers of derivatives also removed assets when they demanded collateral to reflect the increased risk of their contracts or terminated their contracts outside of bankruptcy.[231] This Section presents a general mechanism of the behaviors, encouraged by the bankruptcy exemption, that pushed firms

222. *See* Blair, *supra* note 199, at 247 (noting that at the peak, outstanding CDS accounted for almost twice the total amount of household mortgage debt at the time); Griffith, *supra* note 178, at 1167 (noting that CDS allowed investors to take more exposure to subprime mortgages than there were such mortgages).

223. Mehrling, *supra* note 108, at 2.

224. *See* Griffith, *supra* note 178, at 1161–62 (describing the counterparty credit risk taken on by the swap buyer).

225. *See, e.g.*, Jeremy C. Kress, *Credit Default Swaps, Clearinghouses, and Systemic Risk: Why Centralized Counterparties Must Have Access to Central Bank Liquidity*, 48 HARV. J. ON LEGIS. 49, 58–59 (2011) (describing the tendency of derivatives transactions to gradually expand to include several financial institutions in one transaction).

226. Blair, *supra* note 199, at 248.

227. Ricardo J. Caballero, *The 'Other' Imbalance and the Financial Crisis* 23 (Nat'l Bureau of Econ. Research, Working Paper No. 15636, 2010).

228. *See, e.g.*, Edwards & Morrison, *supra* note 60, at 92 (citing the Long Term Capital Management example for how bankruptcy was impossible for a highly leveraged financial institution).

229. Lupica, *supra* note 151, at 235.

230. Solomon, *supra* note 142, at 872.

231. Lubben, *Repeal*, *supra* note 176, at 330–31.

closer to insolvency. It then explains how the exemption subsequently operated to prevent resolution of the firms within bankruptcy.

The easing of credit in U.S. financial markets reached a limit when housing demand and home prices began to fall.[232] Property prices declined, sometimes to levels far lower than the amount of the mortgages on the properties.[233] With the risk of mortgage default increasing, investors, including financial institutions, that held mortgage-backed securities began to write down their assets.[234] Other financial institutions that held mortgage risk as counterparties to swaps and other derivatives trades were also affected by the reversal in the housing market.[235]

As the value of mortgage-backed securities fell, the entities that had insured mortgage risk through derivatives trades began to call for more margin, triggering a process similar to a bank run.[236] The entities that insured mortgage risk had incentives to grab collateral before mass sell-offs of the assets underlying the collateral caused the value of the assets to fall.[237] Because the bankruptcy safe harbor protected the insurers from the bankruptcy of their counterparties, the insurers demanded collateral regardless of the effect of the collateral calls on the solvency of the counterparties.[238]

Not only did seizing collateral weaken entities that were already in trouble, but it also threatened to spread losses through the financial system to other entities.[239] When the same assets collateralized the derivatives trades of other entities, sell-offs of those assets by one entity reduced the liquidity of the others holding them, creating condi-

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232. McCoy et al., *supra* note 191, at 1332.

233. *Id.*

234. Davidoff & Zaring, *supra* note 96, at 472.

235. *See, e.g.*, Michael Greenberger, *Overwhelming a Financial Regulatory Black Hole with Legislative Sunlight: Dodd-Frank's Attack on Systemic Economic Destabilization Caused by an Unregulated Multi-Trillion Dollar Derivatives Market*, 6 J. BUS. & TECH. L. 127, 146 (2011) (illustrating how the sheer market size of CDOs led to shock and an overall economic meltdown).

236. *See, e.g.*, Edwards & Morrison, *supra* note 60, at 105–06 (describing the risk of a "run" triggered by derivatives counterparties); Gary Gorton & Guillermo Ordonez, *Collateral Crises*, 104 AM. ECON. REV. 343, 346 (2014) (describing overcollateralization through haircuts).

237. *See, e.g.*, R. Christian Bruce, *Krimminger's List: A Little More Chapter 11, a Little Less Title II*, 97 Banking Rep. (BNA) No. 22, at 1030 (Dec. 13, 2011) (describing the rapid selloffs of collateral and subsequent decline in value).

238. *See, e.g.*, Sullivan, *supra* note 154, at 1521 (noting that an individual firm may recognize the risk that its counterparty is too thinly capitalized but that the firm can still protect itself by calling for collateral before the counterparty defaults).

239. *See, e.g.*, Ayotte & Skeel, *supra* note 99, at 494 (describing how the failure of a major debtor, such as AIG, could have sufficient market impacts to incentivize the government to provide a rescue loan).

tions for other risk insurers also to begin calling on their counterparties to post additional collateral.[240]

All of the counterparties to derivatives trades had incentives to meet the collateral calls without filing for bankruptcy.[241] If they entered bankruptcy procedures, those insuring the risk of the mortgage-backed securities that had contracted for ipso facto clauses had the legal right to terminate all of their derivatives trades at once.[242] Cross-default clauses would cause one default to terminate a series of other, unrelated derivatives trades.[243]

As the insuring entities jettisoned their derivatives trades, their counterparties had to sell more collateral to meet their obligations.[244] This, in turn, caused the insurers to rush to close out their trades, before the price of the collateral assets fell further.[245] Lehman Brothers, for example, had to terminate nearly 725,000 of its over 900,000 derivatives trades within five weeks of filing for bankruptcy.[246]

The safe harbor thus encouraged derivatives traders to dismember institutions that may have been economically viable.[247] While ordinarily the automatic stay and preference rules would prevent them from running on collateral in the lead up to bankruptcy and protect their counterparties from having to liquidate assets in a collapsing

240. *See, e.g.*, Guynn, *supra* note 122, at 127 ("During a financial panic, [fire-sale liquidations] also minimize the perceived value of similar assets throughout the financial system and maximize the incentives of depositors and other short-term creditors to stage a 'run'—that is, to pull their cash out of the system.").

