

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

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Abstract

Chapter 11 bars bankrupts from immediately repaying their creditors, so that the court can reorganize the debtor without creditors shredding the bankrupt firm's business. Not so for the bankrupt's derivatives counterparties, who can seize and liquidate collateral, net out gains and losses, terminate their contracts with the bankrupt, and keep both preferential eve-of-bankruptcy payments and fraudulent conveyances they obtained from the debtor in ways that favor them over other creditors. Their right to jump to the head of the bankruptcy repayment line, ahead of even ordinary secured creditors, warps their pre-bankruptcy incentives both to monitor the pre-bankruptcy debtor and to adjust their investments to better account for counterparty risk, since they do well in any resulting bankruptcy. If they bear less risk, other creditors bear more risk and have more incentives to monitor the debtor or to assure themselves that the debtor is a safe bet. But the other creditors — such as the United States of America — are poorly positioned contractually to provide that monitoring. Bankruptcy policy should harness private incentives for counterparty monitoring by cutting back the extensive de facto priorities embedded now in chapter 11 and related laws for these derivatives counterparties. Repeal would induce the derivatives market to better recognize the risks of counterparty financial failure, which in turn should dampen the possibility of another AIG/Bear/Lehman financial melt-down, thereby helping to maintain financial stability. Yet the major financial reform packages now in Congress do not yet contemplate the needed cutbacks.

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INTRODUCTION

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

The Bankruptcy Code did so by sapping the failed firms' counterparties' incentives to account well for counterparty risk — the risk that their financial trading partner would fail (as AIG, Bear, and Lehman eventually did). Each failed firm likely had more super-priority debt than it otherwise would have had, if that debt did not enjoy the strong, better-than-secured-creditor priorities that the Code gives them. Other causes are important, but the bankruptcy rules' impact for derivatives players' incentives in structuring their transactions is in need of analysis.

Were those Bankruptcy Code super-priorities not so broad, the failed firms' financial trading partners would have lowered their exposure to a potential failure of Lehman, AIG, or Bear. Were they not in the Code, each of the three failed firms would have been incentivized to substitute away from what turned out to be risky, often overnight, financing and toward a stronger balance sheet. Were the super-priorities not in the Code, the three firms' counterparties would have had reason to substitute away from some trades with the failed firms, into trades with the next tier of financial firms. Together, those results would have made each of these three firms *less* financially central and *less* inter-connected. The financial system would have been more resilient.

These bankruptcy-induced problems are not small. When Bear failed, a quarter of its capital came from the “repo” market via short-term, frequently overnight borrowings.² Without the Code's priorities, such a precarious capital structure would

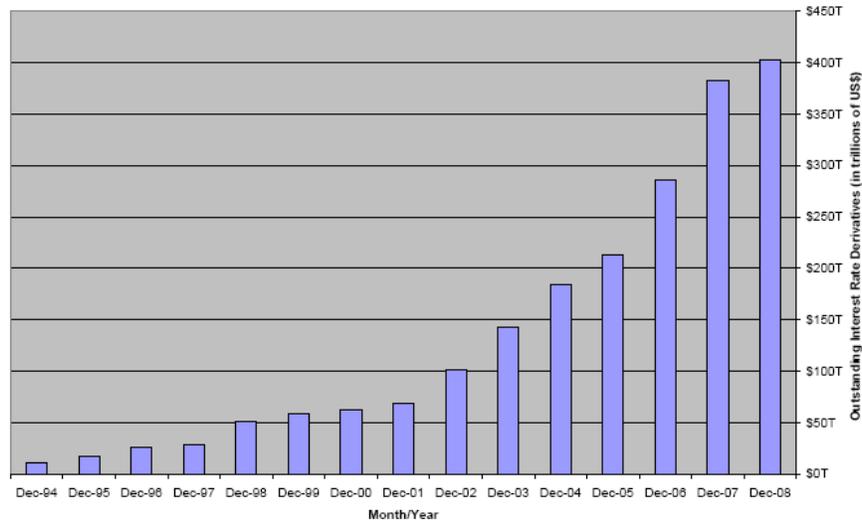
* Professor, Harvard Law School. Thanks go to Douglas Baird, Martin Bienenstock, Albert Choi, John Coates, Isaac Corré, Andrew Feldstein, Bruce Haggerty, Howell Jackson, Christian Johnson, Jonathan Lipson, Lynn Lopucki, Stephen Lubben, Craig Pirrong, Hal Scott, David Skeel, Richard Squire, and George Triantis for comments on a prior draft.

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

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

not have been viable. When AIG failed, its excessive credit default derivatives exposure destabilized it further. Without the Code's swap priorities, such a precarious position would not have been so easily viable. Without the Code's priorities, Lehman's extensive repo transactions to reduce revealed balance sheet leverage during the few days before filing reports would have been harder to effectuate.

Figure 1. Growth in the Market for Interest Rate Derivatives.³



Overall, these are not just local financial structures that unfortunately failed: As the financial crisis opened in June 2007, we had \$2.5 trillion in overnight repos, when the aggregate insured bank deposits were only twice as much.⁴ Just one type of derivative — the interest rate swap, explained below — grew to more than \$400 trillion by December of 2008, with \$4 trillion of collateral backing up the derivatives market overall.⁵ Figure 1 illustrates the market's explosive growth in the dozen years preceding the financial crisis. Combine the overnight repo market with the collateralized portion of the derivatives markets and we have a financial market bigger than the FDIC-insured banking system. If there's a failure in these markets, the first set of governing rules come from the Bankruptcy Code.

Repos and derivatives differ financially, but enjoy the same super-advantages under the Code. A repo is a sale of assets, often over-night, with the seller promising to buy the assets back. Repos are typically used to finance a firm, often a financial firm. Derivatives trade financial outcomes such as those of changing currency rates or of long-term for short-term interest rates. Derivatives typically transfer risks.

³ The underlying data is from Int'l Swap and Derivatives Ass'n, Summaries of Market Survey Results, <http://www.ida.org/>, last accessed Apr. 15, 2010.

⁴ Adam Ashcraft, Federal Reserve Bank of N.Y. discussion paper, *available at* <http://imf.org/external/np/res/seminars/2009/arc/pdf/ashcraft1.pdf>.

⁵ INT'L SWAPS AND DERIVATIVES ASS'N, ISDA MARGIN SURVEY (2009). Larger numbers are often quoted for the derivatives market. When a party to an interest swap trades a floating interest rate for a fixed one on, say, \$100 million of debt that neither party has borrowed or lent, the \$100 million "notional" amount is often reported as the market's size — that number totaled \$400 trillion at year-end 2008. However, the smaller interest rate is being swapped and an even smaller amount is given as collateral. It's the lower collateral amount that goes into the text's still-big \$4 trillion number.

* * *

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

In Part II, I show how the Code's advantages sap counterparties' incentives to closely monitor the weak debtor. This is the central defect in the Code's rules, one that discourages financial resiliency. Understanding it adds to important prior work on the derivatives priorities. Previous work has focused on the problem of bank-run-style collapse of a derivatives-heavy entity, with the Code priorities facilitating a run and collapse. Run analysis is important (and I analyze it further, indicating limits and extension), but I seek to shift policymakers' focus from the moment before the institution's collapse (when runs and contagion are real) to the months and years before collapse, when bankruptcy law could create better incentives than it does now for counterparties to more efficiently structure their trillion-dollar derivatives and repo book, to *avoid* counterparty collapse. This is the new analysis I bring to bear on the situation and where, I argue, the central bankruptcy priority costs and problems lie.

In Part III, I extend this *ex ante*, market discipline analysis, by analyzing why creditors cannot adjust their contracts to resolve the Code's current major disincentives to counterparty monitoring in the derivatives context. This analysis is missing from the literature, but is central to understanding what went wrong. Just as Code priorities *reduce* the derivatives counter-parties' risks and monitoring incentives, they thereby *raise* risks that the firm's other creditors face. Risk is transferred. Conceptually, those other creditors can react contractually to reduce their exposure to a risky debtor or monitor it more closely. But the relevant players are not the best informed and best skilled at reducing resulting risks because they are not themselves derivatives and repo professionals. The largest affected creditor is the United States as *de facto* guarantor of weak, too-big-to-fail financial debtors. But the United States has no contract, unless we conceptualize the Bankruptcy Code rules as its *de facto* contract. If we conceptualize the Code as its contract, that contract needs to be revised going forward. Hence, one channel to the bailouts runs through the Bankruptcy Code.

In Part IV, I examine the core arguments favoring derivatives and repo priorities. Then, in Part V I examine the current proposals in Congress and why they do not adequately address the derivatives and repo arising of the financial crisis.

Finally, I conclude. The Bankruptcy Code's safe-harbor, super-priorities for derivatives and repurchase agreements are ill-conceived. Like others before, I am skeptical that the bankruptcy priorities are wise, but my skepticism here comes from different analysis, one based on the counterparties' *ex ante* incentives. The Code priorities decrease the derivatives players' *ex ante* monitoring incentives. But noting this disincentive is alone not enough to affect policy, because that result raises the firms' other creditors' monitoring incentives. If the others react well contractually or otherwise, there is little cost to the rule. But they cannot react well because they are poorly informed or because they, like the United States, are distant and contingent.

Mixing weakly-incentivized with poorly-informed players encourages risky, knife's edge financing. When pursued in financially central firms, the Code's impact is to transfer risk to the United States as the ultimate guarantor of the firms' solvency,

draining financial resiliency in a way that has not previously been analyzed. The Code-induced monitoring misalignment and the ex ante weakening of financial resiliency are central bankruptcy issues here.

