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Derivatives Safe Harbors in Bankruptcy and Dodd-Frank: A Structural Analysis

By Stephen D. Adams

Abstract

The Bankruptcy Code exempts financial derivatives and repurchase agreements from key provisions, such as the automatic stay. The primary rationale for this special treatment has been the fear that the failure of an important market participant could cascade if counterparties could not immediately exit their contracts. Reflecting on the recent financial crisis and the Lehman bankruptcy, some scholars have suggested that exempting these financial contracts from bankruptcy may have exacerbated other kinds of systemic risk and contributed to the decision to bail out systemically important financial institutions (SIFIs) instead of allowing them to enter bankruptcy. Congress attempted to address this flaw by enacting a Bankruptcy alternative, Title II of the Dodd-Frank Act, instead of addressing the problems in the Bankruptcy Code safe harbors that were the source of the systemic risk. This article demonstrates that the view that Title II replaces bankruptcy reform is mistaken. Title II actually increases both the need and opportunity to reassess the proper limits of the safe harbors.

Without bankruptcy reform, the threat of irreversible damage if the SIFI files bankruptcy before intervention may force Title II to compete with bankruptcy in order to reach potential SIFIs first. However, the difficulty in evaluating whether some firm failures involve systemic risk incentivizes Title II decisionmakers to intervene in cases of doubt, leading to over-intervention, strain on resources and damage to Bankruptcy's role as the default failure system. In addition, uncertainty over whether Title II will intervene will lead large firms to delay filing bankruptcy far past where resolution is optimal. However, with Bankruptcy reform, the Bankruptcy system would complement and mitigate weaknesses in the Title II safety net. In addition, Title II removes the primary justification for the safe harbors for financial derivatives and repurchase agreements, the fear of the consequences of the bankruptcy of a SIFI. In its wake, the safe harbors for derivative and repo creditors are at odds with powerful fairness and efficiency rationales behind default bankruptcy rules. Dodd-Frank may make Bankruptcy reform easier to achieve and more urgent.

I. INTRODUCTION	3
II. A PRIMER ON DERIVATIVES IN BANKRUPTCY	4
A. DERIVATIVES DESCRIBED	5
B. DEVELOPMENT OF THE BANKRUPTCY SAFE HARBORS	6
C. HOW THE BANKRUPTCY SAFE HARBORS WORK	7
III. SAFE HARBOR JUSTIFICATIONS AND SYSTEMIC RISK	8
A. SAFE HARBORS AS SYSTEMIC RISK MITIGATORS	9
B. SAFE HARBORS AS SYSTEMIC RISK CREATORS	11
IV. DODD-FRANK'S TITLE II AND SYSTEMIC RISK.....	13
A. SYSTEMIC RISK IN BANKRUPTCY AND TITLE II	15
B. COSTS OF TITLE II	18
V. SAFE HARBOR PROBLEMS AFTER TITLE II	21
A. ARE THE SAFE HARBORS NECESSARY IN A DODD-FRANK WORLD?	21
B. THE SAFE HARBORS DISTORTION OF OLA INTERVENTION DECISIONS	22
1. THE COSTS OF PREMATURE DECISIONMAKING	23
2. SAFE HARBORS INCREASE THE COST OF BEING WRONG.....	26
VI. CONCLUSION	29

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By Stephen D. Adams¹

I. INTRODUCTION

The relationship between the derivatives exemptions from bankruptcy (called safe harbors in the trade) and systemic risk has received great attention recently.² The architects of the Dodd-Frank Act added a new twist to the discussion by enacting a bankruptcy alternative, the Orderly Liquidation Authority (OLA), aimed at reducing systemic risk independent of the bankruptcy code.³ How this important provision of the Dodd-Frank Act changes the fundamental outlines of the debate over the derivative safe harbors has not yet been examined.⁴ The central argument for the special treatment of derivatives and repos in bankruptcy is that to subject them to the normal bankruptcy rules could enhance systemic risk if it delayed major financial counterparties from liquidating large positions during a liquidity crisis. The OLA was designed, and has the capability, to resolve a systemically risky situation by snatching a Systemically Important Financial Institution (SIFI) out of bankruptcy and resolving it under special, accelerated rules. But if the reason for the safe harbors has been diminished, why should the bankruptcy code not return to its basic principles of protecting the common pool and safeguarding

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² See, e.g., Patrick Bolton & Martin Oehmke, *Should Derivatives be Privileged in Bankruptcy*, working paper (2012); Darrell Duffie & David A. Skeel, Jr., *A Dialogue on the Costs and Benefits of Automatic Stays for Derivatives and Repurchase Agreements*, Working Paper (2012); David A. Skeel, Jr. & Thomas H. Jackson, *Transaction Consistency and the New Finance in Bankruptcy*, 112 COLUM. L. REV. 152 (2012); Stephen J. Lubben, *Derivatives and Bankruptcy: The Flawed Case for Special Treatment*, 12 U. PA. J. BUS. L. 61 (2010); David L. Mengle, *Close-Out Netting and Risk Management in Over-The-Counter Derivatives*, Working Paper (2010); Mark J. Roe, *The Derivative's Market's Payment Priorities as Financial Crisis Accelerator*, 63 STAN. L. REV. 539 (2010); David A. Skeel, Jr., *Bankruptcy Boundary Games*, 4 BROOK. J. CORP. FIN. & COM. L. 1 (2009).

³ See, e.g., Douglas G. Baird & Edward R. Morrison, *Dodd-Frank for Bankruptcy Lawyers*, 19 AM. BANKR. INST. L. REV. 287 (2011); Kimberly Summe, *An Examination of Lehman Brothers' Derivatives Portfolio Post-Bankruptcy and Whether Dodd-Frank Would Have Made Any Difference*, Working Paper (2011); Kenneth Ayotte & David A. Skeel, Jr., *Bankruptcy or Bailouts?*, 35 J. CORP. L. 469 (2010); DAVID A. SKEEL, JR., *THE NEW FINANCIAL DEAL: UNDERSTANDING THE DODD-FRANK ACT AND ITS (UNINTENDED) CONSEQUENCES* (2010); Edward R. Morrison, *Is the Bankruptcy Code an Adequate Mechanism for Resolving the Distress of Systemically Important Institutions?*, 82 TEMP. L. REV. 449 (2009).

⁴ However, David Skeel and Thomas Jackson do raise this question briefly in Skeel & Jackson, *supra* note 2 at 197–98.

the out-of-bankruptcy bargained-for positions of creditors? The question now is not whether the Bankruptcy Code can afford to take the risk, but whether the Bankruptcy Code will take the opportunity provided by the OLA to return to fulfilling its role.

The debate has focused around the chance that the default of a SIFI will cause a chain of consequent bankruptcies or major disruptions. The OLA addresses this risk and should allow the debate to refocus on what the best treatment of derivatives in bankruptcy is in the much larger percent of cases. The Code should return to its central purpose of providing a debt collection system that protects the common pool, treats creditors fairly and equally, and does not shift value from some creditors to others without reason.

Moreover, lest financial regulators think the derivative safe harbors are simply a technical problem for bankruptcy professionals, the derivative safe harbors create a number of structural problems when joined with the OLA that could reduce the accuracy and efficiency of financial resolutions. The view that Title II makes bankruptcy reform unnecessary is thus doubly wrong.

This article develops as follows. Part II describes what derivatives are and how they are treated under the bankruptcy safe harbors. Part III introduces, but does not evaluate, the historical justifications for the bankruptcy safe harbors. From early on, advocates have claimed that they reduced systemic risk by allowing financial institutions to immediately close out their derivative relationships with bankrupt counterparties and therefore minimize the risk of market volatility. Part IV describes, but again does not evaluate, how the Dodd-Frank Act resolves SIFIs under the OLA, looking in particular at its special access to funding and its ability to move good assets temporarily into bridge financial companies, as well as its ability to resolve SIFIs both before and after a bankruptcy petition has been filed. Part V describes why the safe harbors violate basic bankruptcy principles and create problematic structural interactions after Dodd-Frank. Part VI concludes.

II. A PRIMER ON DERIVATIVES IN BANKRUPTCY

Bankruptcy and financial regulation have developed in very different ways. Therefore, bankruptcy practitioners may need an introduction to financial derivatives, and financial economists may need instruction about the basics of bankruptcy, and in particular how they apply to derivatives. This part will do both. The first section explains the basic concepts behind the most common derivative forms. Next, it is shown how the bankruptcy safe harbors for derivatives developed in a deregulatory environment and that the safe harbors received very little scrutiny when they were first adopted. The third part of this primer presents how the current bankruptcy safe harbors work in detail that will be useful in understanding which parts might be most useful for modification.

A. Derivatives Described

What are derivatives? Derivatives are financial contracts (contracts focused on money) that derive their ultimate value from a formula based on the value of an underlying asset (called the ‘underlying’).⁵ As the value of the underlying changes, the value of the contract changes.

There are many, many different kinds of derivatives. The most variation comes in a versatile form of derivative called a “swap” because the buyer and the seller “swap” cash flows, usually in the form of interest payments on pretend loans.⁶ For instance, in an interest rate swap, the parties swap variable rate interest payments for fixed rate interest payments in the same currency on some made up amount of money they pretend to lend to each other.⁷ The buyer (often a nonfinancial business of some kind) wants to reduce their exposure to interest rate volatility, say, but they are not able to borrow favorably at a fixed rate. Therefore, they will enter an interest rate swap with a swap dealer who will pay them a variable rate while they pay the dealer a fixed rate (or rather, they will “net out” the two rates so that one will simply pay the other the difference between the two). Swaps have been used to manage foreign exchange rates,⁸ weather risks,⁹ energy rates, credit risks,¹⁰ and many other things.¹¹ Even within these types, you may have many, many kinds, with different underlyings, terms, and maturities. The make-pretend amount that the interest rate payments are made on is called the “notional amount” and it is never actually exchanged.