241. *See, e.g.*, Ayotte & Skeel, *supra* note 99, at 484, 495 (proposing that fund managers will go to great lengths to avoid bankruptcy).

242. Charles W. Mooney, Jr., *The Bankruptcy Code's Safe Harbors for Settlement Payments and Securities Contracts: When Is Safe Too Safe?*, 49 TEX. INT'L L.J. 245, 252 (2014) (noting how ipso facto clauses function as an exception to the automatic stay).

243. *Exploring Chapter 11 Reform: Corporate and Financial Institution Insolvencies; Treatment of Derivatives: Hearing Before the Subcomm. on Regulatory Reform, Commercial & Antitrust Law of the H. Comm. on the Judiciary*, 113th Cong. 3 (2014) (statement of Jan Vris, Chair of the Capital Markets Committee, National Bankruptcy Conference) (stating that if a parent company has guaranteed its subsidiaries' derivative obligations, a bankruptcy filing by the parent triggers defaults by each of its subsidiaries).

244. *See, e.g.*, Ayotte & Skeel, *supra* note 99, at 494–95 (describing how AIG and Lehman's counterparties forced them to post their collateral to satisfy their debts).

245. *See, e.g.*, *Regulating and Resolving Institutions Considered "Too Big to Fail": Hearing Before the S. Comm. on Banking, Hous. & Urban Affairs*, 111th Cong. 53 (2009) [hereinafter *Bair Hearing*] (testimony of Sheila Bair, Chair, FDIC) (testifying that at-risk financial firms are more prone to closing out on their trades because of increased collateral demands, which can depress prices).

246. Kimberly Summe, *Misconceptions About Lehman Brothers' Bankruptcy and the Role Derivatives Played*, 64 STAN. L. REV. ONLINE 16, 18–19 (2011).

247. Roe, *supra* note 153, at 564–65.

market, the bankruptcy exemption made the provisions of the bankruptcy law inapplicable.[248] The entities insuring the mortgage risk did not have to participate in the bankruptcy process.[249] Rather than compromising with their counterparties and agreeing to losses, they had every reason to strip their counterparties of assets, leaving the counterparties without money to support restructuring or to distribute to other creditors in accordance with the established bankruptcy hierarchy.[250]

C. Case Studies

The bankruptcy exemption hastened the collapse of each of the three institutions that headlined the financial crisis[251] and magnified the risk that their defaults would paralyze the financial system.[252] The following Sections explore how the general mechanism described in the previous Part played out in the specific contexts of Bear Stearns, Lehman Brothers, and AIG.

1. Bear Stearns

Bear Stearns relied heavily on repo financing, perhaps because of the incentives that the safe harbor generated.[253] Repo financing accounted for twenty-five percent of the balance sheet of Bear Stearns when the firm failed.[254] The safe harbor appeared to reduce the cost of repo financing by eliminating bankruptcy risk from its price.[255] Ultimately, however, the safe harbor made it necessary to bail out Bear

248. Lubben, *Repeal*, *supra* note 176, at 330–31 (explaining how safe harbors worsen systemic risk after default); *see* Chiesa, *supra* note 158, at 2 (explaining how investors had contractual rights to banks' assets while risk remained with banks).

249. Chiesa, *supra* note 158, at 2.

250. *See, e.g.*, Ondersma, *supra* note 59, at 86–87 (describing the effects of safe harbors, generally, and in the case of Lehman Brothers).

251. *See Bair Hearing*, *supra* note 245, at 52–53.

252. *See* Bruce, *supra* note 237, at 1030 (describing how the bankruptcy exemption can hasten and expand systemic impact).

253. *See* Roe, *supra* note 153, at 552–53 (describing incentives for repo counterparties).

254. David A. Skeel, Jr. & Thomas H. Jackson, *Transaction Consistency and the New Finance in Bankruptcy*, 112 COLUM. L. REV. 152, 163 (2012). Bear Stearns had borrowed $100 billion on the repo market and had only $400 billion in assets. *See* Roe, *supra* note 153, at 552.