Although several bankruptcy derivatives and repo advantages are functional and ought to be kept, the full range is far too broad. Most are more likely to destabilize financial markets, many undermine ex ante market discipline in the derivatives and repo markets, some already have had that effect, and many need to be scaled back.

I. DERIVATIVE AND REPO COUNTERPARTIES' CHAPTER 11 SUPER-ADVANTAGES

A. The Code

A failing firm's bankruptcy filing affects its creditors: First, the Bankruptcy Code bars its creditors from suing the debtor for repayment, bars them from trying to otherwise collect debts due from the bankrupt, and, if secured, bars them from immediately seizing or liquidating their security. Second, creditors who are repaid on an old loan in the 90 days before bankruptcy must return those payments to the bankrupt, thereby allowing all creditors to share in that value. Third, ordinary creditors lack an unlimited right to set-off their own debts due *to* the debtor against debts due *from* the debtor. Fourth, bankrupts can recover pre-bankruptcy fraudulent conveyances — whereby the debtor sells its own assets for less than their fair value — for the benefit of all of the bankrupt's creditors. Fifth, the Code limits creditors' and suppliers' rights to terminate contracts with the bankrupt. Sixth, creditors cannot terminate their contracts with a bankrupt just because the firm files for reorganization via chapter 11.⁶

For creditors holding derivatives and repurchase agreements with the bankrupt, each rule is reversed in their favor. These counterparties can collect on their debts and seize collateral while other creditors wait for the bankrupt to reorganize. They need neither return eve-of-bankruptcy preferential payments on old debts nor give back preferential collateral calls that other creditors must return. They have strong set-off rights that allow them to escape handing over money they owe to the debtor. They are exempt from most fraudulent conveyance liability. Finally, derivatives counterparties can terminate contracts; and they need not suffer the debtor's option to assume or reject the underlying contract.⁷ The total impact of these exemptions and special rules is to give the favored a super-priority.

⁶ First: Bankruptcy Code, § 362(d) (automatic stay); second: § 547 (preferences must be returned); third: § 362(a)(7) (set-off requires judicial permission); fourth: § 548 (fraudulent conveyance liability for mismatched consideration); fifth: § 365(e)(1) & § 541(c)(1); and sixth: § 365.

⁷ First: Bankruptcy Code, §§ 362(b)(17), (27), 560 (can liquidate collateral in their possession); second: § 546(g), (j) (exempt from preference rules); third: §§ 553(a), 560 (automatic option to set-off); fourth: § 546(g), (j) (exempt from constructive fraudulent conveyance liability); fifth and sixth: §§ 555, 559, 560, 561 (can terminate repos, swaps, and master netting agreements). These apply in both chapter 7 liquidations and chapter 11 reorganizations. Not all of these favorable rules are unwise. Most though are too broad. Termination choice, for example, usually rests with the bankrupt. Putting the choice there may not be wise in general and its impact on large, open financial contracts can be severe, inequitable, and inefficient. But adjusting the baseline rule does not require the full reversal, which may be equally unwise,

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

The normative point here is not that the baseline rules are uniformly wise; several could be done better if Congress overhauled the Code. The point is that we have two sets of bankruptcy rules — one for derivatives counterparties and one for everyone else — and having two sets of rules here is unwise.⁸ One set limits creditors' seizures from the bankrupt firm. The second set exempts seizures and accords extra priorities to creditors holding financial contracts called “derivatives” or “repurchase agreements.” It is no surprise that sophisticated finance players seek this favored framework because it protects them. By doing so, the super-prioritized counterparties' incentive to ration their dealings with financially weak debtors declines.

These negative incentives can perniciously affect the debtor itself, its other creditors, and, ultimately, the economy. Better to re-do most priorities in any financial reform package that emerges from Congress, repealing some and cutting back others. Doing so would reduce the possibility of another AIG-Bear-Lehman melt-down.

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

This is not the place to describe the full breadth of the financial crisis and the role the collapse of AIG, Bear, and Lehman played in extending and reflecting the crisis. Good narratives can be found elsewhere.⁹ Nor is this the place to look at the range of problems — legal, economic, and political — that induced and accelerated the financial crisis. Bank capital rules, regulatory lapses, rating agency mistakes,

that the Code effectuates. More below, in Part III.B.3., on the cutback's appropriate scope. Bank are not restructured under the Code, but the governing rules are parallel.

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

⁸ There may be reason to make some basic rules more creditor-friendly than they are (I offer no view on that here) but little reason and much cost to doing so only for a favored group of creditors.

⁹ E.g., WILLIAM D. COHAN, *HOUSE OF CARDS* (2009); LAWRENCE MACDONALD, *A COLOSSAL FAILURE OF COMMON SENSE: THE INSIDE STORY OF THE COLLAPSE OF LEHMAN BROTHERS* (2009); HENRY M. PAULSON, *ON THE BRINK: INSIDE THE RACE TO STOP THE COLLAPSE OF THE GLOBAL FINANCIAL SYSTEM* (2010); GILLIAN TETT, *FOOL'S GOLD* (2009).

transactional complexity,¹⁰ and the politics of subsidizing the subprime housing market all were important, with some more important than the bankruptcy rules standing alone. Instead, we cull core features of the three mega-collapses to see how derivatives' super-advantages in chapter 11 contributed to monitoring disincentives and to the firms' eventual collapse. These Code-induced monitoring disincentives exacerbated other problems, made their own contribution, and are not technically difficult to ameliorate.

1. *AIG*. Consider AIG, the huge insurer. AIG was a big player in the credit default swap market, by which it assured others that it would pay up if another firm's financial product failed. When AIG failed in September 2008, it was obligated on \$400 billion of credit default obligations. Some of these credit default swaps, which functioned as guarantees, were on other companies. Some guaranteed performance of mortgage pools, including those infamous sub-prime housing mortgages.¹¹

Goldman was one of AIG's major counterparties. It had protected other investors in the mortgage market on about \$14 billion of securities, then purchased credit protection from AIG at a lower rate, profiting from the \$50 million difference. According to a former chief of AIG's financial products unit, in a post-mortem: "It seems shocking to me that Goldman would become so exposed to AIG and kept doing deals with them and laying on the risk."¹² This is suggestive of Goldman paying insufficient attention to the creditworthiness of its counterparty, AIG, a result consistent with it expecting to have the derivatives priority in bankruptcy. Its Code priorities plausibly distorted Goldman's incentives as it dealt with AIG.¹³

AIG had earlier been an AAA, investment-grade risk, from which derivatives counterparties did not require collateral. When AIG lost its AAA rating, its counterparties, such as Goldman, demanded large collateral postings, as their contracts allowed. Any resulting collateral paid over from AIG was conceptually a preference. Goldman insisted that it was well-protected even without the government's eventual \$85 billion bailout of AIG. Uninvestigated is whether this self-protection claim could have been accurately made without the Codes' derivatives exceptions for preferences.

On the eve of its failure, AIG insisted that Goldman return several billion dollars of what AIG thought to be its own collateral overpayments to Goldman, as front-page newspaper headlines tell us.¹⁴ Had Goldman lacked the exceptions from rules barring

¹⁰ See Jonathan Lipson, *Enron Rerun: The Credit Crisis in Three "Easy" Pieces*, in LESSONS FROM THE FINANCIAL CRISIS (Robert W. Kolb, ed., forthcoming); Committee on Capital Markets Regulation, *The Global Financial Crisis: A Plan for Regulatory Reform*, May 26, 2009, available at <http://www.capmksreg.org/research.html>.

¹¹ Ben Levisohn, *AIG's CDS Hoard: The Great Unraveling*, BUS. WK., Apr. 6, 2009; Matthew Phillips, *The Monster that Ate Wall Street*, NEWSWEEK, Oct. 6, 2008.

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

¹³ OFFICE OF THE SPECIAL INSPECTOR GEN'L FOR THE TROUBLED ASSET RELIEF PROGRAM, *FACTORS AFFECTING EFFORTS TO LIMIT PAYMENTS TO AIG COUNTERPARTIES*, SIGTARP-10-003, Nov. 17, 2009. But cf. Carrick Mollenkamp & Serena Ng, *Report Rebutts Goldman's Claim on AIG*, WALL ST. J., Nov. 17, 2009.

¹⁴ Gretchen Morgenson & Louise Story, *Testy Conflict With Goldman Helped Push A.I.G. to Precipice*, N.Y. TIMES, Feb. 7, 2010, at 1.

preferences and fraudulent conveyances, its bargaining position would have been weaker, as AIG could have been anticipated to recover the funds from Goldman in chapter 11. Instead, Goldman did not have to, and in fact did not, return the money.¹⁵

2. *Bear, Stearns*. Consider Bear, the huge investment bank and securities trader. While AIG faced problems from its credit default swaps, Bear's immediate problem prior to its failure was its financing method, using "repos." Prior to its failure, it financed itself largely in the "repo" market. Banks like Bear need cash; Bear obtained much of its liquidity by selling its securities, promising to buy them back later, often the next day. Bear's sale with an obligation to repurchase turned the transactions into short-term loans to Bear. And, because the overnight loans were typically rolled over, Bear's repo financing became de facto long-term financing, until Bear, in trouble, could no longer roll over its overnight borrowings. This kind of financing was common for securities firms and was "repeated day after day for some thirty years ... leaving Morgan Stanley, Merrill Lynch, Lehman Brothers, and Bear Stearns ... always just twenty-four hours away from a funding crisis."¹⁶

Bear's short, largely overnight borrowing was at the \$100 billion level. With \$400 billion in assets when it failed, a quarter of it was in the repo market, an amount eight times Bear's total equity capital at risk.¹⁷ This level was a sharp increase from 1990, when Bear's net repo financing was only 7 percent of its total liabilities and only twice its equity. Congress added derivatives priorities to the Code over the decades, expanding them in major ways in 1982, 1994, 2005, and 2006. Bear's financing counterparties would have had difficulty so heavily supporting Bear's short-term repo financings were they unable to enjoy the Code's advantages.¹⁸ Bear was not alone: the portion of total investment bank assets financed by overnight repos doubled between 2000 and 2007.¹⁹ Bear failed, but the entire sector financed itself similarly.