Derivatives have always had a close relationship with bankruptcy. Some firms have used them to great effect to fine tune their risk exposure to a wide range of factors that are out of their control. Southwest airlines used fuel hedges to mitigate huge oil price increases in the late 90s and early 2000s and to avoid the multiple trips through

⁵ See Rene M. Stulz, *Demystifying Financial Derivatives*, 2005 MILKEN INST. REV. 20, 20.

⁶ See JOHN HULL, *OPTIONS, FUTURES, AND OTHER DERIVATIVES* 148 (6th Ed. 2005) (“A swap is an over-the-counter agreement between two companies to exchange cash flows in the future.”).

⁷ See RENE M. STULZ, *RISK MANAGEMENT & DERIVATIVES* 505 (2005) (“[O]ne party receives fixed rate payments equal to the notional amount times the quoted fixed interest rate. In exchange for receiving the fixed rate payments, the party pays the floating rate times the notional amount.”).

⁸ One account of the early growth of the derivative market suggest that it was the “breakdown of the Bretton Woods fixed exchange rate system” in the 1970s which created demand for a financial innovation to help companies manage exchange rate fluctuations. Financial Crisis Inquiry Commission, Preliminary Staff Report—Overview on Derivatives 3 (2010).

⁹ See Geoffrey Considine, Introduction to Weather Derivatives, 1.

¹⁰ See HULL, *supra* note **Error! Bookmark not defined.** at 548–58.

¹¹ See, e.g., CFTC, Order Prohibiting the Listing or Trading of Political Event Contracts (2011); GAO Report on Issues Involving the Use of the Futures Markets to Invest in Commodity Indexes (2009); Travis L. Jones, An Overview of Investment Hedging with Stock Index Futures (2008).

bankruptcy that seemed standard in the airline industry.¹² Other firms, however, have been driven into insolvency (if not always bankruptcy) through misuse of derivatives. Most recently, AIG's unhedged involvement with Credit Default Swaps was the cause of its failure in the Financial Crisis.¹³ Earlier, Long Term Capital Management's brilliant option-trading strategy exploded in their face after Russia defaulted on its bonds in 1998 and required an industry bail-out (sometimes called a "bail-in").¹⁴ Bankruptcy creates a third concern for derivative parties, however, which is the sizeable risk if their counterparty enters bankruptcy.

B. Development of the Bankruptcy Safe Harbors

The Bankruptcy Code of 1978 had limited safe harbors from the automatic stay for forwards and commodity contracts (futures)¹⁵ based on concerns about their volatility.¹⁶ However, as the use of derivatives exploded over the next decade and the kinds multiplied, driven by computer technology, the valuation power of the Black-Scholes option pricing formula, and increasing fluctuations in currency exchange rates¹⁷ and other market prices like gas and electricity prices, the Bankruptcy Code would eventually follow suit. In 1984, Congress added protections for repurchase agreements.¹⁸ In 1990, it exempted swap transactions.¹⁹ Finally in 2005 and 2006, it expanded its protections for repurchase agreements and certain procedures associated with netting.²⁰

¹² See, e.g., Southwest Annual Report 2 (2007), available at <http://southwest.investorroom.com/company-reports>.

¹³ See Michael Lewis, *The Man Who Crashed the World*, VANITY FAIR (August 2009), available at <http://www.vanityfair.com/politics/features/2009/08/aig200908>

¹⁴ Statement of Alan Greenspan, 84 FEDERAL RESERVE BULLETIN 1046 (Dec 2008).

¹⁵ See, e.g., Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, §§ 362(b)(6), 548(d)(2)(B).

¹⁶ See, e.g., Skeel & Jackson, *supra* note 2 at 160–61.

¹⁷ Financial Crisis Inquiry Commission, Preliminary Staff Report, Overview of Derivatives at 1; see also Fischer Black & Myron Scholes, *The Pricing of Options and Corporate Liabilities*, 81 J.POL. ECON. 637, 649-53 (1973) (deriving a valuation formula for options and applying it to corporate liabilities).

¹⁸ 11 U.S.C. §362(b)(7) (repurchase agreements exempt from stay); 11 U.S.C. §559 (repurchase agreements exempt from anti-*ipso-facto* provisions).

¹⁹ 11 U.S.C. §362(b)(17) (swaps exempt from stay); 11 U.S.C. §560 (swaps exempt from anti-*ipso-facto* provisions).

²⁰ See, e.g., 11 U.S.C. §101(47) (expanded repurchase agreement definition); 11 U.S.C. §362(b)(27) (master netting agreements exempt from stay); 11 U.S.C. §561 (exempt from anti-*ipso-facto* provision). Steven Schwarcz and Ori Sharon have persuasively argued that the development of the safe harbors represents "path-dependent" legislation. That means that the legislation grew up out of historical circumstances that may no longer apply, but which have constrained complete vetting of the legislation making discussion about them currently desirable. See Steven Schwarcz and Ori Sharon, *The Bankruptcy Law Safe Harbor for Derivatives: A Path-Dependence Analysis*, 71 *Washington & Lee Law Review* (forthcoming), available at: http://scholarship.law.duke.edu/faculty_scholarship/3151.

The final exemptions are broad. In addition to futures and options, the Bankruptcy Code exempts a long list of different kind of swaps and any instrument similar to them. The ultimate effect has been described as insulating the entire derivatives market from the operation of the Bankruptcy Code and courts.²¹

C. How the Bankruptcy Safe Harbors Work

By 2006, the current structure of the derivative safe harbors was set, and it is useful to examine the role that each of the safe harbors plays in the overall effect. The core of the safe harbors are found in sections 559,²² 560,²³ and 561,²⁴ which apply respectively to repos, swap agreements, and master netting agreements (which is not the same as a ISDA contract, but is rather a contract that provides for netting between *different* products and contracts). Tracing the development of the safe harbors, §559 was added in 1984, §560 in 1990, and §561 in 2005. Each includes similar language, so I will provide §560 as an example:

The exercise of any contractual right of any swap participant or financial participant to cause the liquidation, termination, or acceleration of one or more swap agreements because of a condition of the kind specified in section 365(e)(1) of this title or to offset or net out any termination values or payment amounts arising under or in connection with the termination, liquidation, or acceleration of one or more swap agreements *shall not be stayed, avoided, or otherwise limited* by operation of any provision of this title or by order of a court or administrative agency in any proceeding under this title.²⁵

Section 365(e)(1) prohibits so-called *ipso facto* clauses, which provide for termination of the contract upon defaults of certain kinds, including filing for bankruptcy.²⁶ As a result, §§559–561 allow participants in repos, swaps, and master netting agreements to terminate their agreements upon the filing of bankruptcy by a counterparty and to net out the values, liquidate any collateral to the extent of any amount due from the bankrupt party, and to do all this without consulting the bankruptcy judge or the estate trustee. As a belt-and-suspenders arrangement, §§362(b)(7), (17), and (27) provide specific safe harbors from the automatic stay and setoff limits for each of the three types of contracts, and §§546(f), (g), and (j) similarly emphasize safe harbors from preferences and constructive fraudulent conveyances.

Functionally the safe harbors work together like this. The exemption from the *ipso facto* clause prohibition is critical because it

²¹ See generally Edward R. Morrison & Joerg Riegel, *Financial Contracts and the New Bankruptcy Code: Insulating Markets from Bankrupt Debtors and Bankruptcy Judges*, 13 AM. BANKR. INST. L. REV. 641 (2005).

²² 11 U.S.C. §559.

²³ 11 U.S.C. §560.

²⁴ 11 U.S.C. §561.

²⁵ 11 U.S.C. 560 (emphasis added).

²⁶ 11 U.S.C. §365(e)(1).

allows counter-parties who did not terminate their contracts before the bankruptcy filing to terminate the contracts after the filing, which otherwise would be prohibited.²⁷ Once terminated, the safe harbor from the stay on setoffs, allows the counterparty to net out the notional amounts of the derivative so that it is only the net amount that is owed.²⁸ The inability to net out the notional amounts was one of the great concerns of the proponents for the safe harbors because derivative participants rightly pointed out that if counterparties could not net out their offsetting positions they might be found to owe the entire notional amount, which neither party had contemplated. The exemption from the stay also allows derivative parties to seize and sell collateral, and repo counterparties to sell the underlying assets backing the transactions.²⁹ Finally, the exemption from all preferences and fraudulent conveyance liability except for fraudulent conveyances of actual intent allows the parties to complete the terminations with the confidence that they will not be drawn back in.³⁰ The total effect is that derivatives and repurchase agreements may terminate and collect immediately from their collateral in bankruptcy.

III. SAFE HARBOR JUSTIFICATIONS AND SYSTEMIC RISK

The derivatives and repo safe harbors are an important deviation from the fundamental plan of the Bankruptcy Code.³¹ Such a significant exception has required significant justifications.³² Optimism about free markets and lack of understanding about these complex new instruments were a part of that justification, but the most important argument in favor of the justifications was the fear of systemic risk.³³ When several financial crises finally drew attention to the derivative safe harbors in the early 2000s and particularly during the financial crisis of 2008, the emerging criticisms of the safe harbors also focused on systemic risk: the systemic risk that the safe harbors *contributed* to the financial system by exacerbating the financial distress of major financial institutions. The Dodd-Frank Act, influenced by this debate, developed a system explicitly to handle the systemic risk that comes with the financial distress of large derivative counterparties, an important part of which was Title II, the Orderly Liquidation Authority (OLA).