255. Louis Massard, *A Review of* The New Financial Deal *by David Skeel*, 16 N.C. BANKING INST. 435, 451 (2012).

Stearns.[256] The bankruptcy exemption made resolution within bankruptcy impossible.[257]

A series of events culminated in a run on Bear Stearns by the counterparties to its derivatives trades. In June 2007, Bear Stearns paid $3.2 billion in an attempt to save two hedge funds it advised that had invested in subprime mortgage-backed securities.[258] Meanwhile, Bear Stearns took $1.9 billion in write downs, or reductions in the estimated value of its assets, based on its own exposure to mortgage-backed securities.[259] Witnessing these losses, its derivatives counterparties began to demand additional collateral, but Bear Stearns had trouble raising enough cash to meet the calls.[260] In the four days before the government bailed it out, its liquidity dropped by $16 billion.[261]

Entering bankruptcy would not have put a stop to the collateral calls, and would have instead exacerbated systemic problems.[262] Without the automatic stay and avoidance provisions to block the counterparties, the run appeared certain to continue.[263] In order to prevent a mass sale of collateral that would drive down the value of mortgage-backed securities even further, the government provided a backstop guarantee to forestall bankruptcy.[264] As the Secretary of the Treasury, Henry Paulson, testified to the Financial Crisis Inquiry Commission, "If Bear had gone there were hundreds, maybe thousands of counterparties that all would have grabbed their collateral, would have started trying to sell their collateral, drove down prices, created even bigger losses."[265]

2. *AIG*

AIG held a portfolio of mortgage-backed securities,[266] as well as $527 billion in credit default swaps backed by subprime mortgages.[267]

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256. *See, e.g.*, Greenberger, *supra* note 235, at 149 (explaining how an absence of the safe harbor would have resulted in further runs to liquidate collateral).
257. *See, e.g.*, Davidoff & Zaring, *supra* note 96, at 478–79 (describing the decision to bail out Bear as motivated by fear of widespread, systemic failure).
258. *Id.* at 473–74.
259. *Id.* at 474.
260. Goralnik, *supra* note 203, at 490.
261. FIN. CRISIS INQUIRY COMM'N, *supra* note 106, at 289 fig.15.1.
262. Skeel & Jackson, *supra* note 254, at 163.
263. Ondersma, supra note 59, at 112.
264. Skeel & Jackson, *supra* note 254, at 163.
265. FIN. CRISIS INQUIRY COMM'N, *supra* note 106, at 291.
266. Ayotte & Skeel, *supra* note 99, at 475.
267. Alexander Charap, *Minimizing Risks, Maximizing Flexibility: A New Approach to Credit Default Swap Regulation*, 11 J. BUS. & SEC. L. 127, 137 (2011). Had the

As the value of the mortgage-backed securities fell, AIG directly lost money and also had to provide additional collateral to its swaps counterparties.[268] As a result, its liquidity decreased.[269]

On September 15, 2008, the liquidity of AIG dropped to a level that triggered ratings downgrades.[270] The swap contracts required AIG to post more collateral in response to the downgrades.[271] Under the contracts, the declining value of the mortgage-backed securities also triggered additional collateral requirements.[272] AIG owed collateral worth $14.5 billion, making it technically insolvent.[273] Meanwhile, the value of the mortgage-backed securities it held to meet the collateral demands was also falling, and the securities were becoming more difficult to sell.[274] Sales of the securities were taking essential assets out of the institution, threatening its ability to continue to operate.[275]

A self-reinforcing cycle began.[276] If AIG had declared bankruptcy, ipso facto clauses in derivatives contracts would have allowed derivatives counterparties to terminate their derivative contracts all at once.[277] In order to avoid the mass termination, AIG continued to liquidate assets for as long as it could.[278] Posting collateral, however, worsened its liquidity problems, which in turn led to more ratings downgrades and more collateral calls from the counterparties.[279]

The safe harbor prevented entry into bankruptcy from putting a stop to the cycle.[280] Without the bankruptcy exemption, bankruptcy law could not block the counterparties from "dismembering the firm and forcing fire sales of its assets."[281] The avoidance rules would have

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government bailout not occurred, AIG would have defaulted on $440 billion in CDS contracts. *Id.* at 138.

268. Ayotte & Skeel, *supra* note 99, at 475; Griffith, *supra* note 178, at 1171.

269. Charap, *supra* note 267, at 137.

270. CONG. OVERSIGHT PANEL, *supra* note 116, at 37.

271. Lubben, *Repeal*, *supra* note 176, at 319–20.

272. CONG. OVERSIGHT PANEL, *supra* note 116, at 37.

273. Davidoff & Zaring, *supra* note 96, at 495.

274. CONG. OVERSIGHT PANEL, *supra* note 116, at 45.

275. *See* Ji Hun Kim, *The Need to Amend the Bankruptcy Code's Treatment of Derivatives*, 18 NORTON J. BANKR. L. & PRAC. 649, 654 (2009).

276. Lubben, *Repeal*, *supra* note 176, at 320.

277. CONG. OVERSIGHT PANEL, *supra* note 116, at 77.

278. *See, e.g.*, Nicholas M. McGrath & Ji Hun Kim, *Deciphering Derivatives in Bankruptcy*, AM. BANKR. INST. J., Apr. 2011, at 56, 56.

279. CONG. OVERSIGHT PANEL, *supra* note 116, at 7, 38.

280. *See, e.g.*, Roe, *supra* note 153, at 551, 565.