Because Bear's repo counterparties could seize and sell their security, because they were not subject to the Code's stay against collateral liquidation after any potential filing to reorganize under chapter 11, they were even less concerned with Bear's viability and liquidity than ordinary secured creditors, who are themselves Code-favored but not as extensively. Absent the super-priorities, Bear would not have been as able to finance a quarter of its total assets in the repo market for as long as it

¹⁵ Id.

¹⁶ COHAN, supra note 9, at 4-5, 32. Short-term financing can make all concerned more alert. But there is no public policy reason to subsidize that advantage via favored bankruptcy status.

¹⁷ Bear Stearns, Form 10-Q (Feb. 29, 2008), supra note 2, at 4, <http://sec.gov/Archives/edgar/data/777001/000091412108000345/be12550652-10q.txt>; COHAN, supra note 9, at 32, 94. While this is the number reported in the media, Bear's net repo position is more relevant, as it also bought securities subject to sale-back. But its net position parallels its liability position alone. When it failed, its net repo position was nearly 20% of total liabilities and six times its equity; in 1980, the net had been only 7 percent of liabilities and only twice its equity.

¹⁸ When Bear failed, it had been using non-prime collateral for its repos. It lost access to repo financing when the market would only take government securities for repos. Peter Hördahl & Michael R. King, *Developments in repo markets during the financial turmoil*, BIS Q. REV., Dec. 2008, at 37, 46. Prior to the 2005 Code amendments, only repos of Treasuries and similar securities could obtain super-priority.

¹⁹ Markus K. Brunnermeier, *Deciphering the Liquidity and Credit Crunch 2007-2008*, 23 J. ECON. PERS. 77, 79-80 (2009).

did.²⁰ Instead, Bear's borrowings would have likely had to go longer-term, thereby better stabilizing the firm against reversals.²¹

3. *Lehman*. Consider Lehman Brothers, the long-lived investment bank. Prior to its collapse, Lehman owed JP Morgan about \$20 billion. Four days before Lehman's bankruptcy, Morgan froze \$17 billion of Lehman cash and securities that Morgan had and demanded \$5 billion more in collateral.²² Creditors cannot ordinarily seize and liquidate their collateral in chapter 11, but instead must wait for the bankruptcy court to decide whether the assets are needed for a successful reorganization, with the court protecting the secured creditors otherwise.²³ But because of the exception from the Code's automatic stay for favored counterparties,²⁴ Morgan could immediately liquidate the collateral in Lehman's bankruptcy. Standard secured creditors could not and would have risked that the bankrupt could recover their pre-bankruptcy benefits.²⁵ But the Code super-priority exemptions put Morgan in a better position.²⁶

The Reserve Fund, the nation's oldest money market fund, owned Lehman commercial paper. It failed shortly after Lehman did, attracting vibrant media attention and exacerbating that moment's panicked atmosphere. Money market funds, like the Reserve Fund, invest in short-term securities and seek to maintain an asset value of \$1.00 per share to indicate their financial stability and near-bank-like safety. "Breaking the buck" is considered a shocking event in that financial sector and, when the Reserve Fund broke it, the Treasury felt compelled to guarantee all money market funds for a time during the financial crisis.²⁷

The Reserve Fund held \$785 million of Lehman commercial paper — effectively a short-term IOU running from Lehman to the Reserve Fund. That loss was

²⁰ Ordinary creditors, even secured creditors, can be called on to turnover property needed by the estate to reorganize. Bankruptcy Code §§ 541, 542; *U.S. v. Whiting Pools*, 462 U.S. 198 (1983). They must be protected in Code terms, but creditors frequently think they are not made whole.

²¹ And, Bear's counterparties revalued Bear subprime collateral just before Bear failed. Jason Hsu & Max Moroz, *Shadow Banks and the Financial Crisis of 2007-2008* (Mar. 19, 2010), available at <http://ssrn.com/abstract=1574970>. Any collateral called up would have been conceptually a preference, but one exempt under the Code's derivatives exceptions. The AIG situation was similar. See *supra* Part I.B.1.

²² See Darrell Duffie, *The Failure Mechanics of Dealer Banks*, 24 J. ECON. PERS. 51, 67 (2010) (describing JPMorgan-Lehman eve-of-bankruptcy dealings); Susan Craig & Robin Sidel, *Crisis on Wall Street: J.P. Morgan Made Dual Cash Demand*, WALL ST. J., Oct. 8, 2008, at C2; Iain Dey & Danny Fortson, *JP Morgan 'Brought Down' Lehman Brothers*, THE SUNDAY TIMES, Oct. 5, 2008; David Teather, *Lehman Brothers: JP Morgan Accused over Bank's Downfall*, THE GUARDIAN (London), Oct. 6, 2008.

²³ Bankruptcy Code §§ 361, 362.

²⁴ Bankruptcy Code §§ 362(b)(17), (27), 560.

²⁵ Bankruptcy Code § 546(g), (j). If an asset is transferred for less than full value from a bankrupt in the two years before bankruptcy, it is a fraudulent conveyance, which the bankrupt estate can recover.

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

²⁷ U.S. Dep't of the Treasury, Office of Domestic Finance, Treasury's Temporary Guarantee Program for Money Market Funds, <http://www.treas.gov/offices/domestic-finance/key-initiatives/money-market-fund.shtml> (accessed Nov. 13, 2009).

enough to induce a run of redemption requests that ended with the fund's collapse.²⁸ Because Lehman's derivatives counterparties could grab value out from Lehman ahead of Lehman's other creditors, those other creditors, like the Reserve Fund, lost more than otherwise.²⁹

While the Reserve Fund's collapse has been linked to Lehman,³⁰ Lehman's impact on the fund's collapse is less critical than the ex ante problem of monitoring disincentives. Someone had to lose money when Lehman failed. But had the super-priorities not been in place when Lehman built its capital structure and derivatives portfolio, Lehman's derivatives and repo counterparties' incentives for a more stable Lehman would have been greater. And Lehman itself would have been incentivized to keep to a safer capital structure, to encourage the counterparties to keep dealing with it.

This monitoring incentive problem, which should be a central consideration in structuring the Code, but was not in either the legislative deliberations or subsequent analyses, is the problem we focus on next.

II. THE CORE BANKRUPTCY ISSUE: CODE-INDUCED DISINCENTIVES TO MARKET DISCIPLINE

A. The Code-Created Mismatched Monitoring Incentives

The Bankruptcy Code's core negative consequence from favoring derivatives contracts and repurchase agreements is that by doing so it encourages investors in these instruments to slacken their efforts to contain the risk of counterparty failure. Prior analysis (summarized below) has focused elsewhere.

1. *Derivatives and repo counterparties have knowledge, but limited incentives.* The priorities reduce the counterparties' risks, inducing them to accept a higher, perhaps even imprudently higher, level of derivatives and repo financing with weak counterparties. If they bore more risk of counterparty failure, they would demand better-capitalized counterparties. The Code undermines market discipline.

2. *Exposed unsecured creditors have incentives, but limited knowledge.* Because the derivatives and repo counterparties bear less risk of debtor failure, the debtor's other creditors correspondingly bear more risk. One could mistakenly believe that the total level of incentives to monitor and ration risk here are kept the same, as a sort of Modigliani-Miller irrelevance proposition, but this is not the case.³¹

²⁸ The Reserve Fund, Press Release, Sept. 16, 2008, available at http://www.reservefunds.com/pdfs/Press%20Release%202008_0916.pdf; Marcin Kacperczyk & Philipp Schnabl, *When Safe Proved Risky: Commercial Paper during the Financial Crisis of 2007-2009*, 24 J. ECON. PERS. 29, 40-41 (2010); Jeffrey N. Gordon & Christopher Muller, *Avoiding Eight-Alarm Fires in the Political Economy of Systemic Risk Management* (working paper, Nov. 9, 2009) (MS at 11, 31 n.131).

²⁹ The Reserve Fund could have faced problems just from the other creditors being secured, although the actual transfer sequence suggests a \$5 billion eve-of-bankruptcy preference to JP Morgan Chase that benefited from the derivatives' exemption from preference law.

³⁰ *Id.*

³¹ Modigliani and Miller showed that a firm's risks emanated from its underlying operations, not from how it sliced up its capital structure, absent transactions costs. Here, the risk of counterparty failure emanates from the counterparty's underlying business; if one creditor bears less risk, another takes on

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

a. Commercial paper (Lehman). When it failed, Lehman had sold \$4.8 billion of its commercial paper.³² The unwillingness of the commercial paper market to roll-over Lehman's obligations was a proximate cause of Lehman's failure.³³ Commercial paper players (like the Reserve Fund) operate on very small margins. They invest very short-term, do not write financial covenants into their investments, and are not positioned to monitor their debtors in the fine-textured manner that bank loan officers might try.

