Written Testimony of David A. Skeel, Jr.

Before the Subcommittee on Commercial and Administrative Law
Committee on the Judiciary
United States House of Representatives
October 22, 2009

Thank you for the opportunity to testify about the role of bankruptcy in effective financial regulation reform. It is a great honor to appear before you today.

Last summer, the Obama administration rolled out an extensive package of proposed financial reforms.[1] The principal resolution proposals in the proposed reforms would give bank regulators sweeping resolution authority with respect to financial institutions that are designated as systemically important, and which are in financial distress. In my view, some of the administration's proposals are desirable, and would improve our financial regulation. But the resolution proposal would make the regulatory framework far worse, rather than better. H.R. 3310, which would rely on bankruptcy rather than the bailout approach used in the recent crisis, is a much more promising approach, as are the existing bankruptcy laws.

Under the resolution proposal in its current form, a financial institution could be designated as systemically important at any time, including right before intervention. If the Treasury concluded that such an institution was in financial distress, it could invoke the special resolution regime "after consulting with the President" and "upon the written recommendation of two-thirds of the members of the FDIC Board (or, if the largest subsidiary is a brokerage, two thirds approval of the SEC commissioners). At this point, the Treasury would appoint a regulator, usually the FDIC, to step in and take steps to resolve the financial distress.

[1] The administration released a lengthy white paper outlining its financial reform proposals in June 2009. U.S. Department of the Treasury, Financial Regulatory Reform: A New Foundation (June 17, 2009), *available at* http://www.financialstability.gov/docs/regs/FinalReport_web.pdf

This proposal is designed to expand the rescue process that was used in 2008 with Bear Stearns and AIG.[2] It would institutionalize the ad hoc bailouts of the last year. There are at least three problems with this approach. First, it, together with the designation of systemically important institutions, would increase the number of institutions that are "too big to fail," and would lead to even more concentration in the financial services industry than we already have. Second, the resolution proposal is backward looking: it assumes that the financial regulatory landscape will be the same in the future, and pose the same problems, as it did last year -- such as the opacity of the derivatives markets. Finally, it would abandon a far superior approach: bankruptcy

In the remarks that follow, I will focus primarily on the benefits of a bankruptcy-based approach, and the significant costs of institutionalizing the bailouts of the past year. My discussion will consider four issues:

1) I first critique a key piece of the conventional wisdom about the crisis: the view that the default of Lehman Brothers was the sole reason for the financial panic last fall, and that Lehman casts doubt on the efficacy of bankruptcy. These claims are not borne out by the evidence.
2) I outline several of bankruptcy's key benefits.
3) I describe the serious costs of relying on bailouts.
4) I conclude that the best use of Congress's time would be to consider possible ways to improve the bankruptcy laws, in particular by imposing a stay on at least some derivatives, and thus reversing Wall Street's effective campaign in the 1990s to protect the derivatives markets from regulation.

Much of the discussion that follows draws on current scholarship of mine that develops these arguments in more detail, particularly an article with Northwestern Law professor Kenneth Ayotte.[3]

---

[2] The White Paper introduces the proposal with the statement that the "government's responses to the impending bankruptcy of Bear Stearns, Lehman Brothers, and AIG were complicated by the lack of a statutory framework for avoiding the disorderly failure of nonbank financial firms." *Id.* at 74.

[3] Kenneth Ayotte & David A. Skeel, Jr., *Bankruptcy or Bailouts?*, Journal of Corporation Law (forthcoming 2010), *available at* www.ssrn.com.

1—<u>The Lehman Myth—Rethinking the Crisis</u>

According to the conventional wisdom, Federal bank regulators were right to bail out Bear Stearns in March 2008, and to bail out AIG in September 2008. Their only mistake was failing to bail out Lehman Brothers, also in September 2008. The Lehman Brothers bankruptcy and the turmoil in the financial markets in September and October 2008 show, it is claimed, that bailouts are a better solution to the financial distress of a large investment bank or other nonbank financial institution than bankruptcy. This understanding, which is central to the case for expanding bank regulators' authority, is deeply misleading.

To put the events of 2008 into their proper context, it is necessary to start by considering the bailout of Bear Stearns six months before Lehman's collapse, and the effects that the bailout had. After the markets lost confidence in Bear and its $18 billion of cash reserves began to disappear in March, Bear Stearns chief executive Alan Schwartz called Timothy Geithner, who was then head of the New York Federal Reserve Bank. Geithner, then-Treasury Secretary Hank Paulson and Ben Bernanke pushed Bear into the arms of J.P. Morgan, a much healthier bank. The deal was structured so that the creditors of Bear Stearns would be fully protected, while its shareholders would lose much of the value of their shares. The government provided a $29 billion guarantee of Bear's most dubious assets.