281. Christopher K. Kiplok, *ABI Commission Hearing Focuses on Safe Harbors in Financial Contracts and OLA*, 32 AM. BANKR. INST. J. 10, 11 (2013).

forced the counterparties to return to the bankruptcy estate collateral payments that occurred on the eve of bankruptcy.[282]

Instead, the Fed acted to stop the cycle.[283] Because the bankruptcy exemption made counterparties eligible to recoup all of their collateral if AIG entered proceedings, the Fed had limited leverage to force the counterparties to accept losses.[284] The Fed provided an $85 billion credit facility to AIG, enabling the counterparties to make full recoveries.[285]

3. *Lehman Brothers*

At the time it filed for bankruptcy, Lehman Brothers had 906,000 derivatives transactions outstanding.[286] News of problems at Lehman Brothers had sparked demands for additional collateral.[287] On September 10, 2008, Lehman Brother reported a loss of $3.9 billion in its quarterly earnings and $7.8 billion in write downs.[288] It also announced plans to isolate the troubled real estate assets that it held within a "bad" bank, a corporate structure used to segregate illiquid and high-risk securities from other assets.[289] Demands for collateral in reaction to the news placed the liquidity of Lehman Brothers at risk.[290] Lehman Brothers, for example, owed J.P. Morgan $20 billion worth of collateral.[291]

The bankruptcy exemption made it possible for counterparties to derivatives trades with Lehman Brothers to strip the institution of its assets.[292] The claim by J.P. Morgan resulted in the liquidation of $17 billion worth of assets.[293] The avoidance rules did not operate to prevent J.P. Morgan from removing the assets from Lehman Brothers.[294]

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282. *See Roe Hearing*, *supra* note 177, at 99.
283. Charap, *supra* note 267, at 138.
284. CONG, OVERSIGHT PANEL, *supra* note 116, at 144.
285. Kress, *supra* note 225, at 60.
286. Summe, *supra* note 246, at 18.
287. Ondersma, *supra* note 59, at 115.
288. Davidoff & Zaring, *supra* note 96, at 491.
289. *Id.*
290. *See, e.g.*, Ondersma, *supra* note 59, at 116 (discussing $310 billion in withdrawals from money market funds).
291. Cloar, *supra* note 152, at 1680.
292. *See, e.g.*, McGrath & Kim, *supra* note 278, at 56 (discussing how parties rushed to close out their derivatives with Lehman Brothers).
293. Cloar, *supra* note 152, at 1680.
294. Roe, *supra* note 153, at, 553.

After failing to identify an entity willing to buy the institution, Lehman Brothers filed for bankruptcy on September 15, 2008.[295] Counterparties to 700,000 derivatives transactions terminated their contracts.[296] The closeouts have been valued to have cost the firm $50 billion.[297] They also cost other institutions that held similar assets that lost value when a large volume of the assets reached the market at the same time.[298]

Ultimately, however, Lehman Brothers retained control of more assets than anticipated, and its bankruptcy concluded with a sale of its viable businesses to Barclays.[299] Many of the derivatives trades that Lehman had entered stemmed from contracts that turned out to be undercollateralized.[300] Some counterparties nevertheless potentially had rights to significant collateral, including Nomura, which made a claim for $1 billion.[301] The estate litigated the boundaries of the bankruptcy exemption and succeeded in preventing some counterparties from terminating their trades.[302] The U.S. Bankruptcy Court for the Southern District of New York found that collateral that had become commingled with the general accounts of Lehman Brothers fell outside of the safe harbor.[303]

IV.
Bankruptcy as Backstop

As the financial crisis has begun to recede into the distant past and consideration of how to respond better in future crises has started to take place, attention has returned to the existing bankruptcy pro-

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295. Davidoff & Zaring, *supra* note 96, at 493; Timothy E. Lynch, *Gambling by Another Name; the Challenge of Purely Speculative Derivatives*, 17 Stan. J.L. Bus. & Fin. 67, 103 (2011).

296. Summe, *supra* note 246, at 18–19.

297. *Roe Hearing*, *supra* note 177, at 92.

298. *See, e.g.*, Morrison, *supra* note 189, at 449 (describing how non-distressed institutions that held similar assets to Lehman Brothers suddenly plummeted in value).

299. Ayotte & Skeel, *supra* note 99, at 482.

300. *See, e.g.*, Kim, *supra* note 275, at 653. Contracts were "out of the money," such that the counterparties owed Lehman money. For example, many municipalities and nonprofits had issued floating rate bonds and entered into interest rate swaps with Lehman whereby they paid a fixed rate and received a floating rate. In other words, some of these swap counterparties were "out of the money" to Lehman, as the fixed rate was higher than the floating rate prior to Lehman's bankruptcy.

301. Greenberger, *supra* note 235, at 149.

302. *See* Goralnik, *supra* note 203, at 500 (describing the ongoing litigation).

