Epic Fail: An Institutional Analysis of Financial Distress

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This paper presents an institutional analysis of financial distress. “Institutional analysis” compares the effectiveness of large-scale processes, such as markets, courts, and governments, at solving social problems. Although financial distress is one of our most acute problems, there has been virtually no effort to analyze it from an institutional perspective. This paper begins to fill that gap.

Institutional analysis shows that, contrary to conventional wisdom, financial distress is not a problem that courts, such as bankruptcy courts, usually solve by themselves. Instead, it is increasingly a problem that political organs (whether elected or regulatory) both create and purport to resolve. Government creates financial distress when it subsidizes private debt, for example through guarantees and regulatory exemptions for certain debt-like transactions, such as credit derivatives. Government increasingly seeks to resolve it through laws such as Dodd-Frank, which would apply a bank-failure (regulatory) model to non-bank firms.

Institutional analysis is, in important part, about stakeholder participation. On this metric, the trend is worrisome. Government tends to rob stakeholders of the participatory capacity to engage in more prudent debt contracting ex ante, and to negotiate the resolution of financial distress ex post. Markets and courts, by contrast, generally create more participatory mechanisms, most commonly through the renegotiation (“work out”) of debt. To be sure, government has an important role to play in resolving financial distress. It is likely the best institution to prevent bank panics. But this is precisely because of the unusual participatory failures that characterize a panic.

Failing to recognize the institutional dimensions of financial distress has important implications. In the short term, laws such as Dodd-Frank codify institutional missteps that contributed to the financial crisis. In the long term, government cannot subsidize debt as it has in recent years without creating significant problems of intergenerational equity.

The paper concludes by exposing weaknesses in recent proposals to prevent future crises. I also offer an example of an institutionally-attuned solution: the strict liability claw-back for compensation received on account of government-subsidized debt.

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**Epic Fail: An Institutional Analysis of Financial Distress**

“Most of us . . . find it hard to draw useful lessons from our missteps. We tend to fail at failure. (My teenage son and his friends would call this an ‘epic fail’)”

“They should have let Bear Stearns fail”

Introduction

If the financial crisis has taught us anything, it is that how we fail may matter as much as, or more than, whether we fail at all. How we fail is, in part, a product of the institutions we choose to manage financial distress. “Institutions” are, for this purpose, “large-scale social decision-making processes” such as markets, courts, and government agencies, whether elected or regulatory.\(^3\) Ill-informed institutional choices thwart productive social participation and thus our ability to achieve whatever social goals we think matter. In the case of financial distress, choosing the wrong institution may create failures where none would otherwise exist, or exacerbate those that are inevitable.

“Institutional analysis” shows how to understand these choices. It comprises a large body of literature that considers both the design of institutions and how we choose among them to solve various problems.\(^4\) Although scholars and observers across disciplines have come to recognize that

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1 Adi Ignatius, *When We Fail at Failure*, HARV. BUS. REV., Apr. 2011, at 12.


financial distress is among our most acute socio-economic problems, there has been virtually no attempt to understand it from an institutional perspective. This paper starts to fill that gap in a Prologue and three Parts.

The Prologue describes institutional-choice missteps that epitomized the financial crisis. Part 1 develops an institutional analysis of the crisis, its aftermath, and financial distress in general. Part 2 applies the analysis, comparing the effectiveness of markets, courts, and government in addressing problems of financial distress. Part 3 exposes institutional weaknesses in prominent proposed solutions. I suggest, instead, one type of programmatic change—strict liability compensation clawbacks—that addresses participatory failures in our approach to financial distress thus far.

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As discussed in Part 1, I distinguish the work of the foregoing authors, who focus on institutional processes ("process institutionalism"), from "substantive institutionalism." Substantive institutionalism is concerned largely with the design of social arrangements, and is often associated with the work of Elinor Ostrom, Douglass North and other social scientists. See discussion at note 43 infra. Substantive institutionalism looks chiefly at non-legal (or extra-legal) institutions to determine how decisions are made in more or less coordinated and productive ways. Its focus is structurally endogenous, exploring theories about the conditions (with or without "law") that produce preferable social results. Process institutionalism, by contrast, assesses exogenously the relative strengths and weaknesses of various social institutions.


The massive debts accumulated over the last forty years can't be paid in full, and they won't be paid. The debt crises of Greece, Ireland and Portugal are just the start . . . Economics and politics for the next decade and beyond will be dominated by this issue, as social classes and countries debate where the brunt of the pain will fall.


6 The one exception is Susan Block-Lieb, Logic and the Limits of Contract Bankruptcy, 2001 U. Ill. L. Rev. 503, 503 (2001). Written almost seven years before the credit crisis, and focused on the bankruptcy court system, it could not have anticipated the significant institutional mistakes that precipitated and accelerated the current crisis or its implications.
Financial failure is inevitable in a complex, interconnected society. The important question, therefore, is not whether—but how—we will fail. Failures are “epic” when they are enormous or when we learn nothing from them. Absent an institutional appreciation of financial distress, we risk more of both.

**Prologue: From Bear to Lehman and Back Again**

To understand the role that institutional analysis plays in financial distress, recall the case of Bear Stearns. When the investment bank realized in March 2008 that it faced a liquidity crisis, it had choices. Like Drexel Burnham in 1990, it could have commenced a bankruptcy case under chapter 11 of the Bankruptcy Code. In that event, it would have chosen the judiciary as the institutional solution. Alternatively, it could have renegotiated with its counterparties and/or sought a buyer on its own. In that event, it would have chosen the market as the institution to solve its problems.
Instead, Bear chose a different institution: the government. By receiving a $30 billion government guarantee of its debts in its sale to J.P. MorganChase, Bear Stearns and political institutions (in particular the Federal Reserve Bank of New York and the United States Treasury) made an important and problematic institutional choice.

The choice was important because, as I will explain below, it was yet another step in a deeper, and largely unrecognized, institutional transformation in the way we treat financial distress: Financial failure is increasingly a problem we expect government—not markets or courts—to prevent and solve.

It was also problematic, although not for the reasons conventionally given. Conventional wisdom frowns on “bailouts”—government aid to resolve financial distress—out of concerns about the public fisc, i.e., moral hazard and costs to taxpayers. In fact, the costs of the Bear Stearns transaction, and other “bailouts,” in hindsight appear to be far lower than the $700 billion price tag bandied about.

Rather, the problem was the signal it sent to other market participants, sophisticated financial firms (SFs?): You need not renegotiate (in the vernacular, “work out”) the complex

11 See FCIC REPORT, supra note 7.
12 See, e.g., NEIL BAROFSKY, BAILOUT, 19 (2012) (arguing that “the entire crisis was unleashed by the greed of a small handful of executives who exploited a financial system that guaranteed that no matter what risks they took, they’d be able to keep the profits and lavish pay those risks generated with the assurance that if their outsized bets went wrong, the U.S. taxpayer would cover their losses.”).
13 Compare Jonathon G. Katz, Who Benefited From The Bailout?, 95 MINN. L. REV. 1568, 1590-91 (2011) (“In its retrospective report, the Treasury has projected a final TARP cost of $51 billion (including the auto bailout). With the success of the GM IPO, the sale of AIG foreign subsidiaries, a future AIG government stock sale, and if the HAMP program continues to be unsuccessful, it is conceivable that the final cost to the taxpayer will be close to zero.”) with OFFICE OF THE SPECIAL INSPECTOR GENERAL FOR THE TROUBLED ASSET RELIEF PROGRAM, SIGTARP QUARTERLY REPORT TO CONGRESS, 7 (April 2012) (“Taxpayers are still owed $118.5 billion (including $14 billion written-off or otherwise lost).”) available at http://www.sigtarp.gov/Quarterly%20Reports/April_25_2012_Report_to_Congress.pdf. There is little question that the government gave away too much, too soon, and too easily, both before and during the crisis. The important question is what institutional choices made these inefficient economic results possible and—apparently—preferable.
14 I distinguish SFs from “systemically important financial institutions” identified by Dodd-Frank, who might be
contract (e.g., derivative) obligations you owe one another, which is what other social institutions, such as the market or a bankruptcy court, would expect. Instead, you need simply wait until the government bails you out. Which, apparently, they—and it—did.

Until Lehman Brothers.

Writers tend to claim the decision to allow Lehman Brothers to go into bankruptcy on September 15, 2008 was a mistake. Presumably, they believe that but for Lehman Brothers’ “disorderly” bankruptcy, the financial crisis would have been less severe than it proved to be.

While Lehman and its management team, led by CEO Richard Fuld, have been criticized for failing to do more to prepare for, and prevent, a bankruptcy filing, it is not difficult to understand subjected to its orderly liquidation authority (OLA), which I discuss extensively below, although they may overlap. One could keep the number small, reflecting the five investment banks dispassionately permitted to set their own leverage ratios pursuant to the SEC’s 2004 Consolidated Supervised Entity program, Goldman Sachs, Morgan Stanley, Merrill Lynch, Lehman Brothers and Bear Stearns. U.S. SEC. & EXCH. COMM’N, FINAL RULE: ALTERNATIVE NET CAPITAL REQUIREMENTS FOR BROKER-DEALERS THAT ARE PART OF CONSOLIDATED ENTITIES, available at http://www.sec.gov/rules/final/34-49830.htm#P105_39776, accessed 7/14/2012. Notably, only two (Goldman and Morgan Stanley) survive as independent firms. One could expand the list a bit to include the “13 banks” alluded to in the title of Simon Johnson and James Kwak’s account of the financial crisis, although they argue that we will ultimately be left with six “oligarch” banks. See SIMON & KWAK, supra note 5.

15 As discussed in text at note 196, below, many derivatives are effectively exempt from bankruptcy treatment, a problem with its own institutional implications. Markets nevertheless were (and should have been) used to “unwind” these obligations in many cases.

16 See, e.g., SORKIN, supra note 5, at 535 (“On the day that Lehman went into Chapter 11,” Alan Blinder, an economist and former vice chairman of the Federal Reserve, said, “everything just fell apart.”); Kimberly Anne Summe, Lessons Learned from the Lehman Bankruptcy, in ENDING GOVERNMENT BAILOUTS AS WE KNOW THEM 60 (Kenneth Scott & John Taylor eds., 2010) (“Lehman Brothers . . . survived the Civil War and two world wars, but faltered in September 2008, taking with it the fragile U.S. and global economy.”). Compare Kenneth Ayotte & David A. Skeel, Jr., Bankruptcy or Bailout?, 35 J. CORP. L. 469, 490 (2010) (suggesting AIG bailout may have caused as much market damage as Lehman bankruptcy).