Commercial paper buyers do not typically participate in the derivatives market. Hence, they should not be expected to understand it well, and they do not. Indeed, the monitoring potential for all is made hard because of the derivative market's opacity.³⁴

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

b. Unsecured policyholders (AIG). A large portion of an insurance company's creditors are unsecured policyholders. The Code's super-priorities put them at risk if the insurance firm's affiliated financial products subsidiary fails and the counterparties pull value out from the insurer. Cross-guarantees are (and were) common and the businesses are hard to fully separate.³⁵ But policyholders are not well-positioned to monitor the insurer's derivatives portfolio, because the policyholders are too often small, retail insurance consumers, who lack the financial expertise to understand the insurer's underlying investment portfolio. Realistically, the insurer's regulator would

more. But, as the text shows, the transaction costs decline if the creditor bearing the risk is best-positioned to monitor the debtor. The original M-M paper is Franco Modigliani & Merton H. Miller, *The Cost of Capital, Corporation Finance, and the Theory of Investment*, 48 AM. ECON. REV. 261 (1958). For an important application in secured lending, see Lucian Bebchuk & Jesse M. Fried, *The Uneasy Case for the Priority of Secured Claims in Bankruptcy*, 105 YALE L.J. 857 (1996). On monitoring incentives and disincentives in general, compare Richard Squire, *The Case for Symmetry in Creditors' Rights*, 118 YALE L.J. 806, 818-19 (2009), with Saul Levmore, *Monitors and Freeriders in Commercial and Corporate Settings*, 92 YALE L.J. 49, 56 (1982).

³² Lehman Bros. Holdings Inc., Form 10-Q (May 31, 2008), available at <http://www.secinfo.com/d11MXs.t1C1k.htm#1stPage>.

³³ INT'L MONETARY FUND, BANK FOR INT'L SETTLEMENTS, AND SECRETARIAT OF THE FINANCIAL STABILITY BOARD, GUIDANCE TO ASSESS THE SYSTEMIC IMPORTANCE OF FINANCIAL INSTITUTIONS, MARKETS AND INSTRUMENTS: REPORT TO THE G-20 FINANCE MINISTERS AND CENTRAL BANK GOVERNORS 19-22 (Oct. 2009), available at <http://www.imf.org/external/np/g20/pdf/100109a.pdf>. Lehman's lost access to other financing sources as well, and the coup de grace came when "its clearing bank, JP Morgan, cut its credit line." Id. at 19.

³⁴ On opacity, see Frank Partnoy & David A. Skeel, *The Promise and Perils of Credit Derivatives*, 75 U. CIN. L. REV. 1019, 1036 (2007). Better disclosure rules could help. But even with better disclosure, the incapacity of players like commercial paper buyers to assess the meaning of the exposure would persist.

³⁵ See Richard Squire, *Shareholder Opportunism in a World of Risky Debt*, 123 HARV. L. REV. 1151, 1187-89 (2010).

take over the entity and shield the policyholders. But this hardly improves the monitoring here — the policyholders are saved, but the regulator is not the best-positioned to keep an eye on counter-party risk.

c. Unsecured depositors and bank creditors (Citicorp). Big banks, as custodians of the nation's payments system, are the quintessential systemically vital financial institutions. Lowering their counterparties' risks raises the risks to depositors (or to the depositors' guarantor): if the bank lacks enough assets to pay off all of its creditors, the counterparties come first and the depositors second. Retail depositors are of course poorly placed to monitor a commercial bank's assets at all, much less understand and monitor a complex derivatives portfolio.³⁶ In the end, it's the regulator that counts.

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

This is not to say that the United States is passive, unable to deal with a specific firm, once they're alerted to a problem. But we usually do not expect regulators to be all over the firm-by-firm portfolio specifics of the financial markets early on.

Rather, the United States can best control its exposure not by contract but by regulation, including capital and portfolio rules, but also, importantly, by fixing the bankruptcy rules here. Conceive of the Bankruptcy Code adjustments I recommend as one vital way a regulator who is also a guarantor adjusts to a market that is putting a heavy risk load on the government's shoulders.

* * *

Derivatives lawyers advise their clients to be wary that a counterparty might fail. In a leading derivatives lawyer's guide for derivatives-dealing managers, the author implored firms to develop a derivatives risk management program.³⁷ That program should include having senior people responsible and accountable,³⁸ with manuals that indicate tasks and risk management. But those manuals presumably need not overly emphasize the fundamentals of counterparty risk, because, says the guide in a lawyer's sequence on "What the Pros Recommend" for risk management, counterparty risk is best handled by being *sure that the bankruptcy super-priorities have been obtained*.³⁹

³⁶ Although commercial banks do not reorganize in chapter 11, their affiliates do. FDIC resolution procedures today would treat the derivatives contracts of a failed Citibank similarly to how they're treated for other counterparties under the Bankruptcy Code.

³⁷ PHILIP MCBRIDE JOHNSON, *DERIVATIVES: A MANAGER'S GUIDE TO THE WORLD'S MOST POWERFUL FINANCIAL INSTRUMENTS* 47 (1999). Johnson wrote as a derivatives lawyer and former chair of the Commodity Futures Trading Commission, the derivatives' markets main regulator.

³⁸ *Id.* at 49.

³⁹ *Id.* at 115-16. The lawyer-author so advised even before all of super-priorities were in place.

As finance people say, “[d]ue to these credit enhancements, market participants commonly view interest rate swaps as free of counterparty default risk.”⁴⁰

In the derivatives market’s early days, before super-priorities, “it would be quite rare to see a ... derivatives transaction that did not involve Fortune 500 firms or top-tier financial institutions. Indeed, ... commercial and investment banks even formed AAA-rated subsidiaries to handle derivatives....”⁴¹ It’s plausible to wonder whether derivatives’ explosive growth during the past quarter-century depended in large part on their expanding exemptions from normal bankruptcy practice.

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

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

Counterparty monitoring could take several forms. One is obvious and traditional: the strong counterparty could keep an eye on the weak one’s financial state, examining its finances and assessing its derivatives and repo exposure. Another is simpler but potentially more effective: the strong one could do business only with well-capitalized counterparties. Some systemic financial weakness in 2007-2008 emanated from investment banks, such as Lehman and Bear, having had thin equity layers of only 3% of their total assets. Incentivized players could have insisted on only doing business with counterparties having, say, equity of at least 5% of assets. Third, these counterparties might have sought more stable financial structures generally, trying harder to move more trading go through resilient clearing houses and exchanges, or lobbying the SEC not to lower investment banks’ required capitalization.

1. By substituting other financing structures. Raising the expected private costs to the strong counterparties, even by only a small amount on a low-margin business, will press them to substitute away from risky instrument to others that are more stable.

(a) From overnight repos to longer-term financing. A quarter of Bear’s assets came from repurchase agreements that were regularly rolled over, until Bear got into trouble.⁴² These overnight sale and repurchase contracts were effectively loans, with the difference between the repurchase price and the sale price being the interest.

Because the Code’s priorities made these repos safer for Bear’s counterparties, the Code enabled Bear to substitute short-term hot money for safer financing such as equity and longer-term loans. A primary attraction for Bear’s overnight lenders was that the de facto loans would get the Code’s super-priorities, enabling those lenders to

⁴⁰ Michael Johannes & Suresh Sundaresan, *The Impact of Collateralization on Swap Rates*, 62 J. FIN. 383, 383 (2007). See also BRUCE TUCKMAN, *FIXED INCOME SECURITIES: TOOLS FOR TODAY’S MARKETS* (2d ed. 2002).

⁴¹ *Id.* at 56.

⁴² Bear Stearns Form 10-Q (Feb. 29, 2008), *supra* note 2, at 4.

charge Bear a bit less than otherwise. Other parties — in the end, the United States of America — accordingly took more risk.

One could conceptualize Bear's financing as a long-term borrowing for one-quarter of its capital structure, with the lender able to declare a default, accelerate its loan, and demand repayment on any day. Normally, a creditor accelerating such a loan cannot obtain immediate access to its collateral: the debtor files for chapter 11 and the creditor is, unlike the derivatives and repos counterparties, enjoined from realizing upon the collateral immediately. Eventually the secured creditor is repaid, but the wait can annoy creditors into being wary of dealing with potential bankrupts.⁴³

If Congress raised counterparty risk for repos back to secured creditor levels, by returning the counterparties to no more than the same strengths secured creditors have, even if by only the hiccup of the automatic stay until the court concluded whether the underlying assets were useful to the reorganization (and protected the creditor otherwise), then counterparties to a future Bear would have more reason to want a more stable Bear than they have now. And firms like Bear would have more reason to keep themselves more stable, because they could not lower their cost of capital by using the overnight repo Code priorities, which would be gone. They could then better lower capital costs by having more equity and a more stable base of liabilities. And a more stable base of liabilities would use more longer-term debt and less overnight hot money. Such shifts would make future financial failures less likely and, by making some key financial institutions more stable, also steady the financial system.