303. David A. Skeel, Jr., *Bankruptcy Boundary Games*, 4 Brook. J. Corp. Fin. & Com. L. 1, 12–13 (2009).

cess.[304] The importance of functional bankruptcy law to backstop financial risk has gained traction in policymaking circles.[305] Since the 1970s, the current bankruptcy law generally has achieved more efficiency, fairness, and transparency than the non-bankruptcy response did during the crisis.[306] The bankruptcy code has also provided a detailed rulebook, elucidated through several decades of commentary, and bankruptcy practitioners and courts have built up skills and knowledge over time.[307] By contrast, a theoretical new set of procedures for financial institutions would be untested and would infrequently generate results to inform improvements.[308] This Part sets out current legislation to establish a new resolution authority, and explains how it supplements the bankruptcy code while continuing to rely on it.[309] The Part then turns to more recent suggestions to reform the bankruptcy code, in order to enable the resolution of financial institutions solely within bankruptcy.[310]

A. New Resolution Mechanism and Bankruptcy

The Dodd-Frank Act establishes a new "orderly liquidation" authority (OLA)[311] that functions as a complement to Chapter 11, rather than as a stand-alone replacement.[312] The legislation expresses a preference for using the existing, rules-based system of bankruptcy, administered by judges in a predictable, fair, and transparent way.[313] Language in Titles I and II of the Dodd-Frank Act reserves the OLA for use only in the limited situations in which existing bankruptcy law would be ineffectual.[314] Where the OLA applies, it provides for tem-

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304. *See, e.g.*, *ABI Members Testify on Medical Debt and "Bailouts vs. Bankruptcy," supra* note 28, at 72 (discussing possible improvements to how derivatives are treated); *Panel 3: Bankruptcy & Restructuring of Financial Institutions*, *supra* note 112, at 265 (discussing lessons learned from the financial crisis regarding the bankruptcy process).

305. *See* discussion *infra* Sections IV.A–C.

306. *See supra* Part II.

307. Guynn, *supra* note 122, at 137; Lubben, *Repeal*, *supra* note 176, at 332.

308. *See* Hollace T. Cohen, *Orderly Liquidation Authority: A New Insolvency Regime to Address Systemic Risk*, 45 U. Rich. L. Rev. 1143, 1153 (2011) (discussing the unknown impacts of regulations that haven't yet been promulgated); Lubben, *Repeal*, *supra* note 176, at 332 (explaining the outline of an alternative system and the concerns associated with it).

309. *See infra* Section IV.A.

310. *See infra* Sections IV.B–C.

311. Block, *supra* note 102, at 342–43.

312. Bipartisan Policy Ctr., *supra* note 105, at 2–3.

313. *Id.* at 2–3.

314. *Hearing on H.R. 5421 Before the Subcomm. on Regulatory Reform, Commercial & Antitrust Law of the H. Comm. on the Judiciary*, 113th Cong. 2–3 (2014)

porary relief from the safe harbor.[315] The former general counsel of the FDIC, Michael Krimminger, who oversaw the implementation of the Dodd-Frank Act, has stated publicly that he would prefer never to use the new OLA.[316] He, and others, support eliminating the safe harbor from the bankruptcy code, in order to increase possibilities for resolving firms within bankruptcy.[317]

The Dodd-Frank Act creates a hybrid system that defers to the bankruptcy code in all but exceptional circumstances.[318] Title I requires certain institutions to devise advance plans for their own resolution.[319] Multiple regulatory agencies evaluate the feasibility of the plans against the benchmark of Chapter 11.[320] If the agencies determine that a plan is not credible and would not facilitate an orderly resolution within Chapter 11, then the institution must revise the plan to demonstrate how an orderly resolution within Chapter 11 would be possible.[321]

If institutions become distressed, the OLA offers a last-resort solution that supplements the existing bankruptcy code in situations of systemic risk.[322] Institutions enter the alternative OLA system in rare cases in which regulators determine that bankruptcy "would have serious adverse effects on financial stability in the U.S.," and using OLA "would avoid or mitigate such adverse effects."[323]

The key effect of introducing the OLA alongside traditional bankruptcy is to offer a work-around to the problems caused by the bankruptcy exemption.[324] When the OLA preempts the bankruptcy law, use of the OLA triggers a one-day stay that prevents counterparties to derivatives transactions from terminating their contracts.[325] Un-

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[hereinafter *Jackson Hearing*] (statement of Thomas Jackson, Distinguished Professor and President Emeritus, Univ. of Rochester).

315. Lubben, *Transaction Simplicity*, *supra* note 11, at 202–03.

316. Bruce, *supra* note 237, at 1030.

317. Massard, *supra* note 255, at 452, 455.

318. *Jackson Hearing*, *supra* note 314, at 3–4; Lubben, *Transaction Simplicity*, *supra* note 11, at 203.

319. Dodd-Frank Wall Street Reform and Consumer Protection Act, 12 U.S.C. § 5365 (2014); *see also, e.g.*, *Jackson Hearing*, *supra* note 314, at 2–3.

320. Thomas H. Jackson, *Resolving Financial Institutions*, BANKING PERSP., Q1 2014, at 24.

321. *Jackson Hearing*, *supra* note 314, at 42.

322. Block, *supra* note 102, at 343–44 (discussing the systematic risk determinations and OLA of Dodd-Frank resolution).