Note that Summe is wrong not only because it would appear that there is reason to believe that the Bear Stearns intervention—not the Lehman bankruptcy—was more likely the proximate cause of the crisis, but also because in hindsight it is now clear that there was no “global” economic collapse. The financial crisis was largely concentrated in the northern hemisphere of the “rich” world (e.g., the United States and the European Union). See, e.g., Jennifer G. Hill, Why Did Australia Fare So Well in the Global Financial Crisis, in THE REGULATORY AFTERMATH OF GLOBAL FINANCE CRISIS (E. Ferran et al., eds., 2012); Andrea Beltratti & Rene M. Stulz, The Credit Crisis Around the Globe: Why did some banks perform better? 105 J. Fin. ECON. 1 (2012) [Sydney Law School Research Paper No. 12/35] available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2063267 (visited June 21, 2012).
how and why they might have believed that government would have saved them, too. As the Examiner’s Report prepared in Lehman’s bankruptcy explained:

In July 2008, rumors circulated globally that Lehman was “done & dusted” with no forthcoming “Bernanke bailout.” . . . [Yet] senior members of the Government, Wall Street executives and experts doubted that the Government really would refuse to make money available for Lehman if necessary. As late as September 10, 2008, the [Federal Reserve Bank of New York (FRBNY)] circulated a presentation that discussed potential federal monetary assistance to Lehman. . . . Lehman’s apparent belief that the Government would provide help was a “real fact of life” and . . . most attendees of the FRBNY meetings on September 12 through 14, 2008, “probably assumed that [Paulson’s statement that there would be no Government help] was a negotiation.”

Although Lehman did announce a hastily-constructed “restructuring plan” Wednesday, September 10, 2008,18 no government support came. The firm was then downgraded by rating agencies.19 Unable to find a strategic buyer or to obtain government assistance, Lehman realized that it lacked liquidity to open for trading Monday, September 15, 2008.20 “Finally,” the Examiner reported, “on Sunday, September 14, 2008, the SEC, with the support of the FRBNY and Treasury, all but directed Lehman to declare bankruptcy.”21 Which it did the next day.

Lehman was thus left with a particular institutional choice, the judiciary (a bankruptcy court). Not so for AIG, however. Although also eligible for bankruptcy, government nevertheless apparently believed that AIG really was too big too fail. On September 16, 2008—the day after

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18 Id. at 620 (“On the morning of Wednesday, September 10, Lehman pre-announced its third quarter earnings and restructuring plans, including the future spin off of its commercial real estate assets.”) (citing Final Transcript of Lehman Brothers Holdings Inc. Third Quarter 2008 Preliminary Earnings Call (Sept. 10, 2008)).


20 See Lehman Report, supra note 17, at 621.

21 Id. (citing Lehman Brothers Holdings Inc., Minutes of Meeting of Board of Directors (Sept. 14, 2008), at p. 4 [LBEXAM 0003932]).
Lehman declared bankruptcy—Treasury announced an $85 billion investment to save the insurance company.\(^{22}\)

What explains these very different institutional choices, the judiciary for Lehman and government for Bear and AIG? So far, none. I use institutional analysis in this paper to show why current theories cannot explain this haphazard response to the crisis, and why such unprincipled responses will remain the norm absent a better appreciation of the institutional dimensions of financial distress.

The key institutional lesson of Bear, Lehman, and AIG—and their aftermath—is that government increasingly dominates the creation and resolution of financial distress.\(^{23}\) Being far less accountable for its actions than other institutions, government can make seemingly unprincipled decisions.\(^{24}\) When firms are in distress, it can pick winners and losers without any strong need to explain its decision-making process. Institutional analysis also shows that government’s role in this context has grown, and will continue to grow, for two reasons.

First, government subsidizes the creation of private debt. It does so through implicit and explicit guarantees, as well as other less obvious maneuvers, such as special treatment for certain kinds of debt-like transactions (e.g., credit derivatives), all of which contributed significantly to the rise and fall of firms such as Bear, Lehman and AIG. As described in Part 2, government subsidies of private debt exceed 95% of U.S. gross domestic product. Such subsidies encourage private debt, which can obviously play an important role in stimulating economic activity. But this means that in

\(^{22}\) See FCIC REPORT, supra note 7, at 350.

\(^{23}\) Even Lehman shows this. Richard Fuld—Lehman’s CEO—would doubtless have done a better job of planning for Lehman’s bankruptcy if he believed that government would abandon his firm to courts or markets. But he did not, precisely because he—like every important SF2 agent—believed that at the end of the day, government would save his firm if he—and his lawyers—could not. He was wrong on all counts.

\(^{24}\) The key constraint on government action is that it not be “arbitrary” or “capricious” under the Administrative Procedures Act. See 5 U.S.C. § 706(2).
many cases—whether home mortgages or student loans—lenders and borrowers may dilute or abandon the prudence they would bring to such transactions if they took place only in the market.

Second, the road from Bear to Lehman to AIG shows that government increasingly displaces markets and courts as the institutional choice to resolve financial distress when it does occur.\(^{25}\) As discussed in Part 2, Dodd-Frank—our attempt to prevent future bailouts—actually codifies this institutional choice in its “orderly liquidation authority,” which creates regulatory (government) power to displace bankruptcy courts and markets for certain types of distressed firms.\(^{26}\) The government’s many (largely unsuccessful) attempts to help homeowners avoid foreclosure are another example.\(^{27}\) Recent amendments to the Bankruptcy Code designed to discourage consumer bankruptcy filings,\(^{28}\) and recent Supreme Court decisions such as \textit{Stem v. Marshall},\(^{29}\) which constrict bankruptcy court power, contribute indirectly to this trend.

\(^{25}\) Even when government will not comply (as in Lehman) market actors refuse until the last minute to take seriously their other institutional choices because government has lured them into believing that it will save them, too.


\(^{27}\) The Home Affordable Modification Program (HAMP) is the most notorious example. It was created to directly assist homeowners facing foreclosure by providing a method of renegotiating mortgages to affordable levels. See Office of the Special Inspector Gen. for the Troubled Asset Relief Program, SIG-08-03, Quarterly Report to Congress 135 (2010) [hereinafter “SIGTARP Quarterly Report, July 2010”], available at http://www.sigtarp.gov/reports/congress/2010/July2010_Qtrly&uscore;Report_to_Congress.pdf. The July 2010 SIGTARP report was highly critical of the program: “Despite a seemingly ever increasing array of HAMP-related initiatives designed to encourage participation in the program, the number of homeowners being helped through permanent modifications remains anemic: with fewer than 400,000 ongoing permanent modifications (only approximately 165,000 of which are in connection with the TARP-funded portion of HAMP) . . . .” Id. at 6. The Federal Government is not the only branch weighing in to avert foreclosures. For an overview of more recent efforts by courts state legislators. See, Peter W. Salsich, Jr., \textit{Homeownership—Dream or Disaster?}, 21 J. AFF. HOUSING 17 (2012); Aleatra P. Williams, \textit{Foreclosing Foreclosure: Escaping the Yawning Abyss of the Deep Mortgage and Housing Crisis}, 7 NW. J. L. & SOC. POL’Y 455 (2012).


\(^{29}\) 131 S. Ct. 2594 (2011).
But what, one may ask, is so bad about giving government this task? It is, after all, a well-accepted Keynesian response to market troughs. Institutional analysis offers a two-fold answer.

First, while no institutional choice is perfect, different institutions have different strengths and weaknesses that affect how they solve particular problems. To simplify, markets tend to be good at private ordering, but can suffer from well-recognized (competitive) failures; government has money and muscle, but may be subject to majoritarian bias or interest group capture; courts tend to be good at dispute resolution, but are passive, formalistic, weak and resource-poor.

In order to make intelligent decisions about social policy, we must account for these structural and participatory differences. We may wish that regulators could take a “goldilocks” approach, and get it “just right.” But in the absence of a richer understanding of the institutional fabric that creates and resolves financial distress, it is a fairy tale to believe that mono-institutional adjustments are likely to solve this (or any) social problem well. Government has an important role to play in financial distress, but it is not the one we increasingly ask of it.

Second, CIA is, in important respects, about the nature and effects of stakeholder participation. We participate in the market through contract transactions; we participate in government by voting, voicing opinions, or funding candidates or causes; we participate in the judicial process when we have a problem that we believe the foregoing cannot solve. As explained in Part 2, in the case of financial distress, participation usually takes the form of a workout, a renegotiation of the debtor’s debt contracts.

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30 See JOHN M. KEYNES, THE GENERAL THEORY OF EMPLOYMENT, INTEREST AND MONEY, Book VI, Chapter 22 (1936) (where Keynes describes the role of monetary policy in the business cycle). Keynes has recently (and perhaps conveniently) been “rediscovered” by many public intellectuals who previously disavowed his macroeconomic theories. See, e.g., POSNER, CRISIS, supra note 5 at [XX].

Government’s growing role here has significant participatory consequences. We typically think that financial regulation is a problem of interest group (minoritarian) capture, and worry that $SF^2$s—a small electoral minority—control both Wall Street and Washington. In fact, institutional analysis reveals that financial distress is increasingly a **majoritarian** problem. Both large masses of consumer debtors as well as minorities of sophisticated financial firms will support debt subsidies because they create the illusion that we have addressed a famous concern about public indulgence in the fisc (sometimes wrongly attributed to Tocqueville): “The American Republic will endure until the day Congress discovers that it can bribe the public with the public’s money.”

Of course, Congress has long bribed the American public with “its own money,” and yet the Republic survives. Institutional analysis shows that debt subsidies are not like other Congressional bribes, however. They are opaque because they are contingent and unliquidated. This creates information asymmetries that impair participation by current stakeholders, in particular voters.