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

Bear's history is consistent. In 1990, 7 percent of Bear's capital structure was in Code-protected repos. In 1994, 11 percent. And, in 2008, 19 percent.⁴⁴

2. *By reducing exposure to a single counterparty.* The derivatives market is strongly centralized, with five firms accounting for nearly 90 percent of the industry's

⁴³ Bear is said to have used collateral of decreasing quality over time, starting with Treasury securities and trading down to mortgage-backed securities, such as those famous from the subprime lending. When the lower-quality securities were seen as such, Bear's counterparties asked for higher quality collateral, which Bear could provide for a time. If the loan were long-term and there was a collateral call, the newly-provided collateral would be subject to avoidance in bankruptcy as a preference.

⁴⁴ From Bear Stearns Annual and Quarterly Reports on Forms 10-K and 10-Q. The numbers are net numbers, subtracting Bear's repo assets from its repo liabilities.

I focus on monitoring incentives, but one macro impact needs mentioning. Wall Street firms increasingly used mortgage-backed securities to backup their prioritized repos after the 2005 Code amendments allowed them to do so. See Hördahl & King, *supra* note 18. They were borrowing short, often overnight, to finance what were, when one dug down deep enough, long-term, illiquid assets, i.e., housing and real estate. The Code made it easier to borrow short-term to invest long-term, which is an unwise financial combination. When widespread, it makes the financial system riskier and potentially less liquid.

net credit exposure.⁴⁵ But if Congress altered the Code so that the counterparties were made to bear more counterparty risk, stronger firms would have more reason to diversify their range of counterparties. There would be more players with a smaller stake in this financial market.

C. The Analytic Bidding to Date: Runs and Contagion

Regulators justly feared that one financial failure could induce another and, like dominoes, the financial system could collapse. This fear justified treating derivatives and repos favorably. Less understood when the Code was built, but now understood in academic analysis,⁴⁶ was that the derivatives exceptions also *increase* the incentive of the failing firm's derivatives counterparties to close out their positions, thereby inducing financial failure. Indeed, the Code's super-priorities may well have accelerated recent financial difficulties by pushing derivatives and repo creditors of failing financial firms to rush to cash in their claims in 2008, which other creditors could not do. These cash-outs are familiar as bank runs. They are also familiar in bankruptcy as higher-ranking creditors seek immediate repayment in ways that can halt an otherwise viable firm from reorganizing.⁴⁷

Just as banks with illiquid assets are vulnerable to massive, near-simultaneous requests from depositors for cash, leveraged firms with illiquid assets are susceptible to runs. If creditors sense a weakened debtor and understand that they can rush the debtor to repay and keep any repayment, then creditors have an incentive to rush the debtor to repay. In doing so, they may dismember a firm that was valuable intact or whose value could be better preserved if partially restructured over time.

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

The derivatives' safe harbors from preference law and the automatic stay incentivize the failing firm's counterparties to start a run.⁴⁸ If the failing firm is financially central, they thereby enhance systemic risk, as Franklin Edwards and Edward Morrison have shown.⁴⁹

⁴⁵ OFFICE OF THE COMPTROLLER OF THE CURRENCY, OCC'S QUARTERLY REPORT ON BANK TRADING AND DERIVATIVES ACTIVITIES, 2d.Q. 2009, *available at* <http://www.occ.treas.gov/ftp/release/2009-114a.pdf>; David A. Skeel, *Bankruptcy Boundary Games*, 4 BROOK. J. CORP. FIN & COM. L. 1, 10-11 (2010) (summarizing legislative history skeptically).

⁴⁶ Franklin Edwards & Edward R. Morrison, *Derivatives and the Bankruptcy Code: Why the Special Treatment?*, 22 YALE J. REG. 91, 101, 107-09 (2005); Partnoy & Skeel, *supra* note 34, at 1049.

⁴⁷ THOMAS H. JACKSON, *THE LOGIC AND LIMITS OF BANKRUPTCY LAW* 7-19, 125 (1986).

⁴⁸ Stephen J. Lubben, *Repeal the Safe Harbors* (working paper, 2009), *available at* <http://ssrn.com/abstract=1497040> (MS at 2). See also Stephen J. Lubben, *Derivatives and Bankruptcy: The Flawed Case for Special Treatment*, 12 U. PA. J. BUS. L. 61 (2009). Cf. Duffie, *supra* note 23, at 68-69.

⁴⁹ Edwards & Morrison, *supra* note 46, at 101, 107-09; Partnoy & Skeel, *supra* note 34, at 1049.

1. *AIG: Collateral calls, the run, and private lenders' unwillingness to lend.* The priorities hastened AIG's failure. As AIG weakened, its counterparties demanded collateral from AIG, sapping it of liquidity.⁵⁰ Chapter 11 ordinarily bars such collateral grabs, stopping them via either the automatic stay or via preference law, which forces the grabbed collateral back into the bankrupt's estate to benefit all creditors.

The Code's core preference recovery concept is designed to stymie runs such as AIG's.⁵¹ But the Code doesn't apply the concept for one key class — derivatives counterparties — recreating the bankruptcy run problem. By omitting the concept for the favored counterparties, the Code reduces the potential for firms like AIG to raise new money to stabilize themselves, as the potential new investors want to wait until the run is over to see if enough value is left in the firm.

2. *Credit contagion.* A related, but contrary, view — focused on contagion potential, as counterparties, unable to get their collateral, themselves fail — has justified the Code's derivatives priorities.⁵² But properly analyzed, super-priorities could stifle contagion or they could hasten its spread.⁵³ They spread it, by weakening the already weak firm by draining it of cash. They stifle it, by getting cash into the counterparty. Which effect is more important is indeterminate.

3. *Information contagion.* The Code focuses on credit linkage contagion — one firm fails and brings down its counterparty, inducing a chain reaction of failing dominoes. But the Code does not reflect any fear of information contagion. This absence is a mistake and should be added to prior contagion analysis, indicating that the Code's impact may not be as indeterminate as has been thought.

Consider failure's effects when creditors are poorly informed about their counterparties' financial health. Many creditors rely primarily on collateral, particularly for repos and some types of derivative. Because the Code's super-priorities give them immediate access to the collateral, they're not particularly concerned with their counterparty's *overall* financial health, just with the value of the *collateral*. Next, an unexpected economic shock tells them that their collateral is worth less than they had thought. Surprised, they suddenly must rely on counterparty financial quality. But they are not well-informed about counterparty financial quality, because, until the shock, they had little reason to pay attention to that. So, when Bear, Lehman, and AIG failed, creditors reevaluated their prior beliefs about the collateral they held from others and about their *other* counterparties' solvency. If they had a deeper stock of direct information about their counterparties' overall strength, they might not have repegged downward the quality of all counterparties. But, they lacked enough counterparty-specific information. They faced an informational black hole, into which

⁵⁰ Stulz, *supra* note 6, at 64.

⁵¹ JACKSON, *supra* note 47, at 125.

⁵² 128 CONG. REC. S15981 (daily ed. July 13, 1982) (statement of Senator Dole) ("It is essential that stockbrokers ... be protected from the issuance of a court ... order which would stay [seizure], because ... the insolvency of one party could trigger a chain reaction of insolvencies..."). And, when the safe harbors were expanded: 135 CONG. REC. S1414 (daily ed. Feb. 9, 1989) (statement of Senator DeConcini upon introduction of S. 396); H.R. REP. NO. 97-420, 97th Cong., 2d Sess., at 1, *reprinted in* 1982 U.S.C.C.A.N. 583 (1982); Philippe Jorion & Gaiyan Zhang, *Credit Contagion from Counterparty Risk*, 64 J. FIN. 2053 (2009).

⁵³ Edwards & Morrison, *supra* note 49, at 94. Similarly, see Squire, *supra* note 35, at 1200.

they wished not to enter. Hence, they stopped lending, until they could acquire better information about their counterparties. This suddenly made more of their counterparties more illiquid.⁵⁴

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

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

We thus have reason to go a step beyond prior analyses that indicated that the Code cannot arrest *credit* contagion.⁵⁶ Worse than being unable to arrest *credit* contagion, it can exacerbate *information* contagion. And the broad outline the financial crisis suggests that it did.

III. WHY CONTRACT CANNOT SOLVE COUNTERPARTY RISK

When one creditor’s risks in an enterprise decline, another’s rise. Once that other party understands it bears more risk, it should react by raising its interest rate, by seeking to reduce the risk it faces, or by improving its contract terms. The risk transfer structure of the derivatives and repo priorities has not yet been examined in this vital dimension. Such contract reaction is conceptually possible in the derivatives priority situation we are analyzing. To understand the process, understanding that the derivatives counterparties’ lowered risk lowers their monitoring incentives is not enough, because it raises other parties’ risk and, hence, *their* monitoring incentives.

A large slice of the default risk here is transferred to parties that cannot, or will not, react contractually. The other contracting parties are poorly positioned and too weakly informed to monitor the debtor’s overall riskiness in general and its derivatives portfolio in particular. The new risk-bearers are insurance policyholders, depositors, ordinary commercial paper buyers, and similar players who are not well informed about the derivatives market.⁵⁷ This shift to the poorly informed in derivatives and repo heavy firms applied regardless of where the firm’s risks come from,⁵⁸ regardless

⁵⁴ See Gary Gorton, Slapped in the Face by the Invisible Hand: Banking and the Panic of 2007, available at <http://www.frbatlanta.org/news/Conferen/09fmc/gorton.pdf> (MS at 5, 35). See generally Brunnermeier, supra note 19; Douglas W. Diamond & Raghuram G. Rajan, *Liquidity Risk, Liquidity Creation and Financial Fragility: a Theory of Banking*, 109 J. POL. ECON. 2897 (2001); FRANKLIN ALLEN & DOUGLAS GALE, UNDERSTANDING FINANCIAL CRISES (2007); Franklin Allen & Douglas Gale, *Financial Intermediaries and Markets*, 72 ECONOMETRICA 1023 (2004).