323. BIPARTISAN POLICY CTR., *supra* note 105, at 2–3.

324. Stephen J. Lubben, *Resolution, Orderly and Otherwise: B of A in OLA*, 81 U. CIN. L. REV. 485, 508 (2012) (observing that the OLA enables FDIC to act without court oversight or need to give notice).

325. Lubben, *Transaction Simplicity*, *supra* note 11, at 202–03.

like the bankruptcy law, the OLA can therefore preserve assets within distressed institutions and support the continued viability of their operating subsidiaries.[326]

The Dodd-Frank Act provides the OLA with a limited number of additional powers relative to the bankruptcy code.[327] In addition to suspending the safe harbor, the OLA provides a mechanism for borrowing money directly from the Treasury without court approval.[328] The OLA suspends cross-defaults at entities affiliated with distressed institutions, which destabilize and reduce these institutions' value, and it can distribute assets to individual creditors without regard to the distribution rules of bankruptcy law.[329] In general, it can act with little judicial oversight.[330] While these differences from the bankruptcy system may add facility, they also make resolution through the OLA less predictable and more discretionary than resolution within Chapter 11.[331]

B. Bankruptcy Code Proposals

Rather than maintaining the existing bankruptcy law structure and building on top of it,[332] other policy groups and legislators have advocated for resolving institutions solely within bankruptcy.[333] Competing bills that have developed would create new chapters of the bankruptcy code.[334] The proposals reflect a preference for standing by a system with established rules, rather than displacing it with new guidelines that are subject to politics and the discretion of regulators.[335]

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326. *Id.*; *Jackson Hearing*, *supra* note 314, at 47.

327. *See, e.g.*, Matt Saldana, *Parallel Regimes: Bankruptcy and Dodd-Frank's Orderly Liquidation Authority*, 31 REV. BANKING & FIN. L. 531, 539–40 (2012) (noting that the OLA, unlike the bankruptcy code, requires planning of liquidation and due diligence and prohibits counterparties from terminating qualified financial contracts).

328. *See, e.g.*, *id.* at 540–41.

329. Guynn, *supra* note 122, at 139; Skeel, *supra* note 128, at 190.

330. *See, e.g.*, Block, *supra* note 102, at 364–65 (noting that the FDIC may arrange a purchase and assumption transaction without court approval).

331. *See, e.g.*, Lubben, *Financial Institutions*, *supra* note 11, at 1274.

332. Massard, *supra* note 255, at 449 (summarizing Skeel's arguments that Dodd-Frank's resolution regime is ill-equipped to protect insolvent financial institutions).

333. *See, e.g.*, Diane Davis, *House Panel Considers Draft Bill Providing Orderly Liquidation of Large Financial Firms*, 103 Banking Rep. (BNA) No. 4, at 194 (July 22, 2014).

334. *See supra* Section IV.A.

335. *See, e.g.*, *Hearing on Financial Institution Bankruptcy Act of 2014 Before the Subcomm. on Regulatory Reform, Commercial & Antitrust Law of the H. Comm. on the Judiciary*, 113th Cong. 68 (2014) (statement of Stephen Hessler).

The Hoover Institution has proposed a new Chapter 14 of the bankruptcy code.[336] The proposal, recorded as Senate Bill 1861, would repeal Title II of the Dodd-Frank Act and replace it with Chapter 14.[337] The new chapter would apply to specific financial institutions, which would then have to file for bankruptcy under both Chapter 14 and Chapters 7 or 11 of the bankruptcy code. Chapter 14 would modify the existing rules of Chapters 7 or 11 only to remedy specific obstacles to resolving large financial institutions within bankruptcy, while leaving in place the established resolution framework provided for by the bankruptcy code.

The modifications to the existing chapters of the bankruptcy code, placed under the heading of Chapter 14, would apply only to bank holding companies and would treat them differently in two primary ways. First, Chapter 14 would eliminate the safe harbor for three days, with certain differences for repos relative to other derivatives. The Hoover Institution has criticized the OLA for not repealing the bankruptcy exemption that Chapter 11 provides, and has suggested that, consequently, the advance plans that institutions file will never be adequate under Title I of the Dodd-Frank Act, making liquidation outside of bankruptcy under Title II always necessary.[338] Second, in Chapter 14, a select group of district court judges, rather than bankruptcy court judges, would supervise resolutions, and regulators would receive enhanced rights. The regulators would gain the ability to commence involuntary cases against institutions and to propose their own resolution plans at any time.

A more recent congressional bill, the Financial Institution Bankruptcy Act of 2014, proposes to insert a new Subchapter V into Chapter 11 of the Bankruptcy Code. The idea motivating the proposed legislation is that because Title II of the Dodd-Frank Act prioritizes using the bankruptcy code, and reserves the OLA for specific situations that the bankruptcy code cannot handle, the code instead could simply include the provisions for addressing the special circumstances of distressed financial firms. The legislation therefore recreates in Subchapter V the strategy of the Dodd-Frank Act, but places it within a subchapter of the bankruptcy code in order to emphasize the continued importance of Chapter 11.[339] Under Subchapter V, holding companies would enter bankruptcy proceedings geared towards imposing

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336. *Jackson Hearing*, *supra* note 314, at 40.
337. The Taxpayer Protection and Responsible Resolution Act, S. 1861, 113th Cong. (2013).
338. *See, e.g.*, *Jackson Hearing*, *supra* note 314, at 10.
339. Davis, *supra* note 333, at 194.

losses on the creditors and shareholders of the holding companies, while the operating subsidiaries remained in place, in order to preserve their value.