More problematic still are their intergenerational effects. Intergenerational equity requires that current actors account for the effects of their behavior on future generations. While debt

**Footnotes:**

32 See, e.g., SOBRIN, supra note 5.

33 This quote is often attributed to Alexis Tocqueville but does not appear in his written work. Quoting http://en.wikipedia.org/wiki/Alexis_de_Tocqueville: “This is a variant expression of a sentiment which is often attributed to Tocqueville or Alexander Fraser Tytler, but the earliest known occurrence is as an unsourced attribution to Tytler in Elmer T. Peterson, This is the Hard Core of Freedom, THE DAILY OKLAHOMAN (9 December 1951): "A democracy cannot exist as a permanent form of government. It can only exist until the majority discovers it can vote itself largess out of the public treasury. After that, the majority always votes for the candidate promising the most benefits with the result the democracy collapses because of the loose fiscal policy ensuing, always to be followed by a dictatorship, then a monarchy." See also John J. Pitney, Professor Emeritus of History, Claremont McKenna College, saying of the quote, “It is bogus, he wrote no such thing,” available at http://www.bessettepitney.net/2011/07/more-fake-tocqueville.html

34 “Intergenerational equity” is typically associated with international movements to husband natural resources. See United Nations, Rio Declaration on Environment and Development, June 1992, at 3-14, available at http://www.unep.org/Documents.Multilingual/Default.asp?documentid=78&articleid=1163. The intergenerational equity principle was mentioned in principles 1 and 2 of the Stockholm Declaration on the Human Environment (1972) and stated in Principle 3 of the Rio Declaration as “[t]he right to development must be fulfilled so as to equitably meet developmental and environmental needs of present and future generations.” Id. EDITH BROWN WEISS, IN FAIRNESS TO FUTURE GENERATIONS: INTERNATIONAL LAW, COMMON PATRIMONY, AND
subsidies will stimulate market activity in the present, they will impose uncertain costs on future generations. Some of these costs will certainly be worthwhile. Yet, by definition, future stakeholders (whether debtors, creditors, or voters) cannot participate in today’s decisions about these subsidies, even though they may bear their economic and financial consequences.

Government may also be less effective at resolving financial distress than other institutions. This, too, is because of the participatory consequences of this institutional choice. Government tends towards an administrative model of resolution, such as the one used by the Federal Deposit Insurance Corporation for failed banks, which typically results in an unannounced seizure of the bank in the middle of the night by regulators in order to prevent a bank panic. This is among the least participatory failure resolutions one can imagine short of breaking a debtor’s knees. As I explain in Part 2, the special dynamics of bank failure may warrant this institutional choice for this type of failure. But, the broader and deeper participatory qualities of markets and courts—where “work outs” typically occur—would make them better choices to address most failures most of the time.


Because most of the benefits of climate change regulation will accrue to future generations, the cost-benefit analysis of any regulation will turn in large part on the discount rate used to convert future dollars to their present value. A high discount rate means those future benefits will count for little, and climate change regulation will appear unjustifiable. A low discount rate, on the other hand, justifies more extensive action to mitigate the damage climate change will do to future generations.

Revesz and Shahabian, supra note 34, at 1100

There has been virtually no serious effort to consider the intergenerational consequences of governmental debt subsidies, or their effect on financial distress resolution. Cf. Richard C. Schragger, Democracy and Debt, 121 YALE L. J. 860, 864 (2012)(mentioning intergenerational challenges of state bankruptcy).
Financial distress has long been a serious social problem. Although we tell ourselves we have decriminalized failure, it appears increasingly to be the basis for incarceration. Debtors who do not end up in jail apparently turn to suicide in growing numbers. Sovereigns—whether States or Nations—increasingly cannot pay their debts, or risk anarchy as a consequence of “austerity” measures required by their resolution. These are early warning signs that financial distress is beginning to strain the boundaries of civil society. Institutional analysis helps to explain why this has happened, and what we can do about it.

1. Institutional Analysis

Institutional analysis describes a range of studies in several disciplines, including political science, economics, sociology, and law that share a common goal of better understanding how humans learn to address the “social dilemma” that frequently exists when individual and collective aims conflict. The term “institution” is, itself, the subject of a large and somewhat fluid set of discussions.


definitions. For purposes of developing a better understanding of financial distress, “institutions” are “large-scale social decision-making processes—markets, communities, political processes, and courts.”

In basic terms, we can distinguish analysis of the design of institutions from analysis of their comparative effectiveness. The former, which I will call “substantive institutionalism,” is often associated with the work of social scientists such as Elinor Ostrom and Douglass North, among others. Substantive institutionalism is concerned less with legal institutions (e.g., courts, agencies) than with the outcomes produced by virtue of the design of human affairs in the absence of (or despite) legal institutions. The latter, which I will call “process institutionalism,” takes as given the existence of different institutions, and focuses instead on their comparative effectiveness at solving social problems, and the processes by which choices are made amongst them.


I also put to one side the important, related contributions of “institutional economics,” whether in its “new” form (associated chiefly with Williamson), see, e.g., OLIVER E. WILLIAMSON, THE ECONOMIC INSTITUTIONS OF CAPITALISM (Free Press 1985); Oliver E. Williamson, The Economics of Organization: The Transaction Cost Approach, 87 AM. J. SOC. 548 (1981), or its “old” form. See, e.g., JOHN R. COMMONS, INSTITUTIONAL ECONOMICS: ITS PLACE IN POLITICAL ECONOMY (1936); John R. Commons, Institutional Economics, 12 AM. ECON. REV. 648 (1931).

As explained in text, while these other branches of institutional analysis offer valuable insights into understanding how better to manage financial distress, in the first instance, the process institutionalism I discuss here is likely of greatest salience to lawyers and other legal actors.

40 As Jepperson points out, the following list of things could all in common understanding be considered “institutions”: “marriage, sexism, the contract, wage labor, the handshake, insurance, formal organization, the army, academic tenure, presidency, the vacation, attending college, the corporation, the motel, the academic discipline, voting.” See Ronald L. Jepperson, Institutions, Institutional Effects, and Institutionalism, in THE NEW INSTITUTIONALISM IN ORGANIZATIONAL ANALYSIS 143, 149 (Walter W. Powell & Paul J. DiMaggio eds., 1991).

41 KOMESAR 2001, supra note 4, at 31 (“I use the choice among these institutional processes to clarify basic issues such as the role of regulation, rights, governments, and capitals. These processes are alternative mechanisms by which societies carry out their goals.”).

42 This is not, of course, to suggest that legal scholars have not made important contributions to understanding extra-legal arrangements that produce, in Ellickson’s famous phrase, “order without law.” ROBERT C. ELICKSON, ORDER WITHOUT LAW: HOW NEIGHBORS SETTLE DISPUTES 52-53, 72-76 (1991). See also Stewart Macaulay, Non-Contractual Relations in Business: A Preliminary Study, 28 AM. SOC. REV. 55 (1963).
Process institutionalism is not new, but it has not been brought to bear in any significant way on problems of financial distress. Because problems of financial distress are often (assumed to be) problems of legal process, this kind of analysis is a good place to begin to understand financial distress in institutional terms. The balance of this Article begins that work.

1.1 Process Institutionalism

Modern process institutionalism is rooted in the work of Henry M. Hart and Albert M. Sacks, who taught at Harvard Law School from 1932-1969 and 1952-1991, respectively. They

It dates back at least to the end of the 19th century, when Holmes opined that “[t]he duty to keep a contract at common law means a prediction that you must pay damages if you do not keep it—and nothing else . . . .” Oliver Wendell Holmes, The Path of the Law, 10 HARV. L. REV. 457, 462 (1897). So stating, he recognized the institutional optionality embedded in promissory relations. One can perform a contract one may have come to regret, in which case one has chosen the market as the institution to solve his or her problem. If, instead, one chooses to pay damages, one is advertising directly or indirectly to courts, which (in general) determine whether damages must be paid and, if so, in what amounts.

Holmes was in a sense anticipating Coase’s later observation that markets can be as effective as courts or legislatures in deciding whether to permit or prevent pollution. R.H. Coase, The Problem of Social Cost, in THE FIRM, THE MARKET AND THE LAW, 116-117 (1990). “[In the standard case of a smoke nuisance,” Coase observed, “which may affect a vast number of people engaged in a wide variety of activities, the administrative costs of paying the polluter to cease polluting might well be so high as to make any attempt to deal with the problem within the confines of a single firm impossible. An alternative solution is direct government regulation.”


This is not to suggest that substantive institutionalism has no place here. Much work can be done to bring the insights of writers such as Ostrom, North and others to bear on the “social dilemma” created by financial distress.


famously observed that legal systems—in particular courts—are but one of many institutions available to solve social problems: “[D]ifferent procedures and personnel of different qualifications invariably prove to be appropriate for deciding different kinds of questions,” they taught generations of law students. 48 “So it is that every modern society differentiates among social questions, accepting one mode of decision for one kind and other modes for others—e.g., courts for “judicial” decisions and legislatures for “legislative” decisions.” 49

1.1.1 The Importance of Hart and Sacks

Hart and Sacks were important because they expressed the felt but under-articulated view that judicial systems were only sometimes the best institutional choice to solve various problems. 50 In this way, they were in effect participating in a larger movement in legal thought toward outsourcing social engineering to non-judicial actors. This move is exemplified by Holmes’s deference to legislatures, 51 Brandeis’s to states as the source of common law, 52 and Frankfurter’s to administrative agencies, 53 and made inevitable (perhaps necessary) by the construction of the

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48 LEGAL PROCESS, supra note 4 at 4. As Wisconsin’s Lloyd Garrison and Willard Hurst, among the first to bring this thinking into the law school classroom explained, “the various agencies of the law, such as legislatures, courts and commissions, are themselves often in conflict; and that they together are only one of the many means of social control, which includes churches, schools, families, newspapers and so on.” See Lloyd K. Garrison and Willard Hurst, Law in Society: A Course Designed for Undergraduates and Beginning Law Students, 272 (rev. ed. 1940 1941) (quoted in William N. Eskridge, Jr. and Philip P. Frickey, An Historical and Critical Instruction to The Legal Process, in Hart and Sacks, supra note [], at hxxiv. Volume 1 of the 1941 edition of the Garrison/Hurst materials may be found at http://libed.law.wisc.edu/hurst/SERIES%20B/BOX%203/FOLDER%201/ITEM%201.PDF (visited June 1, 2012).

49 LEGAL PROCESS, supra note 4.

50 “[N]o social question can be intelligently studied,” they argued, “without a sensitive regard to the distinctive character of the institutional system within which the particular question arises.” Id. at 6.

51 See, e.g., Buck v. Bell 274 U.S. 200 (1927) (Holmes, J.) (upholding over due process challenge a state statute permitting compulsory sterilization of the unfit, including the mentally retarded, “for the protection and health of the state”).

52 See Erie R.R. Co. v. Tompkins, 304 U.S. 63 (1938).

modern welfare state. Each institution has its competencies, and it is unlikely that courts, as such, are the best at many things.  