²⁷ David Skeel and Thomas Jackson have suggested a minor modification to this exemption might bring much benefit if larger modifications are not possible. *See* Skeel & Jackson, *supra* note 2, at 199.

²⁸ *See* Mengle (2010), *supra* note 2 at 3; Robert R. Bliss & George G. Kaufman, *Derivatives and Systemic Risk: Netting, Collateral, and Closeout* 8 (Federal Reserve Bank of Chicago Working Paper 2005-03, 2005).

²⁹ *See* Kaufman & Bliss (2005), *supra* note 2 at 7.

³⁰ *See* Roe, *Crisis Accelerator*, *supra* note 2 at 548.

³¹ *See* *infra* Part V.

³² However, for an argument that the legislation that led to the safe harbors was under-considered because of historical reasons, *see generally* Schwarcz & Sharon, *supra* note 20.

³³ *See id.* at 15.

A. Safe Harbors as Systemic Risk Mitigators

The original passing of the safe harbors was uncontroversial. The risk of a “ripple effect” that might result from a bankruptcy filing by a major participant in the financial markets, as well as the unique economic nature of derivatives, obviously seemed to justify special treatment. Congressmen made statements such as this one by Senator Dole to explain the urgent need for exemption:

It is essential that stockbrokers and securities clearing agencies be protected from the issuance of a court or administrative agency order which would stay the prompt liquidation of an insolvent’s positions, because market fluctuations in the securities markets create an inordinate risk that the insolvency of one party could trigger a chain reaction of insolvencies of the others who carry accounts for that party and undermine the integrity of those markets.³⁴

These statements usually contained references to the unusual volatility of financial markets, which can “move significantly in a matter of minutes,”³⁵ and the immediacy with which counterparties needed their contracts resolved. Nonetheless, most cited early public discussion was marked both by vagueness and by lack of opposition.³⁶ The safe harbors were crafted in a period of great optimism about the importance of derivatives markets and the ability of free market forces to control them.

The newness and complexity of derivative instruments were obstacles to full understanding of what they were capable of and how they should be used. One example of how incomplete understandings of how derivatives would interact with the Bankruptcy Code affected the development of the safe harbors is the early concerns about cherry-picking. Derivative observers worried that in the absence of bankruptcy safe harbors, ISDA master contracts would be disaggregated into their many individual transactions, each of which would be subject to the debtor’s ability to assume and reject contracts.³⁷ Since derivatives are usually considered in net, not in gross, when setting collateral or controlling exposure, disaggregation would allow the debtor significant power to assume the transactions that had ended up being profitable while rejecting those that were not profitable and leaving those counterparties to get cents-on-the-dollar as unsecured creditors.³⁸ More recently scholars have suggested these fears may have been overblown.³⁹

³⁴ Shmuel Vasser, *Derivatives in Bankruptcy*, 60 BUS. LAW 1507, 1510 (2004) (citing Statement of Senator Dole, 128 Cong. Rec. S15981 (daily ed. July 13, 1982)).

³⁵ Statement of Senator DeConcini. *See* Vasser, *supra* note 34 at 1511 (citing 135 Cong. Rec. S1416 (daily ed. Feb. 9, 1989)).

³⁶ *See* Skeel & Jackson, *supra* note 2 at 160.

³⁷ *See, e.g.*, John C. Dugan, *Derivatives: Netting, Insolvency, and End Users*, 112 BANKING L.J. 638, 640 (1995).

³⁸ *See* Mengle, *supra* note 2 at 7.

³⁹ *See* Skeel & Jackson, *supra* note 2 at 187 (“Under bankruptcy’s setoff provision, a creditor is entitled to offset mutual obligations that it and the debtor

Even barring that, though, it is telling that instead of addressing the specific problem of the unity of the contracts, the solution adopted was an exemption. The cherry-picking concern reflects well the sense that many people were not sure how these unfamiliar innovations would be considered under a variety of bankruptcy laws.

In the case that uncertainties caused by novelty and complexity were insufficient, advocates for derivative special treatment had a trump card.⁴⁰ Staying derivative transactions, they argued, could create systemic risk through a potential cascade of consequent bankruptcies. If the stay applied to derivatives, the debtor could demand that the counterparties perform on their responsibilities while using the stay as a shield to fend off counterparty demands for debtor performance.⁴¹ The counterparties could thus be stuck in an unpleasant limbo that might be tolerable as long as the markets were favorable to them, but would prevent them from rebalancing their portfolio and adjusting as market conditions changed. An unfavorable market change could be levered many times in unintended ways, creating allegedly disastrous results. When one considered that it could be well over a year before many creditors saw their claims or contracts resolved, the likelihood for disaster was high. Thus, one large derivative player who went bankrupt could unbalance its counterparties. A significant disruption in their credit position could lead to collateral calls and liquidity issues that could further unbalance other derivative participants, potentially creating a chain reaction of disruptions that could roll through a financial system. The threat of such a scenario coupled with the recognition of how important derivatives were to the growing economy was quite convincing, particularly when no one was questioning it.⁴² It would take twenty years until anyone came to really question this thesis, and even then, two of those early scholars would be able to say, “This systemic risk argument has been the major rationale used to justify the enactment of legislation and regulations providing these securities with special protections.”⁴³

The argument from systemic risk was the most important argument behind the safe harbors, but recent events have indicated that it is, at best, incomplete in some important ways. Numerous critics have

owe to one another. Because many, and perhaps all, of the obligations under a master agreement would be treated as mutual obligations, the debtor would not be able to pick and choose which derivatives to assume. The debtor would be required to either assume or reject all of the derivatives in a single master agreement. The cherry picking fear is thus misguided as it relates to a single master agreement.”)

⁴⁰ See Skeel & Jackson, *supra* note 2 at 162 (“The [need to keep systemic risk in check]...tended to silence any lingering objections....”).

⁴¹ Skeel & Jackson suggest that this concern was likely overstated and that the Bankruptcy Code without the safe harbors would have a much more nuanced treatment of derivatives. See Skeel & Jackson, *supra* note 2, at 185.

⁴² “In a lawsuit the first to speak seems right, until someone comes forward and cross-examines.” Proverbs 18:17 (New International Version).

⁴³ See Bliss & Kaufman (2005), *supra* note 2 at 1.

arisen who argue that the safe harbors may exacerbate the financial distress of large financial institutions and in that way actually create systemic risk.

B. Safe Harbors as Systemic Risk Creators

The criticisms of the derivatives safe harbors in bankruptcy, particularly since the financial crisis of 2008, have focused on the possible ways that the safe harbors themselves *contribute to* systemic risk, both through the exacerbation of financial distress and through the undermining of market controls that might work to mitigate such distress.

The fear of the effects of the disorderly termination of a large number of derivatives and repos in LTCM's distress first was one of the reasons that the government strong-armed its largest creditors into offering it a bailout.⁴⁴ Later, the Lehman bankruptcy provided tangible evidence of this risk. Lehman's restructuring advisers have estimated that the disorderly termination of Lehman's derivative portfolio may have cost the Lehman estate \$50 billion.⁴⁵ In addition, the market for a variety of different kinds of derivatives was thrown into disarray after the Lehman bankruptcy for months.⁴⁶

Scholars have suggested that the safe harbors might contribute to systemic risk different ways. The risk of collateral runs can make financial institutions more susceptible to financial crises. Collateral runs occur in a system where derivative and repo counterparties may not be fully collateralized (and traditional credit decision criteria have allowed many counterparties to post less or no collateral). When the market gets a hint that a firm may be in trouble, creditors will exercise rights to increase the collateral supporting their contracts (these are called "collateral calls").⁴⁷ The effect of sudden, market-wide collateral calls

⁴⁴ In 1998, Alan Greenspan, as Chairman of the Board of Governors of the Federal Reserve System, explained the intervention in LTCM's crisis as follows: "[T]he act of unwinding LTCM's portfolio in a forced liquidation [precipitate by LTCM's derivative counterparties] would not only have a significant distorting impact on market prices, but also in the process could produce large losses—or worse—for a number of creditors and counterparties, and for other markets [sic] participants who were not directly involved with LTCM...." (testimony of Alan Greenspan, Hedge Fund Operations: Hearing Before the House Comm. On Banking and Fin. Servs., 105th Cong. 23 (1998), as cited in Franklin R. Edwards & Edward R. Morrison, *Derivatives and the Bankruptcy Code: Why the Special Treatment?*, 22 YALE J. ON REG. 91, 92 (2005).

⁴⁵ See Jeffrey McCracken, *Lehman's Chaotic Bankruptcy Filing Destroyed Billions in Value*, WALL ST. J., Dec. 29, 2008, at A10.

⁴⁶ See Michael Mackenzie, *Negative 30-year swap rate spread lingers*, FINANCIAL TIMES (September 9, 2009) ("A year after the collapse of Lehman Brothers, which sparked chaos across derivatives markets, one striking dislocation persists; a negative 30-year interest rate swap spread."), available at <http://www.ft.com/cms/s/0/3be4e8b8-9d5c-11de-9f4a-00144feabdc0.html>.