If regulators had decided not to bail Bear out, the short-term effects might have been jarring. The creditors of Bear Stearns would have suffered losses, and the shareholders would have been wiped out. But this hard medicine would have sent a very clear message to the managers, creditors and shareholders: better watch what the company is doing, or you could get burned. In more technical terms, a Bear Stearns bankruptcy would have eliminated moral hazard—the tendency not to take precautions if you'll be spared the consequences of bad outcomes.

The government did take steps to limit the moral hazard of the company's shareholders. Indeed, it pushed J.P. Morgan, the buyer of Bear Stearns' assets, to offer less for Bear Stearns' stock than J.P. Morgan originally planned, in order to make sure that shareholders were not completely bailed out. But it ensured that all of Bear's creditors were fully protected. The creditors—mostly Wall Street banks and other

financial institutions—who lent money to or entered into derivatives transactions with Bear Stearns were paid in full, despite having dealt with a highly leveraged institution that had been engaging in extraordinarily risky activities.

When Bear Stearns fell, Lehman Brothers was widely viewed as similarly vulnerable, since it too was highly leveraged and heavily exposed to subprime mortgages. Yet Richard Fuld, Lehman's chief executive, rejected a proposed investment by Warren Buffett and made only desultory efforts to sell the company in the months after the Bear Stearns bailout.

Nor, once bankruptcy became a serious possibility, did Lehman make a serious effort to prepare for bankruptcy. When Lehman filed for bankruptcy, no one even knew who Lehman owed money to and who the counterparties on its derivatives contracts were. AIG behaved in very similar fashion. These responses are perfectly understandable given both companies' assumption—an assumption shared by nearly everyone as a result of the Bear Stearns bailout—that regulators would rescue any big, troubled financial institution. Not only was there no need to plan for bankruptcy. But the bailout strategy gave Lehman and AIG an incentive <u>not</u> to prepare for the worst. The more unprepared they were, the worse the bankruptcy option would look, and the more likely a bailout would be forthcoming.

This, not the bankruptcy system, is why Lehman's collapse was such a shock to market participants. Lehman, its suitor Barclays, and everyone else assumed that a bailout would be forthcoming. But regulators decided at the last minute not to provide bailout funds after all. Lehman's failure to prepare, and the way it was dumped into bankruptcy, were the problems. The bankruptcy itself has gone remarkably smoothly. Lehman's investment banking operations were sold to Barclays four days after the bankruptcy filing, and Lehman has been selling its less time sensitive assets in a more leisurely fashion in the months that have followed.

If Bear had filed for bankruptcy back in March, the managers and investors of Lehman and AIG surely would have acted differently in the weeks before their failures. The prospect of bankruptcy would have given them a very different perspective on the implications of their financial difficulties. At the least, they would have gotten their books in order and started looking for buyers for their businesses much earlier.

Not only have the effects of Lehman's default been mistakenly attributed to bankruptcy, but the evidence calls into question the widespread view that Lehman's collapse triggered the economic panic last fall. In a recent paper, Ken Ayotte and I find that Lehman's default did not cause any more disruption in the financial markets than the government's decision to bail out AIG two days later. The fall in the stock market, as measured by the S&P 500 index, was nearly identical. The rise in the VIX, an index used to measure volatility (and informally known as the "fear index") saw a slightly higher percentage increase following Lehman. The TED spread, an indicator of credit market risk, saw a larger percentage point increase following AIG.[4] Similarly, yields on short-term U.S. Treasury bills (a measure of investor flight to safe assets) saw a larger fall following the AIG news.

Stanford economist John Taylor has provided additional evidence that the Panic of 2008 was not triggered by Lehman's default. Based on, among other things, an analysis of the Libor-OIS spread—which is the difference between the interest rate for longterm loans and the overnight interest rate—he concludes the major triggering event was the requests by Treasury for what eventually became the legislation providing for $700 billion in TARP funds.

In short, the significance of Lehman's bankruptcy filing has been seriously misinterpreted by the conventional wisdom. The effect of Lehman's default was due primarily to its failure to prepare for a bankruptcy filing, and to market participants' surprise when the government refused to bail Lehman out. In addition, Lehman's role in the market disruptions of fall 2008 has been exaggerated. Finally, and of particular importance for this hearing, the actual bankruptcy case has proceeded remarkably smoothly under the circumstances.