Through their legendary teaching materials (never published in their lifetime\(^5\)\(^5\)), Hart and Sacks had an enormous effect on generations of lawyers.\(^5\) Their starting point was not controversial: Social institutions exist to “maximiz[e] the total satisfactions of valid human wants, and its corollary of a fair division of the presently available benefits of group living.”\(^5\)\(^5\) The important question for Hart and Sacks was not the meaning of words such as “maximize,” “satisfaction,” “valid,” “fair” or “benefits.” Rather, meaning would be invested in those terms procedurally, through what they called “institutional settlement.”\(^5\)\(^8\)

“The principle of institutional settlement,” they explained, “expresses the judgment that decisions which are the duly arrived at result of duly established procedures of this kind ought to be accepted as binding upon the whole society unless and until they are duly changed.”\(^5\)\(^9\) The key for Hart and Sacks, therefore, was institutional buy-in, calculated as a function of process quality: If enough people bought into the process enough of the time, the result would probably be good enough, enough of the time.

\(^5\) As Fontana and Braman note, institutions differ in terms of their “perceived competencies” and their “perceived results.” David Fontana & Donald Braman, Judicial Backlash or Just Backlash? Evidence from a National Experiment, 112 COLUM. L. REV. 713, 737-39 (2012).


\(^5\) They were later organized and published by Eskridge and Frickey as LEGAL PROCESS, supra note 4. Hart and Sacks’ work has been called “the most influential work not produced in movable type since Gutenberg.” See Eskridge & Frickey, supra note 55, at 2031 (quoting J. D. Hyman, Constitutional Jurisprudence and the Teaching of Constitutional Law, 28 STAN. L. REV. 1271, 1286 n.70 (1976)).

\(^5\) LEGAL PROCESS, supra note 4 at 105.

\(^5\) Id. at 4 (emphasis in original). “[T]he principle of institutional settlement . . . builds upon the basic and inescapable facts of social living . . . namely, the fact that human societies are made up of human beings striving to satisfy their respective wants under conditions of interdependence, and the fact that this common enterprise inevitably generates questions of common concern which have to be settled, one way or another, if the enterprise is to maintain itself and to continue to serve the purposes which it exists to serve.”

\(^5\) Id. at 4.
The price of failing to develop and sustain processes by which disputes can be “duly” resolved, they argued, would be anarchy, a Hobbesian war of all against all. “[R]egularized and peaceable methods of decision,” they argued, were the “alternative to disintegrating resort to violence.”

The concept of institutional settlement exists in a complex, reciprocating relationship with the rule of law, without which process would have little (or less) meaning. According to Eskridge and Frickey, Hart and Sacks “designated the judiciary as the guardians of rule-of-law values and envisioned the duty of judges to be the ‘reasoned elaboration’ of ‘neutral principles’ and legislative ‘purposes.” They developed the now-common distinction between “rules” and “standards” by which judges would have discretion to apply edicts from other branches (i.e., Congress) depending in part on the nature of the language and purpose of the law or rule. They would not, of course, be permitted unfettered discretion.

The difficult question for Hart and Sacks was how courts would respond when confronted with rules (or standards) that they found problematic because indeterminate in application or responsive to uncertain conditions. Because they tended to prefer deference to legislative majorities or administrative experts, they were sometimes accused of creating an intellectual justification for opposition to landmark jurisprudence that deviated from the rule of (extant) law.

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60 Id. at 4.
61 For example, in discussing the interplay between contract doctrine and federal agricultural regulation, they observed that “private decisions and official decisions” developed in ways that reflect a “chicken-and-egg relationship” that “def[y] any facile description.” Id. at 8-9.
62 Eskridge & Frickey, supra note 55, at [XX] (quoting LEGAL PROCESS, supra note 4, at 15 (“reasoned explanation”); 165, 386-406, 1407-26 (“principles”); at 166-67, 1178-1203, 1405-17 (legislative “purposes”)).
64 See Sable & Simon, supra note 44, at [XX] (discussing Hart and Sacks’ response to indeterminacy and uncertainty).
Yet, for Hart and Sacks, the rule of law—and the role of courts in deciding what the rule of law would mean—were central. While courts may not solve all problems, through judicial review and negation they play a powerful role in determining choices among, and the boundaries of, other social institutions.

Process institutionalism has had a powerful hold on the legal imagination for many years. Yet, it could not answer certain basic questions. First, process institutionalism treated social goals as exogenous to the institutions through which the goals would be implemented. How would we know, for example, what constituted “valid” human wants that social institutions should maximize? This may have led critics such as Duncan Kennedy to conclude that Hart and Sacks and other process institutionalists were intellectually dishonest for failing to disclose (or expose) their presumed political biases.

Second, if social goals were exogenous to process institutionalism, what role remained for law, as such? The logic of process institutionalism led inexorably to the view that law was politics by other means. Politics would, however, reflect the biases of its participants, whether voters in an electoral process or “contextualizing regimes,” in Sable and Simon’s terms, that reflect the expertise—and interests—of industry participants. Law was, in this sense, tragically limited in its

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66 The most prominent challenge of this form comes from the Critical Legal Studies movement, whose literature is too voluminous to cite usefully here. See, e.g., Duncan Kennedy, Form and Substance in Private Law Adjudication, 89 HARV. L. REV. 1685 (1976) (“substantive and formal conflict in private law cannot be reduced to disagreement about how to apply some neutral calculus that will "maximize the total satisfactions of valid human wants." The opposed rhetorical modes lawyers use reflect a deeper level of contradiction. At this deeper level, we are divided, among ourselves and also within ourselves, between irreconcilable visions of humanity and society, and between radically different aspirations for our common future.” (quoting LEGAL PROCESS, supra note 4, at 113)); Robert W. Gordon, Critical Legal Histories, 36 STAN. L. REV. 57 (1984).

67 See Sabel & Simon, supra note 44.
ability to expose or remedy political biases because it was always a product of those biases. Courts may be able to constrain majorities some of the time, but not most of the time.

1.1.2 Interest Group Theory

These questions created an opening for what has become an important (perhaps the dominant) explanation for how social goals are realized: interest group theory (IGT). This predicts that institutional design and choices will be determined by concentrated minorities of special interests. In essence, this view holds that political actors are simply selling their decisions to the highest bidders. Usually, those bidders will be well-organized, well-financed interest groups represented by professional lobbyists.

It takes little imagination to recognize that the me plus ultra of such interest groups are elite financial services firms (SF’s described in the Prologue). They have long heavily influenced (or attempted to influence) the political process as it affects their activities, often under the guise of “deregulation”. Johnson and Kwak, in their popular account of the financial crisis, characterize the dominant SF’s—the “13 bankers” of their title—as having created an “oligarchy” that holds regulators in their thrall. Congressman Barney Frank—whose name is half of Dodd-Frank—has claimed that “all these years of deregulation by the Republicans and the absence of regulation as

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68 A word about the word “bias.” I use it here to refer to preferences of stakeholders. Bias is an inevitable feature of stakeholder participation, and so is not necessarily problematic. Bias becomes troublesome, however, when it produces net social costs (however measured) not internalized by active stakeholders. Economists would refer to the product of bias as “externalities,” “transactions costs,” or “market failures.” (Of course, a goal of this paper is to show that market-based understandings of bias are but one of many institutional ways to characterize the costs of different institutional choices). To the extent bias is problematic, better institutional choices will help to reduce—but never eliminate—the costs of those biases.

69 See, e.g., JAMES M. BUCHANAN & GORDON TULLOCK, THE CALCULUS OF CONSENT (1962); Paul H. Rubin, On the Form of Special Interest Legislation, 21 PUB. CHOICE 79 (1975);

70 See, e.g., JOHNSON AND KWAK, supra note 5, at 191 (discussing, in a chapter entitled “The American Oligarchy,” “the enormous growth of top-tier financial institutions and the corresponding increase in their economic and political power.”).
these new financial instruments have grown have allowed \(SF^2\)'s to take a large chunk of the economy hostage. And we have to pay ransom, like it or not.”

This has intuitive appeal.\(^7\) The U.S. government did embark on a kind of deregulatory program beginning in the early 1970s that saw many industries—from airlines\(^7\) to telecommunications firms\(^7\) to financial services firms\(^7\)—freed from fetters created during and in the wake of the New Deal.\(^8\) Localized to problems of financial distress, there are many glaring examples of deregulation at the behest of \(SF^2\)'s that doubtless contributed to the financial crisis. In 2000, Congress decided in the Commodity Futures Modernization Act that swaps (including credit default swaps) should not be regulated at all.\(^7\) In 2004, the SEC loosened the “net capital” rule, which required that securities broker-dealers limit their debt-to-net capital ratio to 12-to-1.\(^7\) The five investment banks that qualified for an alternative rule—Bear Stearns, Lehman Brothers, Merrill Lynch, Goldman Sachs, and Morgan Stanley—were allowed to increase their leverage ratios, sometimes, as in the case of Merrill Lynch, to as high as 40-to-1. The Federal Reserve repeatedly


\(^7\) 7 U.S.C. § 2(g) (2006).

declined calls to regulate mortgage brokers who originated many problematic subprime mortgages. These and other examples of “deregulation” can best be understood as a series of institutional choices preferring markets to other institutions.

Yet, institutional analysis suggests that the real story is more complex, for at least two reasons. First, it is incomplete. If “unregulated financial markets” were the “consensus position” in Washington, then Congress would never have enacted, and presidents—both Democrat and Republican—would never have signed laws such as FIRREA, Sarbanes-Oxley and Dodd-Frank, which sought to constrain risk-taking, among other things, and imposed enormous regulatory burdens and costs on SFs. Deregulation was never a pure or purely implemented strategy.