⁴⁷ *Id.*

can be similar to a bank run,⁴⁸ causing an immediate liquidity crisis. Failure to meet a collateral call can be an event of default, triggering events possibly including the termination of the contracts.⁴⁹ Because of cross-default clauses, termination of one party's contracts will mean the termination of all other derivative and repo contracts. Thus, failure to meet a collateral call can be deadly, but in the effort to avoid default, a firm can drain itself of capital.

A similar pattern could happen with ordinary secured credit. A secured creditor might be more relaxed about the status of its security while its debtor is doing well, but as soon as there is a hint of trouble, it might start asking for more security or better security.⁵⁰ A default under one contract could trigger cross-default clauses leading to various creditors trying to collect against debtor assets.⁵¹ In reality, this situation rarely pans out because a debtor would file for bankruptcy far in advance. In fact, the creditors know this and know that bankruptcy will impose costs on them, so they usually try to work together with the debtor in advance. However, because of the absence of the stay and preference, derivatives are a different world.

In addition to a collateral run aggravating financial distress, mass termination of derivatives can lead to mass sales of collateral as creditors seize collateral and try to liquidate it before the liquidations of other creditors drive the price down. The effect of these firesale losses can be serious.⁵² Had a large derivative party like Bear Stearns run out of liquid collateral and posted their mortgage-backed securities as collateral to their repos during the financial crisis, as the 2005 Bankruptcy Code amendments permit, and had counterparties tried to sell them en masse, it could have caused the bottom to fall out of the mortgage-backed security market, spreading distress to others. Some people have suggested that this is in fact what Bear Stearns did, and it may have been one reason for their bailout.⁵³

Another risk mentioned early⁵⁴ and analyzed carefully by Mark Roe is the potential for the derivative safe harbors to shift risk from derivative or repo counterparties to lower-priority counterparties.⁵⁵ Such a risk-shifting arrangement would act as a subsidy by lower priority

⁴⁸ See Gary Gorton & Andrew Metrick, *Regulating the Shadow Banking System*, Working Paper 4 (2010) (“The features of [the breakdown in the “shadow banking system”] are similar to those from previous banking panics—safe, liquid assets suddenly appeared to be unsafe, leading to runs.”).

⁴⁹ See Kaufman & Bliss (2005), *supra* note 2, at 19.

⁵⁰ This may be particularly true for a creditor whose collateral is fluid, like an inventory or accounts receivable lender, or an auto floorplan lender.

⁵¹ See THOMAS H. JACKSON, *THE LOGIC AND LIMITS OF BANKRUPTCY LAW* 11–12 (1986).

⁵² See Gaetano Antinolfi *et al.*, *Repos, Fire Sales, and Bankruptcy Policy*, Working Paper (2012).

⁵³ See Nathan Goralnik, *Note: Bankruptcy Proof Finance and the Supply of Liquidity*, 122 *YALE L. J.* 460, 465 (2012).

⁵⁴ See Bliss & Kaufman (2005), *supra* note 2 at 20–21.

⁵⁵ See generally Roe, *Crisis Accelerator*, *supra* note 2.

creditors (in particular the United States, as guarantor of the financial system) of higher priority creditors (like the derivative counterparties).⁵⁶ This subsidy comes about because the priorities allow the derivative counterparty to carry less risk than their contracts create. Because a party would be shifting a sizeable portion of the risk of its contract to the other creditors of the counterparty, it would have less incentive to screen its counterparties carefully and to monitor their creditworthiness, which could lead to lower quality risk management practices and higher systemic risk. In addition, subsidies by non-derivative parties to derivative parties would tend to artificially inflate the size of the derivative and repo market beyond what its own risk would justify without the subsidy, which would also increase the risk in the system.⁵⁷

The purpose of this article is not to evaluate the arguments that the safe harbors contribute to systemic risk. We will see that the Dodd-Frank Act may implicitly accept these risks as true, and so the key point here is to explain some of the ways that the consensus around the utility of the safe harbors has unraveled and why a new approach was felt to be needed. The initial response was the Dodd-Frank Act, and particularly Title II, which created the Orderly Liquidation Authority (OLA).

IV. DODD-FRANK'S TITLE II AND SYSTEMIC RISK

The Dodd Frank Act of 2010 was Congress's response to the Financial Crisis of 2008. Hailed as the most important piece of financial regulation since the New Deal,⁵⁸ it was designed to be a comprehensive response to the problems revealed in the financial crisis. It focused in particular on creating infrastructure that could handle problems of systemic risk, and one of the key pieces of that infrastructure was a new financial resolution system designed for systemically risky companies, the Orderly Liquidation Authority ("OLA")—Dodd-Frank's response to the problem of too-big-to-fail finance.⁵⁹

The filing of Lehman Brothers for bankruptcy was perhaps one of the most controversial occurrences in the financial crisis.⁶⁰ A variety of academics and policymakers attributed the severity of the financial

⁵⁶ See Roe, *Crisis Accelerator*, *supra* note 2 at 581.

⁵⁷ See Roe, *Crisis Accelerator*, *supra* note 2 at 542.

⁵⁸ See, e.g., Financial Regulatory Reform: The Dodd-Frank Act—Two Years Later, Weil Gotshal & Manges LLP, 1, (describing the Dodd-Frank Act as “unparalleled in scope and depth since the New Deal”) available at http://www.weil.com/files/upload/Weil_Alert_Dodd_Frank_Act_Two_Years_Later.pdf.

⁵⁹ Dodd Frank Act, Title II.

⁶⁰ See, e.g., NEW FINANCIAL DEAL, *supra* note 3, at 19–39 (describing and critiquing the “Lehman myth”); see also Kimberly Summe, *Misconceptions about Lehman Brothers' Bankruptcy and the Role Derivatives Played*, 64 STAN. L. REV. ONLINE 16 (2011) (describing misconceptions about the Lehman bankruptcy).

crisis to it, or at least blamed it for triggering the credit panic.⁶¹ The manner in which it accomplished this is disputed,⁶² but the fact that it was the turning point in the crisis is generally agreed. Geithner and Paulson say that they decided not to intervene with Lehman because they did not have the legal authority to resolve Lehman properly or really to extend them a bailout.⁶³ The OLA fixed that problem.

At the time of its introduction, there was a significant debate about the best way to manage systemic risk such as the risk that culminated in the Financial Crisis. Some advocates argued that the Bankruptcy Code was the institution designed to handle that task,⁶⁴ but other involved parties, including several influential policymakers, viewed the Bankruptcy Code as insufficient to the task.⁶⁵ This latter view is widely viewed to have won out in the adoption of the Dodd Frank Act.⁶⁶

The OLA has been subject to doubt as to how well it will handle systemic risk without causing a bailout.⁶⁷ If such speculations are correct, they would increase the urgency of modifying the derivative safe harbors in order to support Dodd-Frank's deficiencies. However, because in this Article I show that Dodd-Frank and the OLA actually increase the need to address the derivative safe harbors even if they are effective, I will paint a more optimistic picture of the OLA in action and also accept various criticisms of bankruptcy on face value, even though many are contested. I make these assumptions to demonstrate that even if the OLA works as it is supposed to, it actually amplifies the argument

⁶¹ See NEW FINANCIAL DEAL, *supra* note 3, at 21 for list of scholars and the implications they have drawn from the Lehman bankruptcy.

⁶² See *supra* note 60.

⁶³ See generally *supra* note 3.

⁶⁴ See, e.g., Ayotte & Skeel, *supra* note 3; NEW FINANCIAL DEAL, *supra* note 3, at 129–154; THOMAS H. JACKSON, BANKRUPTCY NOT BAILOUT: A SPECIAL CHAPTER 14 (2012).

⁶⁵ See Morrison, *supra* note 3; See also Remarks by FDIC Chairman Sheila C. Bair, “Ending Too Big to Fail: The FDIC and Financial Reform”, 2010 Glauber Lecture at the John F. Kennedy Jr. Forum; Harvard University, Cambridge, MA (October 20, 2010) (“One big reason [for the bailouts] is that neither bank holding companies nor non-bank financial companies, both of which figured prominently in the crisis, were subject to an FDIC-like receivership authority.... Instead these entities were subject to the commercial bankruptcy process, where it takes a long time and a lot of money to determine what creditors ultimately stand to collect.”).

⁶⁶ See Baird & Morrison, *supra* note 3, at 287.

⁶⁷ See NEW FINANCIAL DEAL, *supra* note 3, at 129; Baird & Morrison, *supra* note 3, at 313–15. Even many financial regulators are concerned about the effectiveness of the OLA, particularly in cross-border cases, and so they have developed the Single Point of Entry (SPOE) procedure which would take only the holding company for a financial entity into bankruptcy and restructure the entire entity through the one point of entry. In theory the SPOE process may avoid both the safe harbors and Title II, but it will only really apply to FSOC designated SIFIs. If unregulated financial companies (non or borderline SIFIs) have no private resolution option, public resolution options will still face pressure to expand to include them.

for modifying the safe harbors by removing the central justification for their breadth: the need to prevent systemic risk.

A. Systemic Risk in Bankruptcy and Title II

As we have seen, the most powerful justification for the safe harbors was the threat of systemic risk.⁶⁸ Yet, it is precisely this systemic risk that the OLA addresses. By many accounts, it represents a faster, more powerful resolution authority for the riskiest failures that are beyond what Bankruptcy can manage currently. While the effectiveness of the OLA is still untested, my purpose here is to demonstrate how it was tailored vis-à-vis the Bankruptcy Code to address concerns about systemic risk.