To this end, Subchapter V proposes a series of changes, while maintaining certain core provisions of Chapter 11. The legislation would preserve the leadership role of bankruptcy judges, but a subset selected for their experience in handling large cases. Unlike Chapter 11, the legislation would authorize federal regulators to place financial institutions into Chapter 11 involuntarily and permit bankruptcy courts to review resolution plans in light of the public interest. The subchapter would also temporarily reverse the safe harbor. Traditional tenets of bankruptcy that the OLA eliminates, including the absolute priority rule and the general policies of existing managers continuing to run bankrupt companies and authoring plans for resolution, remain in place.

Although the Dodd-Frank Act relies heavily on existing bankruptcy law, the proposals for a new Chapter 14 and a new Subchapter V of the bankruptcy code would replace some of the few provisions that differ from bankruptcy. Title II of the OLA places more of an emphasis on liquidation, while the bankruptcy process has encouraged creditors and firms to negotiate collective compromises.[340] Title II of the OLA empowers the FDIC to treat creditors within classes unequally, while bankruptcy judges do not make substantive decisions about how losses should be allocated.[341] The judges instead review resolution plans for their compliance with distribution rules.[342] Title II transfers authority to politically oriented regulators that operate less openly, while bankruptcy entails a court-centered process that the judges supervise.[343] The more similar the resolution regime for financial institutions becomes to the general bankruptcy law, the easier it becomes to coordinate between the two systems, and to avoid upending the expectations of creditors.[344]

340. *See, e.g.*, Saldana, *supra* note 327, at 534–36 (comparing the OLA and the bankruptcy code with respect to the FDIC).
341. Block, *supra* note 102, at 365.
342. *Id.* at 364–65 (noting that judges have a limited role as referee and do not have authority for substantive decisions over the allocation of losses among stakeholders).
343. *See, e.g.*, Cohen, *supra* note 308, at 1149–50; Davis, *supra* note 333, at 194.
344. *See, e.g.*, Herring, *supra* note 130, at 3–4 ("[L]ack of coordination between bankruptcy court and the FDIC could easily lead to chaos.").

C. Need for Bankruptcy Element

Effective bankruptcy law increases the range of options available for resolving distressed financial institutions.[345] Whether the resolution of financial institutions will occur in the future according to supplements to the bankruptcy code or within the bankruptcy code, the bankruptcy law plays an essential role.[346] Chapter 11 remains a necessary part of any approach.

At a 2009 congressional hearing, Sheila Bair described the qualities required of a resolution authority in a way that echoed many of the qualities that the bankruptcy system already has.[347] She called for a regime that would be "open, transparent and subject to a system of checks and balances."[348] Three things, she said, were needed:

> [A] clearly defined priority structure for settling claims . . . [S]econd, the process must allow continuation of any systemically significant operations. Third, the rules that govern the process, and set priorities for the imposition of losses on shareholders and creditors, should be clearly articulated and closely adhered to, so that the markets can understand the resolution process with predictable outcomes.[349]

Because the U.S. already has in place a mostly successful bankruptcy law, a special authority can build on its strength, or the existing law could be brought into line with modern financial markets without much difficulty.[350] Calls for putting an end to the ability of the safe harbor to derail the bankruptcy process range from modest rollbacks to the complete elimination of the exemption.[351] Small adjustments to the bankruptcy law could enable the law to become a more viable resolution tool for systemically important financial institutions: Some have suggested extending the ban on ipso facto clauses, and others have suggested calibrating the exemption by type of derivative and the specific risks that each poses when their counterparties have the ability to terminate the trades outside of bankruptcy.[352] Transactions dis-

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345. *See, e.g.*, *Bernstein Hearing*, *supra* note 138, at 22.
346. *Jackson Hearing*, *supra* note 314, at 7 ("I believe the 'bones' for a comparably-successful resolution of a SIFI under the Bankruptcy Code are already in place.").
347. *Bair Hearing*, *supra* note 245, at 53.
348. *Id.*
349. *Id.*
350. *See also, e.g.*, Lubben, *Repeal*, *supra* note 176, at 334 (suggesting that with limited tuning, Chapter 11 could address the problems presented by failing financial firms).
351. *See, e.g.*, Ayotte & Skeel, *supra* note 99, at 496 (2010) (summarizing potential legislative solutions).
352. Ayotte & Skeel, *supra* note 99 (proposing a blanket reversal of the automatic stay exemption); Lubben, *Repeal*, *supra* note 176, at 329–30 (proposing extending the

guised to qualify for the exemption could simply be recharacterized.[353]

Reversing the exemption and putting derivatives trades back in the bankruptcy system would restore important incentives.[354] Counterparties would again need to monitor the health of the institutions with which they traded.[355] They would need to manage the counterparty credit risk that they acquired.[356] They would avoid relying excessively on exempt forms of financing, and, in an emergency, it would not be in their interest to ration credit.