Rather, when it comes to financial distress, and laws regarding financial services (which often indirectly affect financial distress), institutional analysis reveals a more complex cycle. In the modern pattern, SFs may seek deregulation, for example of savings and loans (a kind of bank) in the Garn St. Germain Act. Thereafter, many savings and loans failed in the 1980s. But this, in

79 See, e.g., FCIC REPORT, supra note 7, at 77 (“The Fed-Lite provisions under the Gramm-Leach-Bliley Act affirmed the Fed’s hands-off approach to the regulation of mortgage lending.”) Many scholars have been quite critical of the Fed’s claims in this regard. Consider, for instance, the testimony of Professor Kurt Eggert: “The Federal Reserve Board, which held the authority to issue regulations under the Truth in Lending Act and might have curbed the no documentation and exotic loans with multiple layers of risk, instead chose until too late to trust banks largely to self-regulate. The Federal Reserve Board’s then chair seemed to disdain consumer protection, and withheld needed regulation in the belief that lenders’ own self-interest would cause them to act responsibly.” Testimony of Kurt Eggert before the U.S. Senate Committee on Banking, Housing and Urban Affairs. Dec. 1, 2010, available at http://banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=2ab0a7bc-12ee-4cf8-bb70-745b1d0372ab.

turn, begat new regulation (FIRREA), which led to periods of stability, followed by later calls for deregulation.\textsuperscript{84}

Nor is this pattern new. It describes, for example, the rise and repeal of the several bankruptcy laws that were enacted in the 19\textsuperscript{th} century.\textsuperscript{85} In the dominant pattern, creditor interests, usually from the east coast, would press their rights as creditors to collect from debtors in other regions (e.g., the south or Midwest). Larger economic events—recessions, wars—would cause large numbers of debtors to fail, which would lead large numbers of creditors to enforce their rights. Concerns about aggressive creditor enforcement would lead political actors (e.g., Congress) to sometimes view debtors as victims who needed protection, through procedural mechanisms such as the bankruptcy stay and discharge, which are essentially injunctions against the collection of otherwise lawful debts.\textsuperscript{86}

Thus, the first federal bankruptcy law was not enacted until 1800, despite repeated attempts, and then lasted only until 1803, repealed two years short of its scheduled sunset date.\textsuperscript{87} The nation would not have another bankruptcy act until the equally ill-fated act of 1841.\textsuperscript{88} A “permanent” bankruptcy law was not enacted until 1898.\textsuperscript{89}


\textsuperscript{86} See, e.g., Lipson, \textit{Debt and Democracy}, supra note 35, at 613 (discussing history of legislation to protect “honest but unfortunate debtors”). See also 42 \textit{Congressional Globe} 2638 (June 1, 1864) (Thomas A. Jenckes, R.I.) (“Of what advantage can it be to creditors or to the country that so many tens of thousands of the active men of this country should be held in thrall dom? They bear upon their limbs no visible chains, they have no masters who will yield them food for their toil, yet they are in the power of those who may sweep off their earnings at any time, and in some States may incarcerate their persons in prison. . . .”); \textit{Congressional Globe App}, 26 Cong., 1st Sess. 846 (June 4, 1840) (Henry Clay, Ky.) (“I maintain that the public right of the State in all the faculties of its members, moral and physical, is paramount to any supposed rights which appertain to a private creditor. This is the great principle which lies at the bottom of all bankrupt laws.”).


\textsuperscript{88} Bankruptcy Act of 1841, ch. 9, 5 Stat. 440,\textit{ repealed by Act of} Mar. 3, 1843, ch. 82, 5 Stat. 614. There would be one
Why the back-and-forth? The answer in part is the complex interplay between small, concentrated groups of creditors, who largely resisted bankruptcy laws, and the occasional need to protect large groups of debtors from enforcement of otherwise lawful obligations, under bankruptcy laws. Interest group theory could, in other words, explain some but not all of what actually happened with bankruptcy laws, one of several different institutional responses to financial distress.

This pattern extends well beyond bankruptcy. Figure 1 offers a glimpse of this cycle, plotting the rise and fall in the number of proposed and final rules promulgated from 1987-2005 by the Securities and Exchange Commission (SEC) and the Office of the Comptroller of the Currency (OCC). It shows that, rather than a steady decrease (or increase) in the number of rulemakings, rulemakings tended to rise and fall, reaching a peak in the Clinton administration and a trough in the administration of George W. Bush.90


90 The data were collected by Jason and Susan Yackee from notices of proposed and final rulemakings, promulgated under 5 U.S.C. § 553.
Figure 1. Proposed and Final Rulemakings of SEC and OCC (1987-2005)

Of course, regulators are an important presence at the highest levels. If nothing else, they give SFs’s cover when things go wrong. As the Lehman Brothers examiner’s report noted, regulators occupied several offices in the investment bank before it collapsed. They either were not aware of, or were not concerned about, Lehman’s financial condition, or some of its more questionable transactions such as “Repo 105.” Nor has increased regulatory supervision prevented more recent financial debacles, such as those involving MF Global and JPMorgan Chase, both of which engaged in highly risky transactions that proved enormously costly to the firms.

91 See Report Valukas, supra note 17, vol. III.A.4, at 913, available at http://jenner.com/lehman/lehman/VOLUME%201.pdf. (“Asked if the SEC – in connection with its monitoring responsibilities under the CSE division – would have wanted to know that Lehman’s net leverage calculation was based, in part, on “true sale” accounting for certain repo transactions, Eichner [of the SEC] explained that because the SEC’s CSE monitors did not put much stock in leverage numbers, knowledge of the volumes of Repo 105 transactions would not have signaled to them ‘that something was terribly wrong.””).

92 According to the Wall Street Journal, “[u]nder pressure from regulators last summer to increase its capital cushion, MF Global moved some of its risky European debt holdings to an unregulated entity in an effort to avoid having to raise extra money, according to a new report” issued by MF Global’s bankruptcy trustee, Louis J. Freeh. “Shifting the bonds...
The power of large, sophisticated firms with vast amounts of capital and expertise to influence institutions is real and quite serious: When they do not like a regulatory ruling, they can appeal to the D.C. Circuit, which appears inclined to take their side as against the government. But interest group theory—and its expectation that sophisticated minority interests will purchase governmental control—is factually incomplete. Interest groups often fail to get what they want.

This suggests the second, and perhaps larger, problem with interest group theory. Being organized around problems of minoritarian bias, it ignores the possibility that many institutional decisions may be the product of majoritarian bias. We frequently advert to concerns expressed by Tocqueville and the authors of the Federalist papers about the “tyranny of the majority.” Mostly, we associate fears of majoritarian bias with problems of poor decision-making or in-group


95 See ALEXIS DE TOCQUEVILLE, 1 DEMOCRACY IN AMERICA CH. XV “A majority taken collectively is only an individual, whose opinions, and frequently whose interests, are opposed to those of another individual, who is styled a minority. If be admitted that a man possessing absolute power may misuse that power by wrongdoing his adversaries, why should not a majority be liable to the same reproach? Men do not change their characters by uniting with one another.” See also THE FEDERALIST NO. 15 (James Madison) “It is of great importance in a republic not only to guard the society against the oppression of its rulers, but to guard one part of the society against the injustice of the other part. Different interests necessarily exist in different classes of citizens. If a majority be united by a common interest, the rights of the minority will be insecure,” available at http://www.ourdocuments.gov/print_friendly.php?flash=true&case=transcript&doc=10&title=Transcript+of+Federalist+Papers%2C+No.+10+&amp;percent=3B+No.+51+%3B+381787.1788%29&no=51.
dominance. The history of racial subordination, for example, can be understood as a problem of majoritarian bias. Our system can survive with only limited tolerance of true, direct democracy, because the mass of voters are under-informed, easily manipulated and poor judges of their (and society’s) better interests.

Localized to certain types of financial distress, one can see many of the bankruptcy laws enacted in the 19th century—and even the 1978 Bankruptcy Code that forms the basis for current bankruptcy law—as expressing a majoritarian bias for debtors. We can imagine, for example, that expanding access to the discharge for ever-growing numbers of smaller debtors—farmers and tradesman in the 19th century, consumers in the 20th century—was fundamentally a majoritarian move because there were simply so many more debtors than creditors who would benefit from having the ability to discharge their debts. Saving large numbers of debtors from the power of a small number of creditors, while possibly violating well-established common law principles of contract, would nevertheless secure sufficient popular support for at least enough Congressmen that it became a worthwhile endeavor.

When it comes to financial distress—both its creation and its resolution—majoritarian bias may actually present the greatest challenge we face. This is because we can understand participation at this level not merely in immediate terms, but also in temporal terms. In immediate terms, SFs may capture certain elements of certain institutions for some gains—as indeed happened in the partial deregulation of financial services that began in the late 1970s and the 2005 amendments to the Bankruptcy Code, making it more difficult for consumer debtors to discharge their debts. But

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96 This was, indeed, the pattern especially through the 19th century. See Skeel (2001), supra note 85, at 30.

97 Id. at 16.
debt—and the distress that occurs when it cannot be repaid—has certain unique characteristics, one of which is temporal: It is almost always about enjoying today and paying later.

In this sense, we can see that IGT presents serious fiscal concerns. Bribes can also take the form of debt subsidies, which are typically indirect or implicit. To the extent that debt subsidies, whether through government guarantees, or special treatment of derivative instruments, inflate debt beyond that which the market would create, we in effect trade on the ultimate majoritarian bias: That of the present generation, which enjoys the benefits of borrowing, as against the costs imposed upon a future that will have to reckon with the day when payment is due.

Future generations may pay for this in either or both of two ways. First, and most obviously, future stakeholders (whether taxpayers, student-debtors or bondholders) will have to foot the bill for today’s debt subsidies, or deal with the fact that the government cannot service the debt at rates it would prefer. Second, debt service will hive off expenditures that could support long-term social goods, such as primary research and development, education, and infrastructure improvement. While direct government debt can (and will) finance some of those very same projects, the greater the government’s burden for private debt subsidies, the less fiscal latitude it will have to invest in whatever other social projects are deemed worthwhile (including a reduced tax burden if deemed politically desirable). The intergenerational consequences of debt subsidy are significant, yet we pay remarkably little attention to this institutional distribution of participation.  

1.1.3 Komesar’s Contribution—Participatory Process Institutionalism

Hart and Sacks, and other early process institutionalists, recognized that courts were but one of many institutions that could solve social problems, and may not be the best for any given

98 See sources at note 34, supra. This will also tend to make public finances more opaque Viral V. Acharya, Government as Shadow Banks 90 TEX. L. REV. 1745, 1755-1758 (2012).
problem. While interest group theory offered an explanation for how those choices are made, they could not account for majoritarian responses.

Behind these developments were two deeper questions. First, given the possibility of variation in institutional performance and attributes, how do we actually compare them? How do we know when one (e.g., markets) may be more effective than others (e.g., courts) at solving particular types of problems? Second, and more vexing, was the “meta-question”: Who decides who decides? That is, given the reality that many institutions could solve the same problem—but some better than others—how do we go about deciding which institutions should actually make the choice? Neil Komesar, of the University of Wisconsin, addressed these questions.