Early criticism of the Bankruptcy Code argued that judicial approval was too slow a process for the high pace of decisions needed in a major crisis.⁶⁹ The OLA contains procedures and powers to allow it to move very quickly, and to make decisions quickly by a centralized person who is very familiar with these issues. The Secretary of the Treasury, to take action, must merely get the consent of the Board of Directors of the firm.⁷⁰ Only if that is not forthcoming must the Secretary seek out judicial approval, which will be a very highly streamlined process that must occur within 24 hours.⁷¹ Once the receivership begins, the FDIC has great power and discretion in operating, without the need for lots of hearings and approval. The OLA, therefore, contains a very quick and centralized process or resolution, which critics have suggested the Bankruptcy Code lacks.⁷²

Another place where the OLA may be superior to the Bankruptcy Code in handling systemic risk is in the ability to prepare for resolution. The Dodd-Frank Act requires SIFIs to submit and keep up-to-date resolution plans that should be helpful in encouraging greater distress-preparedness.⁷³ Whether companies will respond to these requirements in useful ways is an open question, but the OLA at least creates this possibility.

A third advantage that the OLA provides is the ability to borrow from the Federal Reserve in order to provide DIP financing to the resolution subject.⁷⁴ Because the OLA is most likely to be invoked

⁶⁸ See *supra* Part III.

⁶⁹ See Morrison, *supra* note 3, at 461 (“Federal law permits this kind of speed when the FDIC seizes a bank....[I]t seems overly optimistic to expect that every bankruptcy judge would act with the same dispatch as the judge did in the Lehman bankruptcy case.”).

⁷⁰ Act § 202(a)(1)(A)(i), 12 U.S.C. § 5382(a)(1)(A)(i).

⁷¹ Act § 202(a)(1)(A)(i), 12 U.S.C. § 5382(a)(1)(A)(i).

⁷² See *supra* note 65.

⁷³ Dodd Frank Act § 165(d).

⁷⁴ See FDIC, *The Orderly Liquidation of Lehman Brothers Holdings, Inc., under the Dodd-Frank Act* 9 at note 44, 5 FDIC QUARTERLY (2011) (“The FDIC may issue or incur obligations pursuant to an approved orderly liquidation plan (up to 10 percent of the total consolidated assets of the covered financial company) and pursuant to an approved mandatory repayment plan (up to 90 percent of the fair

within a financial crisis when credit may not be forthcoming particularly for an already-insolvent entity, this is an important ability. Furthermore, the FDIC under the OLA is able to provide what is essentially DIP financing that will avoid some of the necessities firms sometimes are put to in Chapter 11 by their DIP financiers.⁷⁵ Arranging DIP financing is often one of the highest priorities in a large bankruptcy, and it can require a great deal of time in ordinary circumstances. This power meets another open concern about systemic risk in financial crises.

Finally, the OLA contains greater optionality than the Bankruptcy Code does right now in how it handles derivatives within a resolution. The OLA contains aspects of all three major tools used to deal with systemically risky financial companies, particularly financial companies with significant derivative portfolios during the Financial Crisis,⁷⁶ and a policymaker could apply whichever one made most sense. First, the presence of the one-day stay creates the possibility that the Treasury could put together a fast sale of the company or just the derivative portfolio and use the power of the stay and the transfer authority to make the transfer. During the Financial Crisis, when Bear Stearns failed, the Federal Reserve negotiated its quick sale to J.P. Morgan,⁷⁷ over a weekend.⁷⁸ While a one-day stay is short, it could be extended to four days if carefully planned.⁷⁹ In addition, if the OLA had been working with the financial institution in advance, as the FDIC says it does,⁸⁰ it might indeed have enough time to make that transfer.

value of the total consolidated assets of the covered financial company that are available for repayment). *See* section 210(n)(6) and (9) of the Dodd-Frank Act, 12 U.S.C. § 5390(n)(6) and (9). To the extent that the assets in the receivership are insufficient to repay Treasury for any borrowed funds, any creditor who received an additional payment in excess of what other similarly situated creditors received, which additional payment was not essential to the implementation of the receivership or the bridge financial company, may have the additional payment clawed back. *See* section 210(o)(1)(D)(i) of the Dodd-Frank Act, 12 U.S.C. § 5390(o)(1)(D)(i). This provision is consistent with Title II's directive to minimize moral hazard. To the extent that the clawbacks of additional payments are insufficient to repay Treasury for any borrowed funds, the FDIC is required to assess the industry. *See* section 210(o)(1)(B) of the Dodd-Frank Act, 12 U.S.C. § 5390(o)(1)(B)."

⁷⁵ *Id.* at 7.

⁷⁶ *See* FDIC, *supra* note 74 at 1 (describing how the FDIC would have applied the tools of the OLA to the Lehman bankruptcy). *But see* Summe, *supra* note 3 (arguing that the OLA would not have changed the Lehman Brother's bankruptcy significantly and that current bankruptcy rules are sufficient).

⁷⁷ Steve Schaefer, *A Look Back at Bear Stearns, Five Years After Its Shotgun Marriage to JPMorgan*, FORBES.COM, March 14, 2013, at <http://www.forbes.com/sites/steveschaefer/2013/03/14/a-look-back-at-bear-stearns-five-years-after-its-shotgun-marriage-to-jpmorgan/>.

⁷⁸ *Id.*

⁷⁹ *See* NEW FINANCIAL DEAL, *supra* note 3 at 143.

⁸⁰ *See* FDIC, *supra* note 74, at 11 (describing how important early work with Lehman would have been to prepare for resolution).

Suggestions about remedying the bankruptcy safe harbors have focused on a sale of the derivative portfolio.⁸¹

In addition, another approach that was used during the Financial Crisis was for the government to guarantee the troubled assets. Indeed, both Bear Stearns and AIG received these sorts of “bail-out” guarantees. While the idea of bailing out failing financial institutions has become distasteful, the government guarantee of Bear Stearns and AIG was effective in preventing them from failing and would be effective at preventing a set of rolling failures. The OLA contains an element of guarantee. It is authorized to draw on the Federal Reserve in order to lend money to a Bridge Financial Company, in a similar vein to a Debtor-in-Possession loan in bankruptcy.⁸² One potential use for this money that is clearly authorized is for the bridge financial company to bolster the collateral of its derivatives.⁸³ Thus, if a sale or transfer is not easily achieved, this guarantee could help float the portfolio along until it could be more favorably liquidated. This might be particularly effective where previously liquid assets, such as mortgage-backed securities, were made illiquid by market conditions.

Finally, the OLA does not completely reject the option of allowing the derivatives to terminate and the counterparties to close-out their positions. Title II only allows for a one-day stay on ipso-facto clauses, after which the derivatives terminate and can be closed-out. In fact, the only option other than to allow the derivatives to terminate is for the FDIC to notify the counterparty within the one day that their derivative is going to be assumed *and transferred*. If it is just not feasible to transfer the derivative portfolio, or if the chance of systemic risk from the derivative terminations is low (the OLA is not limited to dealing with systemic risk from derivatives), then the FDIC might simply find it makes the most sense just to allow the portfolio to terminate. This was, in fact, what the Federal Reserve allowed to happen with Lehman Brothers.⁸⁴ Outside the value loss from the chaotic close-out, the

⁸¹ See, e.g., Skeel & Jackson, *supra* note 2, at 198 (“The stay would halt a run by the institution’s derivatives counterparties long enough to facilitate a sale or other disposition of key assets.”),

⁸² See Dodd Frank Act § 204(d), 12 U.S.C. § 5384(d) (authorizing receiver to fund liquidation); see also Baird & Morrison, *supra* note 3, at 288 (2011).

⁸³ See NEW FINANCIAL DEAL, *supra* note 3 at 143.

⁸⁴ Several articles have been written evaluating whether Title II would have made any difference for the Lehman Bankruptcy. See, e.g., Summe, *supra* note 3; FDIC, *supra* note 74. However, the much more interesting question for me is whether the OLA would have handled AIG and Bear Stearns better. In retrospect, in terms of dangers from derivatives, Lehman was actually not a tremendous risk to the system. Much of the danger from its bankruptcy was caused by “informational contagion” as the market realized how bad the situation was, and became uncertain what the government would do, see NEW FINANCIAL DEAL, *supra* note 3, at Ch. 2. However, compared with Bear or AIG, Lehman’s derivatives were not too toxic and have ended up being an asset. Bear, however, was using mortgage-backed securities for its repos, and AIG had a very illiquid derivative portfolio. If either of those portfolios had been

derivatives were largely terminated without serious harm caused to the derivative counterparties.⁸⁵ A similar thing happened with the Enron bankruptcy.⁸⁶ However, it should be noted that, as it turned out, both of those bankruptcies had been caused by aspects of the business outside of the derivative portfolio.⁸⁷ In Enron's bankruptcy, their derivatives ended up being a net asset, which was also the case in Lehman's, despite the value loss.⁸⁸ However, where the crisis was caused by losses in or the failure of the derivative portfolio itself, such as in LTCM, Bear Stearns, or AIG, the risk of the negative side effects of mass terminations are more acute.⁸⁹

The OLA was designed to resolve SIFIs, not to replace Bankruptcy. However, this higher resolutionary firepower does not come free. Consideration of the OLA's costs is helpful for thinking about why policymakers should not allow it to encroach in situations where bankruptcy could work effectively.