⁵⁵ Gorton, supra note 54, at 35.

⁵⁶ Edwards & Morrison, supra note 49, at 94; Squire, supra note 35, at 1200.

⁵⁷ Cf. Bebchuk & Fried, supra note 31; Modigliani & Miller, supra note 31.

⁵⁸ While the conventional wisdom is that credit derivatives were central in bringing down AIG and others, some analysts show the riskiness of AIG’s core portfolio to have been more central. Squire, supra

of where the risk comes from, the derivatives and repo exceptions put more risk on the shoulders of parties poorly-positioned to monitor the firms.

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

A. Contractual Reaction and Its Limits

1. *Financial covenants as partial solution.* Once burnt, twice shy. Ordinary creditors of financial firms in the future could take the debtor's derivatives exposure into account. A simple way to do so would be to limit the total derivatives exposure by an appropriate formula. This is common in financial contracting: the lender lends, but requires that the debtor maintain a debt-to-equity ratio of no more than, say, \$2 of debt for every dollar of equity.⁵⁹ Derivatives could be folded into these kinds of financial covenants. Conceptually, contract can help.

But derivatives counterparties can also react and, one expects, will. Some derivatives and repo counterparties did well due to their bankruptcy benefits, but others did not anticipate the financial crisis and, hence, did not take full advantage of the privileges that the Code offers them. In the next financial crisis, one would expect that more counterparties will be prepared for the crisis and, hence, if the Code still permits it, will demand collateral sooner, be sure that their set-off positions are advantageous, and demand repayments that would otherwise be voidable transfers absent the exemptions. Contractual reaction may be an arms race going forward.⁶⁰

note 35, at 1183-87, 1203-04. Cf. Viral V. Acharya et al., *Manufacturing Tail Risk: A Perspective on the Financial Crisis of 2007-09*, 4 FOUNDATIONS AND TRENDS IN FINANCE (2010, forthcoming) (excessive risk-taking in large financial institutions). This would extend the monitoring story: super-priorities reduced the incentives to monitor counterparty risk, with that counterparty risk emanating from both the immediate derivatives trades and from the firm's overall portfolio.

⁵⁹ AMERICAN BAR FOUNDATION, CORPORATE DEBT FINANCING PROJECT, COMMENTARIES ON MODEL DEBENTURE INDENTURE PROVISIONS 326-469 (1971).

⁶⁰ Could counterparties react to repeal by perniciously grabbing collateral earlier, say 91 days before bankruptcy and put themselves outside the bankruptcy preference recovery period? Not really. While Goldman, with a safe harbor, might grab collateral 91 days before it initially *expects* a bankruptcy, cf. *supra* notes 12-14, it cannot assuredly keep the collateral without the preference super-priority exception. That early seizing of collateral is typically a public event, warning other creditors, who can themselves demand repayment or force an early bankruptcy, turning the seizure of collateral day into Day 7 before the debtor's bankruptcy instead of Day 91. Goldman, well-advised that creditors will so react, would, if it lost that favored status, have less reason to seize collateral from an insolvent and more to pursue a collective remedy among creditors. This process is well understood by bankruptcy players. Consult any bankruptcy textbook or treatise, or see JACKSON, *supra* note 47, at 7-19, 122-50. If the preference rules induce the creditor to push the debtor when the debtor is *solvent* (and hence there's no preference, because everyone can then be paid), it induces an efficient early restructuring before the debtor deteriorates into insolvency. Ronald Daniels & George Triantis, *The Role of Debt in Interactive Corporate Governance*, 83 CALIF. L. REV. 1073 (1995). Super-priorities undermine this impact.

2. *The necessary incompleteness of contract: The United States as de facto guarantor.* Large financial institutions have a large, passive creditor that does not act like a financial creditor with a bond indenture to negotiate. The United States is a de facto creditor as it pays up to rescue too-big-to-fail financial institutions. Even if private parties adjusted to their borrowers' derivatives and repo exposures, one of the creditors — the U.S. Treasury — just does not move nimbly. The U.S. Treasury's equivalent to contractual adjustment for the fire next time is regulatory adjustment now.

This is not a small point: *private* contractual reaction to super-priorities now that financial players know the priorities are valuable is likely, but it will be insufficient to solve the ex ante problems because de facto the biggest creditor is the United States. And it can only react by changing the regulatory framework, not by writing another clause into its bond indenture or loan agreement, because it has no bond indenture or loan agreement. It is exposed and its equivalent to a bond indenture here is the panoply of financial regulation, including the Bankruptcy Code, which now largely, although indirectly, disfavors the United States.⁶¹

B. Real Regulatory Reaction

The most sensible bankruptcy reaction for the United States, as de facto guarantor, is to repeal most super-priorities, to limit its exposure to financial failure. Many regulatory tasks need to be done and this is an important one.

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

This does not mean that derivatives players would be thrown cold and naked into the street, unpaid. As long as the debtor is solvent, they would be paid in full. That will motivate the derivatives players to deal with solvent debtors who remain solvent — this is the core of the ex ante analytic perspective I bring to bear on the derivatives and repo problem. Second, many baseline derivatives transactions are not preferences or fraudulent conveyances. The typical transaction has a party place initial margin with a strong counterparty. As the market moves in one or the other's favor, the losing party posts variation margin. These ordinary course posts correspond to actual debts and do not present conceptual problems as either preference or fraudulent conveyances.

The de facto priority problem is in how much *further* the Code goes here. During the financial crisis, strong parties demanded more margin when they saw a weak counterparty. AIG was originally an AAA credit, one that counterparties did require to post collateral. But the counterparties' contract allowed them to demand

⁶¹ For banks — AIG, Bear, and Lehman were not banks — FDIC resolution can treat failed bank's derivatives counterparties roughly as favorably as the Code does. See www.fdic.gov/bank/analytical/fyi/2005/101105fy.html. Unlike for AIG, Bear, and Lehman, the government's bank exposure can, in principle, be controlled via the government's role as bank regulator.

collateral if AIG's credit rating was downgraded, which they did. This is exactly the kind of collateral demand that the Code usually seeks to deter via §§ 547 and 550. These transfers were all conceptually preferential, but were all exempted from preference attack due to the super-priorities, and would all be reclassified as voidable preferences in a sensible roll-back of the derivatives and repo super-priorities.

2. *Justified exceptions for the derivatives and repo market.* While I focus here conceptually on the over-broad nature of the priorities, not every priority lacks merit. I next point to three of the more important justified exceptions for derivatives and repos.

Consider the netting rules. The Code allows derivatives players to net obligations to the bankrupt with obligations from the bankrupt. Netting can be very valuable even if the obligations are identical in size. If the counterparty owes the bankrupt \$100 million on one contract and is owed \$100 million on another, the typical result, without netting, is that it must write a check to the bankrupt for \$100 million, but it receives only a fractional return from the insolvent bankrupt. If the return to the bankrupt's creditors is only 10 cents on the dollar, a typical no-netting scenario yields the counterparty a \$90 million loss. Netting gets it that \$90 million. As between it and the debtor, this result is fair. But as between the counterparty and the debtor's *other* creditors it may not be. Regardless, it is not the general rule in bankruptcy.

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

At one time, a trustee in bankruptcy could look over your counterparty's entire portfolio ..., disavow those with losses, and keep those that were profitable. This practice ... is no longer possible in the U.S. ...⁶²

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

That is, strong counterparties can net strategically, by acquiring a flimsy obligation *from* the debtor and getting it de facto paid dollar for dollar by matching it with a nettable obligation *to* the debtor. Goldman and others did this with the failing

⁶² JOHNSON, *supra* note 37, at 47.

Bear Stearns. Said one trader: “My shareholders ... said, ‘You’re crazy. Why are you guys taking [such a] credit risk without making money?’ ... [But] it just nets you down and offsets, because you’ve made your money on the other side of the trade.”⁶³

Consider termination rights here. Ordinarily the bankrupt debtor chooses whether to terminate or affirm its prebankruptcy contracts. If it affirms, it is fully obligated to perform. If it terminates, it is liable to its counterparty, but the damages are rarely paid in full as they are paid pro rata in “bankruptcy dollars,” with the contracting party sharing the bankrupt estate with all of the bankrupt’s other creditors.

The Code is generous to the bankrupt debtor in giving it this broad an option. But reversing the rule for derivatives players alone requires justification. That justification could come from the chaotic consequence of having unclear obligations for months after a chapter 11 filing, as the bankrupt decides whether to terminate or affirm, paralyzing financial counterparties. But this justification of avoiding chaos, while plausible, proves too much. First, industrial counterparties can also be severely damaged if the bankrupt takes its time deciding whether to affirm or terminate. Financial players have no monopoly here on inconvenience. Second, since uncertainty is the problem, the debtor could be forced to decide in short order whether to affirm or terminate.⁶⁴ Third, a more neutral rule would terminate them all upon the filing of a bankruptcy, thereby disallowing either side from playing the market and cherry-picking to affirm profitable contracts while terminating losing ones.

Lastly here, consider preference law, which allows the bankrupt to recover collateral that a creditor obtains or seizes in the 90 days before bankruptcy on an old (antecedent, as the Code calls it) debt. The concept is that the law should not encourage a race to the courthouse, in which aggressive creditors obtain value over the slower ones.⁶⁵ If a creditor lent previously and seeks repayment or collateral on the eve of bankruptcy, bankruptcy policy does not allow it to jump ahead of other creditors.