Komesar recognized that, while institutions are large-scale decision-making processes, individual stakeholders comprise them. According to Komesar, the performance of (and choices among) institutions is (are) determined by the nature of participation in those institutions. The character of participation, Komesar has argued,

is determined by the interaction between the benefits of that participation and the costs of that participation. The benefit side focuses on the characteristics of the distribution of benefits or stakes across the relevant populations. The central determinants are the average per capita stakes and the extent to which per capita stakes vary within the population. The cost side focuses on the costs of participating in the institutions—transaction costs, litigation costs, political participation costs. These costs generally fall into one of two broad categories—the cost of information and the cost of organizing collective action.

Thus, other things equal, those endowed with the greatest resources, and playing for the highest stakes, are likely to be the most active participants in whatever institutional setting they occupy. For those with low stakes, the problem will not matter. In many cases, small, well-resourced groups playing for high stakes—financial services firms—will produce the “minoritarian

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99 KOMESAR, 2001, supra note 4, at 30
bias” predicted by interest group theory. Yet, as noted above, it is often the case that majorities will in the end produce equal or greater distortions.

Using the simple example of tort law, Komesar shows how the distribution of stakes affects institutional performance and choice. If, for example, we wish to deter forest fires, we would recognize that neither courts nor markets are likely to be the most effective institutional choice because of the distribution of stakes among participants—those affected by the social problem in question. Instead, government is—and is in fact the choice we will likely make. But the question is how do we get there? What model shows this to be a sensible institutional choice?

1.1.3.1 Participation

The answer is stakeholder participation. In the case of forest fires, any one of a very large number of individuals could cause a significant harm. An individual camper failing to douse her fire could destroy forests and homes of enormous value, and cause personal injury or death. The ex ante stakes are low and widely distributed, and the ex post costs are high and widely distributed.

For this sort of distribution, Komesar argues that courts and markets are poor institutional choices because of their unique characteristics. Courts of general jurisdiction tend to be formalistic, bound by precedent, inexpert and atomistic. That is, they use fairly rigid rules of proceeding, proof, and decision to determine individual cases ex post, and (usually) without expertise about the problem. Their decisions are subject to review by remote, inexpert, and constrained courts of appeals. Courts are thus unlikely to deter careless campers from starting forest

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100 Id. at [XX]


fires and, if a forest fire were litigated, unlikely to remedy the harm: successful plaintiffs are unlikely to collect from a judgment proof individual defendant.

But the important question, Komesar explains, is not whether courts are good or bad in isolation at solving a particular problem. Rather, the important question is how they compare to other institutions in dealing with the same problem.\textsuperscript{103} All institutions tend to perform poorly, he notes, and tend to move in similar directions, so the marginal benefits of one institution over another may be small.\textsuperscript{104} Nevertheless, if the goal is deterring a harm perceived to have low ex-ante costs affecting a wide distribution of both injurers and injured, courts may not perform as well as other institutions.

Thus, if we stay with forest fires, and compare courts to markets, we would have to ask whether individual market transactions could do better than courts at preventing or remedying forest fires. The answer here, too, is probably “no.” From a stakeholder perspective, markets are characterized by millions of transactions per day, usually between individual actors (or, perhaps more commonly, between individuals and firms). The modus operandi here is going to be the contract, whether the (probably unread) end-user license used to make purchases from iTunes or the more complex securitization.

The broad distribution and low ex ante stakes of a forest fire make the market an unlikely institutional solution to the problem of preventing or fighting forest fires. Individuals who enter a forest may agree explicitly or implicitly to take precautions designed to prevent fires.\textsuperscript{105} And the

\textsuperscript{103} Id. at 6 (“The correct question is whether, in any given setting, the market is better or worse than its available alternatives or the political process is better or worse than its available alternatives.”)

\textsuperscript{104} KOMESAR, 2001, supra note 4, at 23-24.

process of posting warnings that imply a form of consent might have some cognitive effect that does lead to some deterrence. But the reality seems to be that when we go camping, we do not purchase insurance against starting a forest fire, which would be the only way we could credibly commit to a market transaction designed to prevent this harm. Nor do those who own or operate forests (e.g., the national park service) appear to require any of the contractual formalities one would expect in a market transaction designed to distribute risk of loss ex ante. It is too costly and uncertain to justify the effort.

This would then leave government, which in fact seems to be the principal choice we make when thinking about deterring forest fires ex ante, or fighting them ex post. Those of a certain age will recall “Smokey the Bear”, a cartoon character created to promote fire safety in national parks. Criminal liability associated with recklessly starting a forest fire is likely to be an even more effective deterrent. And, of course, if a fire does start, we do not expect courts or markets to put it out. We expect the government, in the form of fire fighters, to do so.

When will courts perform well? Often in what Komesar calls a “shifted distribution.” In a shifted distribution, “victims’ low distribution ex ante becomes a high uniform distribution ex post.” Staying with torts, this shift may occur, for example, where a small number of manufacturers place consumer goods into the stream of commerce that appear harmless but in fact cause great harm, ex post. Thus, the famous exploding Ford Pinto case, Grimshaw, may be seen as

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106 Smokey the Bear originated as a concept during World War II, presumably due to shortages in firefighting capacity during the war. It is currently the Ad Councils longest running campaign. See Wildfire Prevention, http://www.adcouncil.org/Our-Work/The-Classics/Wildfire-Prevention.


108 KOMESAR 1994, supra note 3, at 135.

an effective institutional use of the judiciary responding to a shifted distribution. It provided a remedy (one admittedly claimed too big\textsuperscript{110}) and this remedy likely had an important deterrent effect on other manufacturers, for whom the risk of multi-million dollar liability created very high stakes. The shift in the distribution, coupled with a court that imposed punishing liability, made courts an effective institutional choice for solving that sort of problem.

Adapting this analysis to financial distress requires that we relax certain assumptions. It is, for example, not always clear who the “injuror” or “injured” is in any case of financial distress. At least presumptively, we would say that unpaid creditors are the “victims” of a debtor who has failed to pay as promised. Indeed, while many of our financial distress legal systems have de-stigmatized financial failure, it nevertheless remains the case that they exist largely—albeit not exclusively—to protect aggregate creditor interests.\textsuperscript{111} Thus, in the case of bank panics, regulators are interested in significant part in protecting depositors, who are highly vulnerable to losses if a bank fails and does not have federal deposit insurance. In the case of bankruptcy—the process available to most non-bank debtors—the automatic stay of collection exists in large part to preserve value for creditors that would likely be lost in a disaggregated race by individual creditors to obtain and enforce judgments against the debtor.

When stakes are uniformly high or low, courts of general jurisdiction may not be the most effective institutional choice. This is because a high-stakes problem affecting a concentrated or well-resourced group will likely be solved in the market place. For example, at least until the financial

\textsuperscript{110} See Jonathan C. Lipson, Cost-Benefit Analysis and Closing Opinion Practice, 63 B.U. L. Rev. 1187 n. 113 (2008) (“Grimshaw’s estate was awarded $2.5 million in compensatory damages, and $125 million in punitive damages, which was later reduced to $3.5 million. The case is legendary in Cost Benefit Analysis discussions because it appears that the jury punished Ford in part because it had done [Cost benefit analysis]”).

\textsuperscript{111} And, of course, the 2005 amendments to the Bankruptcy Code were intended in part to “get tough” on consumer debtors, thus suggesting a Congressional desire to restigmatize financial distress, at least at the consumer level. See Lipson, Debt and Democracy, supra note 35, at [XX] (discussing legislative history of 2005 amendments to Bankruptcy Code).
crisis of 2008, the presumptive institutional choice of sophisticated financial firms was a private workout, backstopped by the possibility of judicial action (bankruptcy) if the deal failed to gel or be honored.

When stakes are uniformly low, courts may also perform poorly by contrast to other institutions. This, for example, may help to explain in part the chronic inability of banks to process the foreclosures of millions of defaulted mortgages. As to any given mortgage, the stakes for the mortgagor (or mortgage servicer) will likely be low (or at least uncertain). Borrowers who are underwater, or who live in non-recourse states, or who simply no longer care, may well walk away from their mortgage—and the foreclosure process—leaving courts to struggle with mountains of poorly documented transactions. While one would hope that markets—workouts—would do much of the work, here, this same indifference to the litigation process likely leads homeowners and mortgagees to stalemates, or worse.

This leaves political solutions, which have not yet been terribly effective at the consumer level. Programs such as “HOPE NOW,” “HOPE for Homeowners,” “HAMP,” and “HAFA,” designed to alleviate the burden on distressed homeowners, have generally been far less

successful than many hoped. This is due not merely to the broad distribution of low stakes, but complicating factors such as the interactions of multiple institutions and the special role that information and computer technologies play (discussed more fully in the next subpart). In particular, we see a breakdown of participation, as lenders and borrowers lack incentives or mechanisms to efficiently renegotiate the mortgage contract.

At the level of large financial institutions, by contrast, it would appear government worked quite well. Indeed, if one worries about the power of SFIs to dominate institutional decision-making, one might say that it has worked too well.

1.1.3.2 Choices Among Institutions

Komesar’s model does not offer an agency-based model of choice among institutions. That is, it is not like the problem of regulatory capture, identified by interest group theory, because institutions are so large that individual actors—even “oligarchies” of “too-big-to-fail” banks—cannot decide which among them would be best for a particular problem. Instead, the participatory nature of institutional dynamics will determine which institutions are in fact chosen to solve particular problems. Bear Stearns, for example, may have “chosen” government. But government also had to “choose” Bear Stearns. If government was unwilling to provide the institutional solution for Bear Stearns, it would (presumably) have ended up looking more like Lehman Brothers than AIG. Institutional—not individual—forces made that choice available to Bear, and Bear took it, as did many other SFIs.

Two particular factors are likely to affect how participation occurs, and thus how institutional choices will be made: “complexity and numbers.” “Complexity” can refer to many

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117 See Salsich, supra note 27, at 40 (“achieving success” in these programs “has proved to be very difficult.”).

118 KOMESAR 2001, supra note 4, at 23 (“Numbers and complexity are variables of great import. They generate shifts and cycles in law and rights. Viewed through the lens of comparative institutional analysis, it is a pattern of shifts and
things, but it is not hard to see that it includes the many elements in a financial transaction (e.g., a securitization), the many special purpose entities created to facilitate that transaction, or the many steps required to obtained a particular result in a regulatory proceeding. Transactions, markets, and the legal institutions that purport to regulate them all present powerful examples of complexity that will necessarily affect the quality and quantity of participation. The greater the complexity of debt and debt-like transactions, the more difficult it can become for courts or even markets to address failures in performance. While government may be a problematic choice for many reasons, it may also be the least worst because of its access to money, force and expertise.