2—<u>The Benefits of Bankruptcy</u>

Bankruptcy has a number of provisions that make it well suited for resolving the financial distress of nonbank financial institutions. It may be useful to briefly outline

---

[4] The TED spread is the difference between 3-month LIBOR (an interest rate at which banks lend to each other) and the 3 month U.S. Treasury Bill rate.

these provisions before I describe the perverse effects of bailouts, and how bankruptcy avoids these problems.

The first key bankruptcy provision is the one that made possible the sale of Lehman's assets shortly after its bankruptcy filing: section 363 of the Bankruptcy Code. Under this provision, the debtor can sell its assets free and clear of any existing liabilities at any time after filing for bankruptcy, subject to approval by the bankruptcy court and an opportunity for the company's creditors to object to the proposed sale. Because sales under section 363 are free and clear of liabilities, financially troubled companies often prefer to effect a sale of their assets in bankruptcy, rather than trying to sell them outside of bankruptcy.

Second, the Bankruptcy Code provides a very generous financing provision (section 364) that often makes it possible for a company to borrow the money necessary to fund its operations during the bankruptcy case. While senior, secured loans are sometime available outside of bankruptcy, in many cases they will not be possible. Most bond indentures, for example, contain negative pledge clauses that limit or prevent the incurrence of new, senior debt. In bankruptcy, by contrast, these clauses are rendered ineffective.

Third, the automatic stay (section 362) requires that creditors cease any efforts to grab assets from the debtor or to try to collect what they are owed. This can provide the firm with the breathing space it needs to conduct its business in an orderly fashion, preventing a desperate scramble to satisfy the claims of withdrawing creditors. The breathing space can be valuable not only if the firm plans to remain as a going concern, but also if it plans to liquidate its assets but needs time to do so. The one major exception to the automatic stay is derivatives: as discussed in more detail below, the derivatives industry, the Federal Reserve and the U.S. Treasury persuaded Congress to exempt derivatives from the automatic stay, through a series of amendments to the Bankruptcy Code over the past several decades.

Fourth, bankruptcy is extremely transparent. Creditors are entitled to examine the debtor and its managers, and a company is required to disclosure a large amount of information about its operations while in bankruptcy. The kinds of hidden activities that have raised considerable concern in contexts such as Bank of America's purchase of

Merrill Lynch would be very unlikely in bankruptcy. As bankruptcy lawyers sometimes say, a company is required to open all its closets and drawers when it files for bankruptcy.

Finally, the bankruptcy trustee—or if there is no trustee, the company itself—has extensive power to retrieve any preference payments or fraudulent transfers made prior to its bankruptcy filing. If a company pays exorbitant bonuses to its executives prior to bankruptcy, and these bonuses squander valuable assets, the executives can be forced to disgorge them.

In short, the bankruptcy laws offer a full menu of provisions for addressing the financial distress of a large nonbank financial institution. With each of the two large investment banks that have filed for bankruptcy—Drexel Burnham two decades ago and Lehman Brothers last year—it has proven very effective.[5]

3—The Problems with Bailouts and the Proposed Resolution Authority

The Adminstration's proposed new resolution authority would expand the authority that the FDIC has over bank failure to every financial institution that is deemed systemically important. The intuition behind the proposal is that the FDIC has done an effective job of resolving bank failures, and that this authority would prove equally effective for systemically important financial institutions. These assumptions are problematic for several reasons.

The first problem with the assumption that Congress should extend FDIC-style authority to other financial institutions is that commercial banks are special. Although the so-called shadow banking system plays an increasingly important role in financial life, commercial banks still are unique because of the importance of protecting ordinary Americans' deposits, and of assuring that business always have access to the lines of credit they secure from a bank. For these reasons, deposits are federally insured. Because the deposit insurance guarantee gives taxpayers a huge financial stake in commercial banks, the FDIC is given dictatorial powers when a bank becomes financially distressed. The FDIC can take over the bank, force its sale, and determine how the creditors of the bank will be treated. Further, its actions are almost completely protected

[5] The Drexel and Lehman cases are discussed in detail in Ayotte & Skeel, *supra* note 3.

from judicial review. These powers, and the complete lack of transparency, are not justified for other financial institutions.

Second, the FDIC's performance is very different with small banks than with large ones. When a small or medium-sized bank becomes distressed, the FDIC often closes it relatively promptly.[6] Indeed, the prompt corrective action rules instruct the FDIC to step in before the institution becomes insolvent. With large institutions, on the other hand, these rules do not apply. In these cases, the FDIC often ends up bailing the institution out. If FDIC authority were extended to systemically important firms as proposed by the administration, we can be sure that these institutions would inevitably be bailed out. As already noted, the proposal would expand and institutionalize the recent use of bailouts.