If counterparties to derivatives trades had to monitor their institutional trading partners, and corporate directors did not postpone bankruptcy to avoid triggering a mass termination of derivatives contracts, the insolvency of financial institutions could perhaps be avoided, or their bankruptcy could be planned for.[357] If bankruptcy law prevented collateral calls from dismembering economically viable institutions, and from reducing the value of assets held by other institutions, devising alternative resolution schemes would become less necessary.[358]

Conclusion

Bankruptcy law has long served to balance the maintenance of the contractual rights to property that creditors have negotiated with the preservation of assets within insolvent firms, so that the firms may continue to operate, and, in appropriate cases, undergo restructuring.[359] The automatic stay has blocked individual enforcement actions by secured creditors, while, meanwhile, the rule of absolute priority has extended to them first priority for receiving asset distributions. The nuanced treatment of secured creditors evidences the importance

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ban on ipso facto clauses); Ondersma, *supra* note 59, at 119 (summarizing proposals for adjusting bankruptcy law).

353. Lubben, *Transaction Simplicity*, *supra* note 11, at 197 (arguing that recharacterizing putative derivatives and repos would resolve overbroad safe harbors).

354. *See id.* at 201.

355. *See, e.g.*, *ABI Members Testify on Medical Debt and "Bailouts vs. Bankruptcy*,*" supra* note 28, at 72.

356. *See, e.g.*, Ayotte & Skeel, *supra* note 99, at 496 (discussing debtor monitoring and avoiding single counterparty overexposure); Griffith, *supra* note 178, at 1162–63 (noting the increased likelihood of counterparty credit risk during periods of financial distress).

357. *See, e.g.*, Skeel, *supra* note 303, at 19 (discussing the potential benefits of the bankruptcy-plus-stay proposal).

358. *See, e.g.*, Massard, *supra* note 255, at 452 ("[C]reditors can generally diminish . . . risks by demanding adequate collateral and taking several smaller derivative positions . . . .").

359. *See, e.g.*, *Sontchi Hearing*, *supra* note 44, at 26 (advocating the inclusions of mortgage loans and interests in the well-established rules governing secured lending).

of retaining their collateral assets within bankrupt firms while a reorganization process takes place.

Although scholars have differed over the precise boundaries of the goals of bankruptcy law, they have seemed to agree that the law should strive to create an efficient, fair, and transparent process. Rather than filing individual enforcement actions to reclaim what each creditor is due, causing mass liquidations of assets at plummeting prices that spread problems to other firms holding the same assets, bankruptcy law has required all creditors to engage collectively with bankrupt firms and negotiate single, comprehensive solutions. Instead of taxpayers absorbing the costs of reorganization, bankruptcy law has placed the costs squarely on creditors and shareholders and created a self-funding resolution regime. This has incentivized creditors to remain cognizant of the risks that the firms they lend to undertake. Instead of a winner-takes-all system, clear and well-understood rules have guided the distribution of assets among creditors. Disclosure requirements and judicial review have offered an additional check on the fairness of distribution, and introduced opportunities for public scrutiny.[360]

Nevertheless, when financial institutions began to fail during the recent financial crisis, the government bailed out many of them, rather than subjecting them to traditional bankruptcy procedures. Doing so preserved the stability of financial markets, but it introduced political discretion, required taxpayer funding, and produced market distortions and public panic. Closed-door sales, on an ad hoc basis and under emergency conditions, appeared less efficient, fair, and transparent than typical outcomes in bankruptcy.

Government officials circumvented the bankruptcy process because securitization structures and derivatives trading exempted essential assets from bankruptcy. The law has respected the separation of assets from an originating entity when the entity transfers assets to a special purpose vehicle, and it has also established a safe harbor, according to which the typical rules of bankruptcy do not apply to counterparties to derivatives trades. As a result, when mortgage defaults caused direct losses at financial institutions and increased the risk of their derivatives trades, setting off a spiral in which derivatives counterparties forced financial institutions to liquidate increasing amounts of assets in order to post additional collateral to reflect the new risk levels, entry into bankruptcy could not stop the cycle.

360. *See, e.g.*, *Bernstein Hearing*, *supra* note 138, at 23 (advocating voluntary proceedings); Morrison, *supra* note 189, at 462–63 (describing the monitoring requirements of President Obama's proposal).

If the crisis was a test of the bankruptcy system and its ability to deal with the risks posed by modern finance, then the bankruptcy system failed. Well-designed networks have circuit breakers, but the bankruptcy exemption left bankruptcy law unable to stop runs on financial contracts held by financial institutions.[361] The more effective the bankruptcy law, the greater the ability to build from it to create specialized resolution regimes or to use it to resolve even financial firms, which would increase certainty among creditors and the public in their expected outcomes.[362]

361. *See, e.g.*, Stiglitz, *supra* note 12, at 4 (noting that large demand or failure in parts of the system would lead to system-wide failure).
362. *See, e.g.*, Lubben, *Financial Institutions*, *supra* note 11, at 1262 (proposing a more unified bankruptcy law while acknowledging political realities).