Repurchase agreement financiers want to be sure that their collateral cannot be a preference that the bankrupt debtor’s creditors could claw back. They are willing to send cash into the weak firm, but they take the purchased asset, and keep the asset if the selling firm fails. But this transaction *should not* be clawed back by the bankrupt estate, as it does not involve payment on a truly antecedent debt, which is the hallmark of a voidable preferential transfer.⁶⁶ It’s a substantially contemporaneous exchange. Clarification in the Code was proper, although unneeded, and should not be repealed.

⁶³ COHAN, *supra* note 9, at 30. As before, this is fair when it’s only the immediate players who are affected. But the results spill-over to other creditors, including the United States.

⁶⁴ Cf. *In re Lehman Bros., Inc.*, No. 08-1355 (Peck, J.) (Bankr. S.D.N.Y. Sept. 17, 2009) (*Metavante* decision).

⁶⁵ JACKSON, *supra* note 47, at 7-19, 122-50.

⁶⁶ There’s good reason to think that the Code should not claw back such payments, even without the derivatives and repo exemptions from preference law. See Bankruptcy Code § 547(b)(2) (to be a prohibited preference, a transfer must be “for or on account of an *antecedent* debt owed by the debtor *before* such transfer was made”) (emphasis supplied).

Repos that are rolled over, day after day, could be recharacterized as longer-term debt. If so viewed, then an increase in collateral in the 90 days before bankruptcy would be preferential. This would be a major reconceptualization. The Code’s preference exception for repos bars it.

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

IV. COUNTER-ARGUMENTS FROM COUNTERPARTIES

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

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

A. Would Repeal Really Change Derivatives Market Incentives?

Critics of repeal might argue that strong counterparties expect the government to bail out failed, weak counterparties. Accordingly, adjusting the Code priority exposure will not affect the strong parties' expectations. They'll ignore counterparty risk regardless, because the government will always step in.

However, firms are unlikely to fully rely on a government bail-out. Lehman failed in 2008 when the Treasury let it go under; Drexel failed two decades earlier. Governments say they will not bail out creditors next time. Although they often do not carry out their threats, there is genuine uncertainty about what the government will do, because their actual strategy is mixed and hard to predict.⁶⁷ Second, a financial firm may be failing but not be too big to fail. If repeal affects behavior, the increasing number of stronger counterparties will make each one less vital systemically. Counterparties lacking super-priorities would so fear and will adjust.

Lastly, the financial players' actions indicate both that *they* are uncertain about what the United States will do and that *they* value super-priority. These players lobbied hard to get derivatives priorities in 1982, 1994, 2005, and 2006. If they did not care about priority because they fully expected United States bailouts, then they would not have lobbied for the super-priorities. Similarly, financial institutions have been

⁶⁷ CHARLES P. KINDLEBERGER & ROBERT Z. ALIBER, *MANIAS, PANICS, AND CRASHES: A HISTORY OF FINANCIAL CRISES* 20 (5th ed. 2005).

lobbying hard now against *any* pull-back in their derivatives priority, thus far successfully. If the financial players fully expected the United States to bail them out, they would have had no reason to lobby so hard against even partial repeal.

Consider the derivatives industry's reaction to reform proposals. Some in Congress and the FDIC proposed that the derivatives overall priorities be limited to about 90 percent of the relevant debt. Reactions included: "Wall Street dealers are facing their worst fear ..."⁶⁸ "Banks have warned that the provision ... could have a chilling effect on the 'repo' market and thus on broader creditor availability."⁶⁹ One financial player said: "The proposed legislation will certainly reduce leverage and liquidity in the repo market.... People who lend cash in [the] repo [market], will demand more collateral."⁷⁰ The chief executive of the Securities Industry and Financial Markets Association was more vociferous, saying the proposal "would negatively affect the efficient operations of the credit markets, increasing the cost of raising capital...."⁷¹ "One head of repo [operations] at a leading bank was blunter, calling the proposed legislation 'nuclear' for the market. He said the industry is finally waking up to the threat, having assumed the legislation would never get this far." The proposal's congressional proponent, Brad Miller, indicated intuitions consistent with the thesis here: His proposal, he pointed out, would "put[] pressure on anyone lending to a systemically significant firm to pay attention to what sort of shape the firm is in.... No one was paying attention to Lehman[.]"⁷²

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

* * *

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

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

⁶⁸ Michael Mackenzie & Helen Thomas, *Repo dealers fear legislation will drain liquidity*, FIN. TIMES, Dec. 7, 2009.

⁶⁹ Tom Braithwaite & Michael Mackenzie, *Creditors to foot bill in US risk regulation*, FIN. TIMES, Dec. 2, 2009.

⁷⁰ *Id.*

⁷¹ *Id.* See Cheyenne Hopkins, *Creditors Fear New Resolution Process*, AM. BANKER, Dec. 7, 2009.

⁷² Braithwaite & Mackenzie, *supra* note 69.

Similarly, one would hardly say that bankruptcy priority was the sole problem that generated the financial crisis or that fixing it is the silver bullet that will prevent future financial difficulties. Rather, it's an important problem and one that is both under-analyzed, under-appreciated in Congress, and remediable.

B. The Unnecessary Asset?

Classic justifications for the bankruptcy stay against creditors seizing security, against preferences that shred the firm, and similar limits on creditors are these: The firm is often worth more held together rather than shredded, so the Code's limits slow the shredding process down long enough for the judge and the parties to determine whether to reorganize the firm. Assets critical to the firm are retained by the firm to maximize the total value of the bankrupt firm, with the affected creditor being compensated for its loss. Is the derivative or repo collateral that kind of vital asset?

Maybe not. The bankrupt steel firm cannot continue its business without the steel mill, so bankruptcy bars the creditors with a security interest in the smelter from seizing the smelter while the chapter 11 process runs its course. The Code protects those creditors, assuring them that they will eventually get full value, but later. (Creditors often conclude that they are not getting full financial value, but the theory is clear: hold the asset to the firm, reorganize, and then pay the affected creditor in full.)

But if the asset that the counterparty seeks to seize is *not* analogous to the steel company's smelter, there's no reason to stay such financial seizures. It's just cash, not a critically-interconnected factory that fits tightly and of necessity with the bankrupt's other operations.⁷³ Cash is generic; a steel mill is not.

This falling away of the justification for the stay here is convincingly plausible for an operating firm, but contestable for a financial firm, which needs *liquidity*, and it is its liquidity that several of the Code's super-priorities damage. The failing *financial* firm's cash or near-cash assets can be as critical for the financial firm as the smelter is for the steel manufacturer. How far one should go here is open to debate and using all of the counterparties cash collateral would be strong medicine. But if derivatives and repo counterparties seize enough value from the failing firm, the financial firm is sapped of liquidity. Dried out, it cannot operate and dies.

Thus the classic justification for the stay and for preference law could still be in play for the financial firm here, even if it's weak for industrial firms. (I add this view here for completeness. Which way one comes out here is not critical: Even if the asset is unnecessary to the financial firm's operations, we would then have a trade-off to make between releasing the unnecessary asset and ex ante market discipline, which as Part II shows militates against letting the counterparty seize and realize upon the asset at liberty.)

⁷³ Edwards & Morrison, *supra* note 49, at 114.

C. Financial Necessity

Policymakers may, and the derivatives industry will, argue that the derivatives industry requires priority in order to work. The persuasiveness of such arguments can be enhanced by the accurate statement that repurchase agreements and derivatives enhance liquidity and risk-management, with liquidity and risk-management important for the economy. Just look at the depth of securities firms' financing via repos and the wide use of credit derivatives to control risk. If Congress denies them their Code-based advantages they will damage the economy's financial arteries.

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

The problem is not that the derivatives industry fails to provide benefits, but that the benefits come with costs from transferring risk to other players. Those costs are hidden and, when widespread, pernicious.

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

Many economic and financial transactions are beneficial. But saying so does not justify prioritizing one side or the other of the trading relationship over the counterparties' other creditors and trading partners, whose trades also benefit the economy.

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

D. The Full Bankruptcy Implications of Any Financial Necessity

Consider a variant on the financial necessity argument. Derivatives and repos have been so fundamental to American financial markets, the argument would run, that they resemble the bank payments system. Just as check-clearing and savings activities

should be safe and fully transparent, so that depositors take on no substantial risk of bank failure, Wall Street needs for repos and both Main Street and Wall Street need credit derivatives. They all need super-protection because they cannot be concerned with their counterparties' creditworthiness.

Two caveats, both substantial, militate here against favoritism. First, the center of this market does *not* consist of widespread retail bank depositors. These are sophisticated players, not naïve retail depositors throughout the nation.

Second, if derivatives and repos resembled the payments system in needing protection and transparency due to their systemic importance, the proper regulatory reaction would not at all be ad hoc bankruptcy priorities. Rather Congress would need to complete the regulatory and contractual loop, by recognizing that the United States is the missing creditor here and needs to complete its contingent, de facto contract status with a regulatory structure that approximates that which we use for deposit banking. There would be greater risk controls and regulation. As of now, we get the costs of favoring derivatives, but without the full panoply of benefits and controls.

I am not arguing for derivatives and repos systemic importance. But if this view is given weight in Congress, the appropriate reaction is a regulatory overlay that recognizes systemic importance and seeks to regulate the resulting risk, not an ad hoc set of bankruptcy super-priorities.⁷⁴

E. Problems and the Next Analytic Steps

The analysis here is that monitoring incentives militate to being wary of the Code's super-priorities for derivatives and repos, and that these priorities and safe harbors need to be limited.