B. Costs of Title II

Use of the OLA should not be extended beyond where systemic risk requires its use because it carries numerous costs with it, both direct and indirect. Most directly, the OLA has some characteristics of a "bail-out" or rescue loan.⁹⁰ Rescue loans create direct costs to taxpayers of providing financing and taking on significant risk that the loan may not be paid back.⁹¹ The OLA limits risk to taxpayers by creating a waterfall for the handling of the costs of funding: first they have access to the unsecured assets of the resolution, then they can clawback assets returned to creditors above and beyond what other equally-situated creditors received, and then they must assess industry.⁹²

However, the OLA produces direct costs to the taxpayer in other ways, even if all loans are repaid. It is very manpower intensive, particularly as generally the FDIC displaces current management and

terminated in mass, the negative effect on the market could have been much worse.

⁸⁵ See Summe, *supra* note 60, at 19 (2011) ("At present, [Lehman's derivative subsidiary] represents about 40 percent of all cash and cash investment positions in the entire Lehman Brothers estate.").

⁸⁶ See Morrison & Edwards, *supra* note 2, at 103–04 (2005) (describing the surprising "success" of the Enron bankruptcy and some distinctions between it and LTCM).

⁸⁷ See Summe, *supra* note 60 at 1–2 ("Misconception #1: Derivatives Caused Lehman Brothers' Failure"); Edwards & Morrison, *supra* note 2 at 104 ("Enron's derivatives trading arm was its *only* profitable operation.").

⁸⁸ See Summe, *supra* note 60 at 18–19.

⁸⁹ See Edwards & Morrison, *supra* note 2 at 105.

⁹⁰ See Ayotte & Skeel, *supra* note 3, at 485–86 (2010) (describing costs of rescue loans).

⁹¹ *Id.* at 484.

⁹² See § 210(n)(6) and (9) of the Dodd-Frank Act, 12 U.S.C. § 5390(n)(6) and (9); § 210(o)(1)(D)(i) of the Dodd-Frank Act, 12 U.S.C. § 5390(o)(1)(D)(i); § 210(o)(1)(B) of the Dodd-Frank Act, 12 U.S.C. § 5390(o)(1)(B).

manages the company itself.⁹³ In addition, with rescue loans the saying may be true, “In for a penny, in for a pound.” Once you start offering rescue loans to a distressed company, it is hard to say no if they need more. The U.S. government initially gave AIG a loan of \$85 billion, but by November, AIG had to come back and ask for more. The loan was eventually raised to over \$150 billion.⁹⁴

A second cost is the increase in moral hazard such interventions create.⁹⁵ Shareholders and debtholders may be more willing to endure risk if they believe they have a higher chance that they will be bailed out. The price of credit default swaps on Lehman’s debt did not spike until very shortly before its bankruptcy, indicating that the market was not expecting Lehman to default, despite its distress.⁹⁶ The market expected a bailout, in other words. The OLA addresses this problem by providing for harsh treatment for different groups. The effectiveness of this treatment will depend upon how it is carried out. Financial crises are hazy and quick-moving things, and sometimes the FDIC may have more important things to do than imposing costs on creditors who might themselves be in distress and close to needing resolution. The key problem here is that these rules are hard to predict and will hopefully not be invoked enough to create serious precedent.

A third cost is the distortion of corporate governance decision-making. Distressed companies often have a change of management, but it is usually at the insistence of the Board of Directors and shareholders. In the rescue loans offered to AIG, Treasury Secretary Paulson made the resignation of Robert Willumstad, AIG’s CEO, a condition of the bailout loan.⁹⁷ But the fact that AIG’s board of directors might have made the same decision does not disguise the fact that the introduction of the Treasury Secretary introduces political factors into the decision. Instead of the Board judging the right time (for instance, it might be useful to have the current management carry it into bankruptcy or the OLA), concerns about the political response may require an earlier decision than is optimal.⁹⁸

Some costs are particular to the specific political forces that formed the OLA. The backlash against bailouts led to a strong emphasis on liquidation within the OLA (hence its name). The Boxer Amendment requires that any company subject to OLA resolution be liquidated.⁹⁹ The FDIC may be able to skirt this requirement by reorganizing through a bridge financial company, but the textual emphasis on liquidation may

⁹³ Also, the FDIC has suggested the possibility of keeping an FDIC team in place at all systemically important institutions to keep them prepared for resolution, which would involve quite a commitment. *See* FDIC, *supra* note 74, at 11.

⁹⁴ *See* Skeel & Jackson, *supra* note 2, at 166.

⁹⁵ *See* Ayotte & Skeel, *supra* note 3 at 485.

⁹⁶ *See* Skeel & Jackson, *supra* note 2 at 164.

⁹⁷ *See* Ayotte & Skeel, *supra* note 3 at 487.

⁹⁸ *Id.*

⁹⁹ *See* Dodd Frank § 214.

subject them to higher political pressure. Not all companies that enter resolution may be economic failures, though. They may have had a liquidity crisis at the same time as a credit crisis and been unable to service their debt, and thus their underlying business may be just fine. The FDIC could move them to a Bridge Financial Company, but the high overhead costs to the FDIC of managing a reorganization likely would make them poorly suited towards a drawn-out reorganization if they were managing it.¹⁰⁰ It is true that the FDIC in those situations would try to sell the company to another company, but for many major financial companies, like Bank of America or Citibank, a reasonable, antitrust-approved buyer might be hard to find. And in any case, such a sale would likely only further concentrate an already concentrated financial services sector.¹⁰¹ The politically-driven liquidation focus of the OLA might be a cost make reorganization of even economically promising companies more difficult.

Finally, a fifth cost is that most of the other four costs increase as the use of the OLA scales up. They are variable costs, not fixed costs that can be spread. The costs of the FDIC manpower to resolve complicated financial institutions would be directly proportion to the number of institutions they supervised. The moral hazard risk would arguably increase as more entities faced the prospect of being resolved by the OLA instead of bankruptcy (although, it is possible that uncertainty about OLA procedures might decrease with use, though the moral hazard risk would increase prospectively while the uncertainty would only decrease retrospectively). The distortions of corporate governance would have more serious impact as its possibility grew and created uncertainty about what set of rules would govern companies in financial distress. Political pressure to liquidate companies that should economically be reorganized would also create more serious distortions as it was used more widely. This scale-cost is not surprising, because the OLA was not designed to be used widely. However, we will see in the next section that failure to improve the way that bankruptcy treats derivatives could aggravate these inefficiencies in ways not intended under the statute.

No doubt the debate about how the OLA will handle systemic risk will continue. However, the new resolution rules do seem to contain more optionality than the Bankruptcy Code currently, and there may be a reasonable basis for optimism that despite their costs, they will have the tools needed to manage very serious systemic risk. The question that remains is whether we could better control systemic risk at a lower systemic cost if our Bankruptcy Code was aligned with and worked with the OLA rather than against it. I argue that it would.

¹⁰⁰ See NEW FINANCIAL DEAL, *supra* note 3 at 149–50.

¹⁰¹ See NEW FINANCIAL DEAL, *supra* note 2 at 150.

V. SAFE HARBOR PROBLEMS AFTER TITLE II

As we have seen, systemic risk was the most powerful and important argument in favor of the exemption of derivatives from the core facilities of the Bankruptcy Code. However, because the OLA represents a holistic and powerful way to deal with the systemic risks of the financial distress of a major financial institution, that concern may be much less important now. The derivative safe harbors are oriented towards liquidation, particularly for parties where derivatives make up a large part of their assets base. However, Chapter 11 is designed to allow for reorganization in order to retain the going-concern value of the firm,¹⁰² or at least, reorganization by sale, if not through plan confirmation.¹⁰³

In addition, the architects of the Dodd-Frank Act, by choosing the OLA with the assume-and-transfer potentiality built into it, at least latently (and under strict limits) rejected bankruptcy's terminate-and-liquidate approach to distress involving derivatives.¹⁰⁴ Despite its name, the OLA has a more reorganization-centric approach to derivatives than Chapter 11 has.¹⁰⁵ Sandwiched between the reorganization-focus of Chapter 11 and the reorganization potentiality of the OLA, the liquidation-focus of the derivative safe harbors stands out as an oddity and demands justification. Thus, in the absence of a compelling justification for the unmodified total safe harbors for derivatives and repos, I suggest that their continuation in duplication of the OLA is essentially inefficient within the bankruptcy framework and leads to less efficient decisionmaking by both OLA decisionmakers and the debtor.

A. Are the Safe Harbors Necessary in a Dodd-Frank World?

The safe harbors are out of step with bankruptcy's own framework. It is sometimes said that the goal of bankruptcy is to enable the efficient transition of assets to their highest value uses by overcoming inefficiencies related to a common pool problem¹⁰⁶ or liquidity-related problems.¹⁰⁷ Both Chapter 7 and Chapter 11 overcome the collective action problems implicit in debt collection against an insolvent debtor through separating the decision of how to use the assets from the decision of how to distribute the assets.¹⁰⁸ The derivative safe harbors,

¹⁰² See LOGIC AND LIMITS, *supra* note 51 at, 14–15.

¹⁰³ See Lynn M. LoPucki and Joseph W. Doherty, *Bankruptcy Fire Sales*, 106 Mich. L. Rev. 1, 12 (2007) (suggesting explanation for increase in sales through bankruptcy).

¹⁰⁴ See NEW FINANCIAL DEAL, *supra* note 3 at 10 (contrasting OLA rules with predictability of bankruptcy law).

¹⁰⁵ See Morrison & Baird, *supra* note 3 at 308–10 (comparing resolution power to reorganize qualified financial contracts with bankruptcy's exemptions).