Bailouts have four very serious downsides. The first problem is that they cause moral hazard, as discussed earlier. If the managers of a financial institution know they will be bailed out in the event the institution fails, they will have an incentive to take extraordinary risks. Investors will have little incentive to monitor the institution if they too will be protected by a bailout. The government significantly reduced the problem of shareholder moral hazard by ensuring the Bear Stearns and AIG shareholders were not fully protected when their companies were bailed out, but it magnified the moral hazard of debt. The creditors of both companies were fully protected. The bondholders of bank holding companies such as Citigroup and Bank of America are also expecting to be protected if either bank fails, which has aggravated the serious moral hazard in the financial services industry.

The second problem is that bailouts cause significant distortions in corporate governance. When the government insists that a CEO be replaced—as with AIG—or that the company complete a problematic merger—as with the acquisition of Merrill Lynch by Bank of America—the decision is likely to influenced by factors other than optimal corporate governance. The distortions may be still greater if the government oversees the investment decisions made by the company even after the initial rescue loan. Both

[6] The FDIC's resolution of the banks during the recent crisis has been criticized by some, and the FDIC has recently announced that it will need to impose additional charges on banks because its guaranty fund is dangerously low. But, in my view, the FDIC have been relatively effective with small and medium sized banks, and its current authority is justified in that context. But there is no justification for extending this power to encompass other financial institutions.

because of the limits of their expertise and because of the conflicting pressures they face, the government's track record when it shifts from regulator to decision maker is not a good one.

Third, bailouts often simply postpone a needed restructuring. The decision to bail out AIG, for instance, seems to have significantly delayed the process of restructuring its operations. The temptation for regulators with a bailout is to "kick the can down the road," delaying the hard decisions of how best to resolve the firm's problem.

Finally, the bailouts of the past year have protected the Wall Street institutions who were creditors of the institutions that were bailed out. Wall Street banks and other financial institutions have often been the principal beneficiaries of bailouts.

None of these problems arise in bankruptcy. The prospect of bankruptcy dramatically reduces moral hazard; is much less likely to distort corporate governance; forces a restructuring; and requires all parties to bear the consequences of the default, not just some.

4—Possible Bankruptcy Improvements—A Stay on Derivatives

My conclusion that bankruptcy is the best mechanism for resolving the distress of nonbank financial institutions does not mean that the current bankruptcy laws are perfect. The current laws are preferable to bailouts, but it is worth considering how the existing bankruptcy framework might be improved. The most important issue in this regard, in my view, is the special treatment given to derivatives and other financial contracts.[7]

Due to the ongoing efforts of the derivatives lobby, as well as the Federal Reserve and the U.S. Department of the Treasury, Congress enacted a series of special protections for repurchase transactions, credit default swaps and other financial contracts in the 1980s, 1990s, and 2000s.[8] Counterparties to these contracts were exempted from several core protections of the Bankruptcy Code. They are not subject to the automatic stay, or to the preference and fraudulent conveyance provisions. Much as they insisted that derivatives should be immune from regulatory oversight, proponents of these provisions

[7] I also believe it would be useful to limit the government's ability to finance a financially troubled financial institution in bankruptcy. H.R. 3310 would impose a strict prohibition.

[8] The legislative history, and the arguments for reversing the special treatment of derivatives that are outlined below, are discussed in more detail in David A. Skeel, Jr., *Bankruptcy Boundary Games*, Brooklyn Journal of Corporate, Financial & Commercial Law (forthcoming, 2010), available at www.ssrn.com.

argued that bankruptcy should not be allowed to interfere with the derivatives markets. If derivatives were subject to the automatic stay, they argued, the bankruptcy of one institution could lead to "ripple effect" failures of other institutions that had entered into contracts with the debtor. The recent crisis has shown, however, that the inability to stop counterparties from exiting these contracts may exacerbate the consequences of a default, not reduce them.

Congress could fix this problem in several different ways. One approach would be to simply reverse the exemption from the automatic stay, based on a view that the arguments for exempting the derivatives markets from bankruptcy no longer seem compelling. Exempting derivatives counterparties from the stay reduces their incentive to monitor the debtor and does not seem to provide a bulwark against systemic risk.

H.R. 3310 offers an alternative approach. Under this proposed legislation, the stay would be applied under certain circumstances in cases in which the debtor is a nonbank financial institution. The special treatment would remain in place for other kinds of debtors.

In my view, either of these approaches would improve on the treatment of derivatives and other financial contracts in bankruptcy.

Conclusion

Bankruptcy is a much better method of resolving the financial distress of nonbank financial institutions than bailouts. If Congress adopts more effective regulation of the derivatives markets and other needed financial reforms, the bankruptcy approach is likely to be even more attractive.