One issue in application is the extent of application. The crux of the analysis is that the Code's exceptions transfer risk among financial firms' creditors, with those risks eventually ending up in the hands of the United States, which needs to react like a contractual creditor would but, lacking a contract, must use its regulatory tools, such as the Code. But not all derivatives contracts involve systemically vital institutions that push risk onto the U.S. Implementing the Code roll-back's might be best done with across-the-board application or it might be done on a more targeted basis, but I offer here no justification as to where, or whether, to draw the line. If only for political expediency, end-users outside of the financial core may have to be exempt.

A second issue is reaction from the affected players. They might react by constructing separate bankruptcy remote vehicles.⁷⁵ They would be affiliated with the core financial institution, but allow its creditors to seize value from the separate entity if the core entity fails. They exist elsewhere in the economy. (Bankruptcy remote

⁷⁴ Regulatory transition is a related issue. Although derivatives and repos are not appropriate for regulatory subsidy, they are financially important in the markets that we have now, because they have received a regulatory subsidy. Any transition should not be abrupt, but have delayed application, with new rules announced for applicability at a later date, so that markets can adjust.

⁷⁵ See Jonathan C. Lipson, *Secrets and Liens: The End of Notice in Commercial Finance Law*, 21 EMORY BANKR. DEV. J. 421 (2005); Kenneth M. Ayotte & Stav Gaon, Asset-Backed Securities: Costs and Benefits of "Bankruptcy Remoteness" (2005), available at <http://ssrn.com/abstract=813847>.

affiliates are companies that hold the target assets and are kept separate from the core company.) But here, removing the derivatives book from the core financial institution differs sharply from the usual bankruptcy remote issue (of manufacturing a firm with priority over the base institution's creditors because the separate vehicle gets the "good" assets). Rather, removal here pushes the derivatives book *out* from the systemically vital institution (the large but shaky financial institution) to a separate affiliate. By doing so, one is removing the derivatives risks *from* having a call on the financially sensitive bank's equity (and, hence, from having a call on the government's guarantee). This is the very problem we are trying to solve.

The financial industry has relied transactionally on the safe harbor priorities and convinced Congress to expand those priorities, and has not heavily used such bankruptcy remote affiliates.⁷⁶ If the safe harbor priorities were cutback, the industry we hope would substitute toward safer financing, and that could *include* well-capitalized bankruptcy remote vehicles that do not put the core financial institution's capital at risk. Indeed, requiring affiliates to handle all derivatives trading is a current regulatory proposal, one that the derivatives-trading banks are expected to oppose vociferously,⁷⁷ presumably because counterparties want access to the government-guaranteed institution and the bank's capital to backup the obligations.

A third issue is the differing rules applications: the Federal Deposit Insurance Act applies to commercial banks; the Code applies to investment banks. But the FDIC priority and safe harbor rules are analogous to the Code rules, as the derivatives industry sought, and obtained, parallel safe harbors in the Code and under banking regulation. Changes should occur in parallel fashion.

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

A. The Bills in Play: Nothing on Bankruptcy Super-Priorities

Three major bills to restructure the resolution of financial institutions are in Congress now. In their original form, the Chris Dodd bill in the Senate⁷⁸ and the Barney Frank bill passed by the House would not alter derivatives' and repos' priorities. The Blanche Lincoln bill focuses on derivatives, but would not change the bankruptcy priorities either. Senator Bill Nelson has proposed to amend the bills to

⁷⁶ For example, AIG used a subsidiary for its derivatives, but one with core company guarantees.

⁷⁷ U.S. Senate, Bill to Improve the Regulation of Swap and Security-Based Swap Activities, 111th Cong. 2d Sess., draft as of Apr. 21, 2010, available at <http://ag.senate.gov/site/legislation.html>; Edward Wyatt, *Veto Threat Raised Over Derivatives*, N.Y. TIMES, Apr. 16, 2010 ("The chairwoman[, Blanche Lincoln,] introduced a ... measure [which] would ... require banks and Wall Street firms to spin off much of their derivatives operations into a separate subsidiary... . financial institutions will fight that provision vigorously.").

⁷⁸ U.S. Senate Bill, Restoring American Financial Stability Act of 2009, 111th Cong., 1st Sess. (proposed bill, sponsored by Sen. Dodd).

eliminate the bankruptcy priorities.⁷⁹ That amendment should be central to congressional consideration.⁸⁰

B. A Derivatives Exchange: Many Eggs, One Basket

The major safety initiative in Congress is focused on mandating a clearinghouse or exchange for derivatives trading. The clearinghouse would promptly call for new collateral if the value of the derivative contract declined. It would also make trading more transparent and better understood by regulators.

While a consensus in Washington seems now to look to the clearinghouse as a nearly complete solution, deep weaknesses afflict the clearinghouse, making it unwise to rely on it primarily. While the clearinghouse can work if its people are alert to counterparty risk, it's unclear whether the exchange would itself be properly incentivized to handle counterparty risk. Better to have the derivatives counterparties making decisions on creditworthiness as well. Moreover and insidiously, the exchange ups the ante on "too-big-to-fail," *because the clearinghouse will itself be too big to fail*. That's fine, but only if it doesn't fail. Recall though that fast moving Russian exchange rates brought down Long-Term Capital Management and its Nobel prize winning managers. And the fast moving revaluations of subprime assets in 2008 may have moved faster than clearinghouse would have been able to react. If the clearinghouse can run as fast a fast-moving market, we're safe. If it can't, we're not.⁸¹

CONCLUSION

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

None of these rules apply to a bankrupt's derivatives and repo counterparties. Instead, derivatives and repo players can seize collateral, net out gains and losses,

⁷⁹ U.S. Senate, Proposed Amendment (unnumbered) to Bill to Improve the Regulation of Swap Activities, Amendment To Repeal Safe Harbor Provisions in the Bankruptcy Code, 111th Cong., 2d Sess.

⁸⁰ In the House bill, proposals came forward to allow the FDIC to take a haircut on derivatives when a financially sensitive firm was resolved. Mackenzie & Thomas, *supra* note 68. A haircut capacity could be useful, but is not the best way to realign incentives. By keeping powerful priorities in non-bailout settings, it keeps the disincentives to market discipline. And, in the heat of a financial melt-down, it would be hard for government officials to cut counterparty claims. Better to eliminate the priority up front, not via the FDIC's discretion in a financial crisis.

⁸¹ See Craig Pirrong, *The Economics of Clearing in Derivatives Markets: Netting, Asymmetric Information, and the Sharing of Default Rules Through a Central Counterparty* (SSRN working paper Jan. 8, 2009), *available at* www.ssrn.com/abstract/paper=1340660; Darrell Duffie, Ada Li & Theo Lubke, *Policy Perspectives on OTC Derivatives Market Infrastructure* (Jan. 2010 working paper), *available at* <http://ssrn.com/paper=1534981>; René Stulz, *Credit Default Swaps and the Credit Crisis*, 24 J. ECON. PERS. 73, 82, 88-89 (2010). The clearinghouse also does not address the repo, knife's edge financing issues. (Repos do not go through a clearinghouse.)

terminate contracts, and keep eve-of-bankruptcy preference payments from the debtor that favor them over other creditors. Their privileged capacity to jump to the front of the bankruptcy repayment line can induce a run on the failing financial institution and such a run may have hit AIG, Bear Stearns, and Lehman, deepening and extending the recent financial crisis.

Yet the run problem, although potentially serious, is not the most severe problem emanating from the derivatives exception, because conceptually the run risk disadvantage is the other side of the coin of the contagion containment advantage. The most severe bankruptcy derivatives problem is the one I analyze: the derivatives players' super-advantages distort pre-bankruptcy monitoring relationships in ways that accelerate and transmit financial instability originating elsewhere in the financial system. That acceleration stems from most derivatives counterparties, with super-priority, having limited incentives to monitor the pre-bankruptcy debtor, since they do well in any resulting bankruptcy. Once they know they can seize the collateral, they monitor the collateral, not the creditworthiness of the counterparty. Once they know they can obtain eve-of-bankruptcy collateral free from preference attack, they have less (although still some, in this dimension) reason to worry about overall counterparty risk than do other regular creditors who aren't so privileged. Although ordinary financial creditors of the debtor correspondingly see their incentive to monitor the debtor rise, they have limited capacity to monitor the debtor's derivatives portfolio, as they typically are not well informed about that market.

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

The best regulatory reaction is to repeal several de facto derivatives priorities in chapter 11. While clarifications are appropriate, such as affirming the integrated nature of an interest rate swap as not comprising two separate contracts for bankruptcy purposes, the derivatives super-priorities are far too strong, going much further than simple, principled clarifications. Repeal would push derivatives and repo counterparties to insist on doing business with a safer debtor. As weak debtors saw the costs of their repo financing and derivatives transactions rising, they would feel pressed to substitute toward longer-term, more stable financing.

Congress needs to do better in drawing out the decision tree this time. Blanket exceptions and super-priorities are quite over-broad and may in fact let counterparties drop their guard in terms of credit monitoring and financial stability. Given that some ex post resolution is unavoidable, we want a bankruptcy system that encourages as much market-based, ex ante market discipline as can be had, via more counterparty monitoring and more resilient financial structures. The Code fails here, but it can be, and should be, fixed.