¹⁰⁶ See David A. Skeel, Jr. & Thomas H. Jackson, *Bankruptcy and Economic Growth* 3 (Univ. of Penn. Faculty Scholarship, Paper 476, 2013) available at http://scholarship.law.upenn.edu/faculty_scholarship/476.

¹⁰⁷ See generally David A. Skeel, Jr. & Kenneth Ayotte, *Bankruptcy as a Liquidity Provider* (Univ. of Penn. Inst. For L. & Econ. Research Paper No. 13-8, 2013), available at <http://ssrn.com/abstract=2234186>.

¹⁰⁸ See Jackson, *supra* note 105 at 23-24.

however, merge those two decisions together and place them back in the hands of the individual creditors, where the incentives are strong for each creditor to close out his position as quickly as possible.¹⁰⁹ Moreover, even though derivatives are financial instruments and financial instruments that are liquid are often considered fungible,¹¹⁰ the Lehman bankruptcy has demonstrated the termination of large quantities of derivatives at the same time often involves significant transaction costs.¹¹¹ Lehman's restructuring advisor has estimated that the safe harbors contributed to the disorderly termination of Lehman's derivative portfolio that might have cost Lehman's unsecured creditors up to \$50 billion in value.¹¹²

This argument should not be taken too far, however. I have argued in a different paper with Mark Roe that while the safe harbors are inefficient, so also the baseline bankruptcy rules would be inefficient if applied to financial derivatives.¹¹³ The derivative market is uniquely volatile which ought to be considered in crafting bankruptcy rules for it. Yet, the current safe harbors provide too little flexibility for maintaining any value that a derivative portfolio has to the debtor's estate. New solutions are required and several are in the process of being proposed.¹¹⁴ No doubt the effectiveness of Dodd-Frank's Orderly Liquidation Authority will need to be examined during these discussions, and that may be good. But the belief that Title II will be a replacement for bankruptcy reform, and therefore that the two systems are necessarily in competition, is false. Even advocates of a government-backed resolution system for SIFIs should be interested in a bankruptcy system that supports the efficient resolution of large financial institutions and does not interfere with it.

B. The Safe Harbors Distortion of OLA Intervention Decisions

In addition to being inefficient within the scheme of bankruptcy on their own, the retention of the safe harbors within the Bankruptcy-OLA system may actually hinder the effectiveness of the OLA at high systemic cost. The safe harbors make it costly for the OLA decisionmakers to wait until an entity has filed bankruptcy to make a final decision to intervene. They must therefore make a decision to intervene or not before a company files bankruptcy, when information is poorer and political costs higher.

¹⁰⁹ See Mark J. Roe & Stephen D. Adams, *Portfolio Value Destruction* 18 (Working Paper 2013).

¹¹⁰ See Edwards & Morrison, *supra* note 3 at 111. Edward Morrison, in a more recent article, has recognized that an efficiency-based argument does not justify the derivative safe harbors in the case of large financial institutions which primarily consist of large bundles of derivatives. See Baird & Morrison, *supra* note 3, at 312.

¹¹¹ See Roe & Adams, *supra* note 219, at 15-18.

¹¹² See McCracken, *supra* note 103. See also Roe & Adams, *supra* note 222 for discussion.

¹¹³ See *id.*

¹¹⁴ See S.B. 1861 Taxpayer Protection and Responsible Resolution Act

1. The Costs of Premature Decisionmaking

Dodd-Frank provides numerous tools for systemic risk dispersion. The safe harbors, however, interfere with the effectiveness of one important tool: the ability to intervene after a SIFI has filed for bankruptcy.¹¹⁵ Once a bankruptcy has triggered the liquidation tendencies within the derivative safe harbors, OLA intervention loses significant potency. Once a firm files for bankruptcy, their derivatives either automatically terminate or at least provide the option to terminate. While many counterparties were slow to terminate in Lehman, the *Metavante* decision¹¹⁶ and the threat of being late to a collateral-selling party will provide stronger incentives for early termination in the future.¹¹⁷ Once the integrity of a derivative portfolio has been breached, the debtor must balance it, either by liquidating other positions, or by reentering the missing trades, likely at a much higher cost. Partial liquidation of a portfolio, therefore, will likely lead to the liquidation of larger portions of the portfolio, if not the whole thing. The OLA contains a stay on ipso-facto clauses, but it does not have anything that would allow it to assume a contract that had already been terminated and closed-out. The presence of the liquidation-tending derivative safe harbors in the Bankruptcy Code interferes with any ability the OLA would have to cooperate with or use the Bankruptcy Code as a first line of defense.

The OLA decisionmakers would be forced to make an important decision about intervention before the bankruptcy filing in order to retain the option to preserve the portfolio. It might seem like a small matter, perhaps only a matter of days, but in actuality it creates a significant amount of cost and unnecessary pressures that threaten to undermine the effectiveness of OLA decisionmaking. First, this timing combines two questions that are better made separately, and in the other order. The policymaker's concern is about systemic risk, not about the resolution of the debtor. However, in order for the debtor to make the decision about whether to go into bankruptcy or not, they must first decide whether there is systemic risk. In addition, combination of those questions puts the decision about when the company is in financial distress in the hands of the person least able to evaluate it, the distant policymaker,¹¹⁸ and involves the debtor's management in decisions about systemic risk, while distorting the management's incentives. Third, combining these questions may artificially hurry the decision making and degrade the information available for it.¹¹⁹ Finally, deciding whether to intervene before a company has filed for bankruptcy may force OLA

¹¹⁵ Act § 208, 12 U.S.C. § 5388. Congress specifically provides the OLA with the right to lift a firm out of bankruptcy in Title II.

¹¹⁶ *In re Lehman Brothers, Inc.*, No. 08-13555 (JMP), 2009 WL 6057286, (Bankr. S.D.N.Y. Sept. 17, 2009).

¹¹⁷ See Skeel & Jackson, *supra* note 2 at 197.

¹¹⁸ See NEW FINANCIAL DEAL, *supra* note 3 at 125 (describing concerns about FDIC delays in major bank resolutions).

¹¹⁹ This was the driving concern behind the intervention in LTCM, Bear Stearns, and AIG, as the story is usually told. The administration was concerned that bankruptcy would trigger severe repercussions.

decisionmakers to make a politically charged decision in a less politically hospitable environment, creating the potential for less resolute action and unhelpful political reactions.

a. The Safe Harbors enlarge the question that must be decided.

The decision to intervene actually involves two separate decisions, with different informational inputs. First there is the decision that a firm is in financial distress. The second decision is whether the financial distress is likely to involve systemic risk. These are very different questions: one involves intimate knowledge of the inner workings of a business, the other involves detailed knowledge about where a business fits into the economy and the likely impact of its failure on others. Forcing the OLA to decide whether to intervene early forces them to bundle these decisions together, which is a much larger decision to make with very different informational inputs.

b. Combining questions complicates an already-complex decisionmaking process.

The Dodd-Frank already requires complicated cooperation between financial regulators for intervention.¹²⁰ Decisions to resolve a company before bankruptcy, however, also require detailed information about the inner workings and financial statuses of financial firms, which only comes from management. Panicked managers during the financial crisis wanted nothing better than to cooperate with the government. But the incentives created by the current system may not always be so aligned.

The current system offers a no-win choice for managers of distressed financial institutions. Bankruptcy leads to disorderly liquidations, unemployment, and disgrace. Dodd-Frank contains punitive requirements for management. Faced with an unattractive options, managers may delay in hopes the markets will turn around, or possibly face higher incentives to cover up mistakes and bad results. This incentive to delay could render management less proactive in preparing for financial distress and less interested in cooperating with the FDIC.

OLA decisionmakers have limited options to correct this weakness. Political realities would deter the OLA decision makers from intervening at a firm whose management did not welcome it. Any weakening of the harsh OLA treatment for management could create serious moral hazard problems. Enforcing the wind-down planning requirement will be difficult in the face of management indifference.

As long as an orderly reorganization is not possible for management of large financial firms under bankruptcy---and the safe harbors likely prevent it for many firms---management will have little incentive to prepare for resolution proactively. Forcing a premature intervention decision requires the OLA decisionmakers to be subject to these weaknesses. A bankruptcy system that presented a viable resolution scheme for mid-to-large financial institutions might entice

¹²⁰ See NEW FINANCIAL DEAL, *supra* note 3, at 135-142.

managers to prepare more actively in order to retain control over their firm.

c. Early decisionmaking may degrade available information.

Premature decisions about intervention may artificially limit the information available to assess whether and when to intervene. As we have seen, early decision making involves combining the decisions when or if to take over the firm and the decision whether there is systemic risk. In a different world, the best information about the first question would come from watching the actions of a management team motivated to prepare for and use bankruptcy proactively. Management knows better when a firm is in distress and how it should be prepared. Yet, the necessity to intervene early means that the OLA decision makers cannot simply wait and make a final decision about intervention after management files for bankruptcy, because that would might cost them their option to preserve the portfolio. Moreover, the value of management cooperation may be limited because of management's strong incentive to delay. Thus, combining the two questions may impair information about when a firm is in distress and should be resolved.

In addition, combining the questions may also hinder the decision about systemic risk. OLA decisionmakers will not be able to wait and assess how the markets react to the news of the firm's bankruptcy. Markets are often considered valuable aggregators of collective information, the collective assessment of market participants. In difficult cases, the reaction of the financial markets to a bankruptcy might provide objective data to support the case to intervene, or at least be useful in politically justifying the action. If the OLA must decide whether to intervene early, though, this information will not be available.

d. Early decisionmaking increases the political costs of intervention.