So, too, for “numbers.” When the number of debtors, or the amount of debt, is small, any trouble in repayment is unlikely to have larger institutional consequences. But as the number and amount of debtors and debt grows—and it has grown at a fantastic rate since the early 1980s—the number of cases of financial distress of all stripes rises. The number of stakeholders affected by financial distress today is enormous. Large corporate debtors can have thousands of creditors. Large financial services firms in distress (e.g., banks) can have thousands or tens of thousands of depositors or other stakeholders (e.g., credit cardholders) who would be affected by its financial distress. If one further recognizes that most U.S. citizens are both debtors and creditors in some cycles more compelling and intriguing than that generated by single institutional analysis.


120 See Kartik Athreya, Xuan S. Tam, & Eric R. Young, A Quantitative Theory of Information and Unsecured Credit, 4(3) A. M. Econ. J. 153 (2012) (finding that “the use of unsecured credit [by consumers] has . . . nearly tripled, as measured by the ratio of aggregate negative net worth to aggregate income, from 0.30 percent in 1983, to 0.67 percent in 2001, to 0.80 in 2004”). As Sullivan, Warren and Westbrook have famously observed, during roughly the same period, the number of consumer bankruptcies has also risen dramatically, from less than 0.1 percent of households/year commencing a bankruptcy case in the 1970s to more than 1.0 percent/year since 2002. THERESA A. SULLIVAN, ELIZABETH WARREN, & JAY LAWRENCE WESTBROOK, THE FRAGILE MIDDLE CLASS: AMERICANS IN DEBT (2000).

non-trivial sense—they owe money for their student debts, credit cards, home mortgages, etc and are owed money by their banks (as depositors) and through holdings of money market mutual funds—the numbers are quite large. It is not surprising that a major breakdown in the system could affect all or almost all of the nation.

Courts, Komesar argues, are generally better at addressing simpler problems involving smaller numbers. Thus, problems of increasing complexity, involving larger numbers of people, will likely tax courts beyond their institutional capacities. Other institutions, in particular government with its greater resources, will then inevitably become the default institutions for resolving such problems. This, in fact, seems increasingly to be the story of financial distress. This then sets the stage for problems of majoritarian bias and debt subsidy largely ignored in literature to date.

1.2 Adapting Process Institutionalism

Process institutionalism developed in an era with simpler financial institutions and technologies. While Congress obviously had the Constitutional authority to regulate bankruptcy, it did not fully exercise the power until 1978, when it enacted the current Bankruptcy Code, creating a somewhat controversial system of courts through which to exercise it. Neither securitization nor hedge funds existed in any meaningful sense when Hart and Sacks were teaching at Harvard. Thus, while institutional analysis offers helpful insights into understanding the dynamics of financial

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122 “Courts' ability decreases as the number of parties and the complexity of the issues increases. As the number of potential plaintiffs or defendants increases, the costs of bringing actions increase and the dynamics of litigation become more complex . . . . The problems of collective action that plague market transactions as numbers increase also plague adjudication: larger numbers mean more hold-outs and greater likelihood of failed settlement.” Komesar, 2001, supra note 4, at 21).

123 U.S. CONST. Art I, § 8, cl 4.

124 See sources at note 9, supra.

125 See Lipson, Re: Defining, supra note 119 at [XX] (discussing history of securitization).
distress (more fully explored in Part 3), it also must be adapted to reflect the current reality that institutions (at least in this context) interact in important ways, and that information and computer technologies will influence questions of “numbers and complexity” and, to this extent, stakeholder participation in financial distress. I suggest both adaptations in this subpart.

1.2.1 Institutional Interactions—Bleeding, Braiding, and Competing

Process institutionalism imagines social institutions as discrete abstractions, insulated from one another, a bit like we imagine corporations to have distinct legal personality. In fact, it would appear that social institutions interact in complex and important ways, at least when dealing with problems of financial distress. I discuss three examples—“bleeding,” “braiding,” and competing—in this subpart.

Institutional “bleed” occurs when different institutions overlap in some important way. The most obvious example is reflected in the much-lamented “revolving door” between regulators and those who are regulated. Close ties between Wall Street and major financial authorities such as the Federal Reserve Bank of New York and Treasury have long been a cause for concern. Periodic attempts to constrain such opportunism appear unlikely to succeed in the short run. It is difficult to imagine that Henry Paulson—former head of Goldman Sachs—would subject that (or other) financial institutions to the independent level of scrutiny envisioned by reformers such as Brandeis, Frankfurter, and Douglas, who were leading proponents behind many of the reforms that created the modern financial regulatory system.126

In the world of financial distress, social institutions bleed into one another in complex ways. To take but the most prominent example, consider ongoing skirmishes about the proper boundaries of bankruptcy court jurisdiction. Bankruptcy courts are not courts of general, original jurisdiction. Instead, they exist to carry out a particular power—that given to Congress in Article I of the Constitution to enact “uniform laws on the subject of bankruptcies.” As I and others have observed, this is a unique, and problematic, division of institutional labor, because it has in effect placed bankruptcy judges in the position of having to exercise the “judicial power of the United States” without the institutional protections required by Article III of the Constitution, life tenure and salary guarantee.

Thus, in the most recent salvo over this structural exceptionalism, the Supreme Court said in the 2011 decision in *Stern v. Marshall* that “[B]ankruptcy judges lack authority under Article III of the Constitution to enter final judgments on claims that constitute ‘the stuff of the traditional actions at common law tried by the courts at Westminster in 1789.’” This is a problem for bankruptcy judges—and indeed the entire bankruptcy system—because the bankruptcy process depends for its *effectiveness* on the power that bankruptcy judges have to exercise the “judicial power” in deciding such basic common law questions as whether a creditor’s claim is (or is not) enforceable.

The important point here is not whether *Stern* was right or wrong, but to note that it is an especially prominent example of institutional bleed. As far as the Roberts’ Court is concerned,

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127 U.S. CONST. art. I, § 8, cl. 4.
130 Admittedly, the *Stern* majority claimed its holding—that a bankruptcy court could not adjudicate Vicki Lynn Marshall’s “tortious interference with gift claim”—was “narrow.” Id. at 2620. But many worry that it will not be so interpreted, and courts have thus far struggled to understand its boundaries. See, e.g., Hon. Richard J. Leonard, Foreword, *Marathon at 30: A Symposium Issue*, 86 AM. BANKR. L. J. 1, 2 (2012) (“the disconnect between the final comforting words [of the *Stern* majority opinion] and the logic that the [C]ourt employed pushes in other directions.”). See also Ortiz v. Aurora Health-Care, Inc., 665 F.3d 906 (7th Cir. 2011) (interpreting *Stern* broadly to preclude bankruptcy judges from adjudicating any affirmative claims against creditor arising from improperly-filed proofs of claim).
bankruptcy courts are beholden to—and thus enmeshed in—Congress. This, the Court believes, renders them institutionally incapable of asserting the independence needed to exercise legitimately the federal “judicial power” in our constitutional order. But, that simply means that two seemingly discrete institutions—courts and political actors—in fact must work in tandem to solve certain classes of financial distress: those for which Congress has deemed “bankruptcy” the appropriate remedy. As discussed below, institutional analysis shows how such interactions are not only the norm, but when they are—and are not—likely to be socially productive.

Institutions also interact in this context synergistically, “braiding” to produce (sometimes) better results in collaboration than a single institution could in isolation. “Braiding” is a term I borrow from contract theory literature that explains how different contractual and social functions can interweave to produce a whole greater than the sum of its parts.

As developed in greater detail in Part 3, perhaps the most prominent examples of this will involve the conjunction of the market, on one hand, and some more official actor, on the other, to resolve financial distress. Thus, for example, when banks fail, the FDIC typically seeks to have another, healthy bank, waiting in the wings to take over the failed bank’s operations in a “purchase and assumption” transaction. This is institutional braiding, as it involves regulators (indirectly political actors) and the market (a private ordering transaction) to resolve financial distress. The bankruptcy process, too, depends heavily on braiding. Because chapter 11 reorganizations are

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131 There is thus no obvious reason that “bankruptcy” could not be addressed by administrative agencies, as distinct from courts. It is largely an accident of history and politics that bankruptcy is judicial—not a governmental—institutional function. See Lipson, Debt & Democracy, supra note 35, at 624-625 (discussing exceptional nature of bankruptcy court status in structural understandings of the Constitution).

132 See, e.g., Ronald J. Gilson, Charles F. Sabel & Robert E. Scott, Braiding: The Interaction of Formal and Informal Contracting in Theory, Practice, and Doctrine, 110 COLUM. L. REV. 1377, 1380 (2010) (describing “braiding” among formal and informal contract enforcement mechanisms as “reliance on one type [which] interacts with reliance on the other”); Ronald J. Gilson, Engineering a Venture Capital Market: Lessons from the American Experience, 55 STAN. L. REV. 1067, 1091 (2003) (“By braiding I mean the fact that the structure of [two] contracts are intertwined, each operating to provide an implicit term that supports the other, and thereby increasing the contractual efficiency of both.”).
generally expected to be negotiated processes, but subject to court approval, markets and judges in effect work together.\textsuperscript{133}

Moreover, it would appear that institutions in effect compete in attempting to address financial distress. While “bankruptcy” as such has lost much of its stigma, it nevertheless appeared sufficiently threatening to political actors in 2008 that government intervention was required in order to manage the crisis.\textsuperscript{134} Thus, political actors viewed themselves as being in competition with courts. Even in the absence of crisis, deeper social goals can place different institutions at odds with one another. The commands of the bank regulator to promote safety and soundness\textsuperscript{135} may well conflict with the aspirations of the Bankruptcy Code, which seeks to protect debtors through, among other things, the stay of collections and discharge of debts.\textsuperscript{136} What title 12 (the banking provisions) of the United States Code give to federal regulators and the banks they regulate, title 11 (the bankruptcy provisions) can take way.

In short, institutional analysis requires a better sense of boundaries between and interactions among institutions. Bleeding, braiding and competition among institutions are inevitable, and there is no reason to think these interactions should stop. Rather, the important question is how to adapt institutional analysis in the light of this form of interaction.