In addition, the decision to intervene before bankruptcy may involve more political costs than intervening afterwards. Pre-bankruptcy interventions mean that the OLA decisionmakers must announce both that a problem exists and that they are going to solve it. The role of the messenger of bad news is a less politically desirable role than the role of the person who responds positively to a publicly recognized disaster. In addition, the OLA decisionmakers might be able to use market reactions to the bankruptcy to help justify their intervention. Splitting the decision for the company to file bankruptcy from the decision for the OLA to intervene would place the OLA decisionmakers in a stronger political position to act firmly and with good judgment.

* * *

In summary, the retention of the safe harbors in bankruptcy would likely create numerous costs and external distortions in the OLA intervention decisionmaking stemming from the necessity to make the decision whether to intervene or not before the firm filed for bankruptcy. Early decisionmaking makes the decision larger and requires

significantly more information. The information needs require the OLA decisionmakers to work closely with management, whose incentives differ. The decision must be made before the best information about systemic risk is available. Finally, early intervention decisions might generate more negative political responses than a decision to intervene after the public announcement of a bankruptcy. If these distortive forces were not enough, however, the safe harbors also heighten the costs of error in deciding not to intervene.

2. Safe Harbors Increase the Cost of Being Wrong

Inaccurate OLA decisions could be failure to intervene when warranted (underintervention), or intervention when not warranted (overintervention). The cost of making an error in a decision (over or under intervention) influences the decision making. If a decision one way would have higher error costs while a decision the other way would have lower error costs, decisionmakers may mitigate difficult-to-make decisions by leaning towards the answer that has less error cost. The safe harbors in bankruptcy change the calculus for OLA decisionmakers by increasing the costs of underintervention, and possibly increasing the likelihood of also-costly over-intervention.

a. OLA Over-intervention

Systematic overintervention transforms the OLA from a system that handles systemic risk into a system that handles large financial failures of all kinds. This transformation from a circumstance-focus to an entity-focus over-enlarges the OLA and presents significant potential costs on the system. OLA activation involves significant political costs (the appearance of “bail-out”)¹²¹ and also involves high bureaucratic costs that have few economies of scale. To patrol more entities, the FDIC would need to hire more people. They have even discussed keeping people at all possible resolution targets around the year to dispel the risk of signaling weakness by bringing people in on the ground during a crisis.¹²² Moreover, the requirement that the FDIC terminate current management means that they will either have to hire a restructuring firm like Alvarez & Marsal who managed the Lehman bankruptcy, or have the people on staff to manage it. Both of those costs scale directly with OLA activity.

Those are small potatoes, though, compared to their authority to draw on the Federal Reserve to fund the distressed firm. In theory, the assets of the distressed firm secure the loan, and any shortfall is made up through a fee on the industry. Both of those are costly, however. The collateral would have gone to unsecured creditors, otherwise, and shortfalls at multiple firms could lead to sizeable fees on the industry. In

¹²¹ See NEW FINANCIAL DEAL, *supra* note 3 at 138–39 (“Bank regulators are likely to postpone resolution if they can...After all, taking over would mean selling or dismembering a complicated financial institution. Even a Treasury secretary who is less of a bailout enthusiast than Timothy Geithner will want to put off the day of reckoning, and it seems unlikely that the Fed or FDIC will be more anxious to invoke the regime.”).

¹²² See FDIC, *supra* note 74 at 11.

addition, overintervention creates the expectation of intervention. One reason the impact of the Lehman bankruptcy was so large was that the market expected the government to bail them out to the very last day. Overintervention loads a bankruptcy filing with significant information about government policy: the OLA chose not to intervene. Markets will react more strongly against mid-to-large size financial bankruptcies, even if there is no systemic risk. None of this is a surprise and the costs of overintervention are not directly driven by the safe harbors. Given the sizeable costs in activating the OLA unnecessarily, however, OLA decisionmakers might prefer to err on the side of underintervention, or at least retain the option to wait and see. The safe harbors raise the costs of that alternative and thus make overintervention more attractive in uncertain cases.

b. Underintervention

The legislators who wrote Title II of the Dodd-Frank Act foresaw the possibility that the OLA decisionmakers might prefer to take a wait-and-see approach, even after a large financial bankruptcy.¹²³ This naturally attractive option, however, is much less attractive with the current bankruptcy safe harbors. If the OLA declined to intervene before bankruptcy, the firm's counterparties have incentives to terminate their transactions immediately and closeout. Title II's authority to pull a firm out of bankruptcy does not include the authority to override prior terminations. Terminations of any size degrade the salability of a derivative portfolio even if it was balanced before filing bankruptcy because buyers will need to do time-consuming due diligence to understand the current exposures. Therefore, any intervention after a termination will already have lost much ground.

In addition, if the consequential mass terminations caused serious price movements in repo collateral or the derivatives market that exacerbated underlying weaknesses, say, the OLA could not do anything about it at that point. Their one point of intervention would be before the bankruptcy filing allowed the derivatives to be terminated. Thus, a crisis of a mid-sized derivative party at the beginning of a crisis, before the potential depth of it was realized, could cause the crisis to develop and deepen more quickly.

In addition, since derivatives play such a critical role in firm risk management for financial firms, the mass-termination of derivatives in the wake of a financial filing could force or hurry the liquidation of critical market player. Effective risk management is essential to most large financial institutions. If large portions of their derivatives were terminated, the firm would likely have to sell other assets in order to lower their risk profile. If the market was not able to absorb the sudden loss of capacity from that liquidation, price dislocations and market disruption could also occur.

¹²³ See Dodd Frank Act §208, 12 U.S.C. §5388.

Finally, the largest risk of underintervention is misreading the expectations of the market. Arguably, the greatest contribution the Lehman bankruptcy made to the Financial Crisis was the government's failure to meet the market's expectation of a bailout.¹²⁴ The road back to confidence was very long and very costly.

Even mild limits on the bankruptcy safe harbors could mitigate the risks of underintervention. A three-day stay, as has been suggested elsewhere,¹²⁵ could present the OLA decision makers with the option of allowing a firm on the margins of significance to file for bankruptcy, giving them more time to evaluate whether intervention was necessary. The risk of underintervention would be mitigated because the OLA would have the option of intervening later, which would allow them to make better decisions about when intervention was justified.

* * *

The bankruptcy safe harbors force the OLA decisionmakers to bundle the decision to intervene together with the decision of whether the company should file for bankruptcy. This bundling is unnecessary and fails to place each decision with the most competent decisionmaker. If bankruptcy had a short stay on ipso facto clauses, however, the OLA decisionmakers could use that time to consider whether the failure of that party really would have systemic effects. Then, if they needed to act, they could act and they would have a better position to do so. However, while bankruptcy allows the willy-nilly termination of all swaps, allowing a preliminary bankruptcy simply will not be possible if the OLA decision-makers want the option to preserve the portfolio.

The original justification for the derivative safe harbors was the risk of cascading failures in the event of the bankruptcy of a large financial institution. The OLA was designed to deal with that situation. Now, however, the derivative safe harbors, rather than helping to restrain systemic risk, if they ever did, artificially distort and pressure the decisionmaking of the very tool that will handle systemic risk situations and hinder the ability of the Bankruptcy Code to play its helpful role as the default system of financial distress rules.

The OLA creates the opportunity for the Bankruptcy Code to expand and follow its basic principles more fully because it now has a safety net. The Bankruptcy Code has little at risk by attempting some better way to handle the dissolution of a financial nonbank, and much to gain. The OLA's statutory mandate to resolve financial distress in times of systemic risk does not mean that it must be the first line of defense or the only one. The OLA frees the Bankruptcy Code up to experiment in the area of derivatives outside the shadow of a systemic crisis. By making some basic changes, the Bankruptcy Code could enhance the efficiency of the OLA's resolution of systemic risk and also take back its title as the default system for handling distress. It also could better

¹²⁴ See NEW FINANCIAL DEAL, *supra* note 3, at 19-39.

¹²⁵ See Skeel & Jackson, *supra* note 3, at 157.

follow its own purpose, the efficient redistribution of assets to their highest use. The OLA need not be a vote of no-confidence in the Bankruptcy Code. Rather, it could be just what the Bankruptcy Code needs to take back its basic territory.

VI. CONCLUSION

Contrary to popular perception, the inclusion in Dodd-Frank of a non-bankruptcy resolution authority need not be viewed as either a fatal judgment about bankruptcy's inability to handle systemic risk or the final word to critics' concerns about the derivative safe harbors in bankruptcy. It can be viewed as a helping hand, a challenge to practitioners and legislators to take this opportunity to develop a better rule-based way to handle systemically risky financial distress and to minimize the need for expensive and problematic ad hoc interventions. Dodd-Frank's Orderly Liquidation Authority weakens the justification for the exhaustive breadth of the bankruptcy derivative safe harbors while adding new structural reasons for limiting the safe harbors.

Financial regulation is sometimes modeled as a sine wave: financial crises are followed by overregulation that eventually causes a backlash leading to underregulation and another crisis.¹²⁶ Recognizing this chance to soberly and thoughtfully improve our rule-based control of systemic risk could help limit the impact of our short memories and help us continue to move toward a stable, reliable, and fair financial system.

¹²⁶ See, e.g., Eric J. Pan, *Understanding Financial Regulation*, Cardozo Legal Studies Research Paper No. 329 (2011) (discussing the "oft-noted 'sine curve of regulatory activity'").