\textsuperscript{133} At a higher structural level, one can see this braiding occurring in Congressional delegation of power to the executive, in famous cases such as \textit{Youngstown Sheet}. Recall Justice Jackson’s concurrence in the steel seizure case: \textit{See Youngstown Sheet & Tube Co. v. Sawyer}, 343 U.S. 579, 635 (1952) (Jackson, J., concurring) (when the President acts pursuant to an express or implied authorization, his authority is at its maximum, for it includes all that he possesses in his own right plus all that Congress can delegate.

\textsuperscript{134} \textit{See Lipson, Shadow Bankruptcy, supra note 10, at 693 (discussing fears of bankruptcy)}.


1.2.2 Information and Computer Technologies

In addition to recognizing that social institutions interact in ways that can have important consequences for institutional analysis, we must also confront the reality that information and computer technologies (ICT) increasingly affect stakeholder participation and, to that end, institutional behavior.

Technological advances, and in particular ICT, have played an especially important and complicated role in the financial crisis. It is difficult to imagine, for example, that the debt bubble that “burst” in 2008 would have grown as large as it did without powerful computer models which, we know in hindsight, often failed accurately to predict instrument performance or investor behavior. Scott Patterson, author of The Quants, told the Financial Crisis Inquiry Commission that “Wall Street is essentially floating on a sea of mathematics and computer power.”

At the consumer end, credit scoring was vital to creating the informational conditions needed to promote the growth of consumer credit. The advent of asset securitization is a transactional development often characterized as a technological advance that enhanced liquidity. The “mortgage electronic registration system” (MERS) was created to facilitate trading in securitized mortgages.

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138 FCIC REPORT, supra note 7, at 44 (footnote and citations omitted).


140 Lipson, Re: Defining, supra note 119.

141 According to its website, “Mortgage Electronic Registration Systems, Inc. (MERS) serves as mortgagee in the land records for loans registered on the MERS® System, and is a nominee (or agent) for the owner of the promissory note. The MERS® System is a national electronic database that tracks changes in mortgage servicing and beneficial ownership interests in residential mortgage loans.” See MERS Today, available at http://www.mersinc.org/media-room/press-kit (visited July 6, 2012).
These and related transactional innovations were made possible only with the development of powerful ICT. While much has been written about the failures of these systems at every level, the more subtle and important point is that they may have had a powerful effect on stakeholder participation, and thus comparative institutional efficacy and choice.

“Actor-network theory” (ANT) for example, holds that technologies can, themselves, influence institutional performance and design. ANT suggests, somewhat controversially, that technologies can be agents who indirectly influence institutional outcomes. ICT is not simply a tool that humans use without consequence to the institutions within which they function. Rather, as John Law, has argued, “the social is nothing other than patterned networks of heterogeneous materials.” The “structuration” of interactions between humans and technologies means that society, as such, is not a one-way street: technologies increasingly influence us, just was we (humans) influence technologies.

At minimum, this means that stakeholder participation in creating and solving problems of financial distress is likely to be influenced in important ways by these technologies. In the near term, for example, it would appear that markets have had the lead. In the ICT arms race, sophisticated financial firms (and thus markets) were clearly beating regulators and courts at least through the

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144 Law, supra note 143, at 383; Steins & Edwards, supra note 143, at 544.

145 See Law, supra note 143, at 381

146 As Pentland and Feldman explain: “The recursive nature of agency and structure is one of the key ideas of structuration theory. Rather than seeing either agency or structure as primary, a structuration perspective theorizes them as mutually constitutive. Agency produces and reproduces structure; structure constrains and enables agency. Conceptualizing agency and structure as mutually constitutive focuses attention on the interaction between them and raises questions about where to place technology in this relationship.” Brian T. Pentland & Martha S. Feldman, Narrative Networks: Patterns of Technology and Organization, 18 ORG. SCI. 781, 785 (2007).
crisis. Whether relatively well-resourced regulators such as the newly-created Consumer Financial Protection Bureau are able to compete technologically will determine, in important respects, their effectiveness.

Perhaps the most important near-term institutional effects of ICT have been its failures, not its successes. As has been well-documented, virtually every important technological innovation that contributed to the growth of debt in the past thirty years has encountered significant problems. Large lenders and mortgage servicers have had enormous trouble tracking, documenting—and thus enforcing—the loans they hold, in part because the ICT on which they rely has not performed reliably, at least under the crisis conditions in which we found ourselves in 2008. Nor does the problem seem likely to go away any time soon. Thus, while ICT might have accelerated growth on the way up, it seems to stymie participation that would lead to resolution on the way down.

While market actors, and in particular SFs, would appear to dominate the creation and use of ICT as it affects financial distress, in the longer term, government may catch up. Dodd-Frank at least attempts to create a financial intelligence department that will presumably attempt to use some of the same sorts of technologies to monitor distress. The requirement that major banks develop and submit living wills and undergo stress tests may also be seen as a means by which regulators harness the technological advantages of large financial firms in order to better monitor them.148

147 The New York Times recently reported that the same. Jessica Silver-Greenberg, Problems Riddle Moves to Collect Credit Card Debt, N.Y. TIMES, Aug. 12, 2012, available at [link](http://dealbook.nytimes.com/2012/08/12/problems-riddle-moves-to-collect-credit-card-debt/?hp) (noting that the Office of the Comptroller of the Currency is investigating JPMorgan Chase “after a former employee said that nearly 23,000 delinquent accounts had incorrect balances.”).

148 See Dodd Frank Act §165 (d) and 12 C.F.R. Part 381. The Dodd-Frank act will require Banks to submit, for example, “management information system information,” “off-balance sheet liabilities,” and “trading, derivative and hedging” activities among other information. Joseph Karl Grant, Planning for the Death of a Systemically Important Financial Institution under Title I § 165(d) of the Dodd Frank Act: The Practical Implications of Resolution Plans or Living Wills In Planning a Bank’s Funeral, 6 VA. L. AND BUS. REV. 467, 497-500 (2012).
To be sure, ICT is not a proxy for institutional analysis. Rather, it would appear to influence the quality and quantity of stakeholder participation in the creation and resolution of financial distress. Like technology generally, its ultimate effects are indeterminate: it would seem to have the capacity to facilitate better or worse results, depending on the competencies of the institutions involved in resolving the financial distress in question. In the first instance, it is important to recognize that, if institutional analysis is about stakeholder participation, and if the important coefficients in assessing participation will be complexity and size, technologies such as ICT—which necessarily affect our capacity to manage large and complex problems—will matter to institutional analysis of financial distress.

2. **Applying Institutional Analysis to Financial Distress**

To understand comparative institutional analysis is to see that the quality and quantity of stakeholder participation ultimately determines the design of, and choices among, institutions. Stakeholder participation is, in turn, determined by the resources (money, ICT), sophistication, and stakes of those affected by various social problems. So viewed, even the most potentially participatory of institutions—the electoral process—can be heavily influenced by minoritarian bias. Yet, as we shall see in this section, financial distress is ultimately a problem whose most important social boundaries will be determined by majoritarian preferences.

This part applies the analysis sketched in the prior section to the three major institutions involved in the creation and resolution of financial distress: markets, courts, and political actors. Institutional analysis reveals that, while markets may historically have been the dominant institutional choice for creating and solving problems of excess debt, the trend appears to be to treat financial distress as a problem that political actors create and purport to solve.
2.1 Markets

There is a tendency to assume that financial distress is a problem that courts—in particular bankruptcy courts—chiefly solve. But this is a law- (and lawyer-) centered view that is historically and empirically almost certainly false. Rather, firms and consumers are far more likely to renegotiate their financial distress privately than to use any other institution. This renegotiation is most likely to occur in something approximating a market setting, where debtor and creditor consensually rewrite the debt contract. In a social system weighted heavily towards private ordering, this should be no surprise. When the problem is financial distress, it is the most directly participatory mechanism we have.

149 See, e.g., ELIZABETH WARREN & JAY LAWRENCE WESTBROOK, THE LAW OF DEBTORS AND CREDITORS 94 (6th ed. 2009) (“bankruptcy is the chief legal relief of choice for most debtors and creditors when financial disaster strikes”); Stephen J. Lubben, Financial Institutions in Bankruptcy, 34 SEATTLE U. L. REV. 1259, 1264 (“Save for when the Dodd-Frank Act’s new resolution authority applies, chapter 11 remains the primary instrument for resolving financial institutions. Unless a specialized regime is in place, such as those for banks or insurance companies, chapter 11 will apply.”)
In the case of consumers, Elizabeth Warren and co-authors have noted that nearly 1% of households file for bankruptcy annually. Yet, as Figure 2 shows, far more consumers in distress never go into bankruptcy. They work out their distress with their lenders, or walk away in cases where the lender lacks the incentive to pursue them through whatever process may be available. A comparable disparity exists for businesses: A recent study shows that between 7-10% of non-bank

Figure 2. Consumer Distress v. Consumer Bankruptcy

![Consumer Distress and Bankruptcies](image)

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businesses that default on debt actually resort to bankruptcy to resolve their distress. At least historically, the rest would use the market.

Indeed, even the term “bankruptcy” derives not from a description of a judicial process, but of one based in markets: According to Blackstone, “bankruptcy” “derived from the word bancus or bankque, which signifies the table or counter of a tradesman . . . and ruptus, broken; denoting thereby one whose shop or place of trade is broken or gone.” Lore had it that traders who failed to pay their debts would have their “benches” broken by their creditors, thus disabling them from further market participation. Formal court proceedings were not contemplated, at least according to the conventional history of the term. The fact that we survived most of the 19th century without a formal bankruptcy law tends to suggest that other institutions (in particular markets) were probably capable of dealing with financial distress in most cases.

How does market participation in financial distress work? Obviously, markets are often an important source of distress. There would be none, as we commonly understand it, without private debt contracting through the market. Markets create financial distress when lenders and borrowers are guileless about (or perhaps indifferent to) debtors’ ability to repay loans. Without markets making many large-scale mistakes, financial distress would be no problem, or at least a very different one.

152 The work of Greg Nini, David Smith, and Amir Sufi shows that fewer than 7% of distressed publicly-traded firms (defined as those announcing a debt covenant default) declare bankruptcy or liquidate through a judicial proceeding. See Greg Nini, David C. Smith & Amir Sufi, Creditor Control Rights, Corporate Governance, and Firm Value, 11-13 (Working Paper Series, 2010), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1344302. For smaller firms, the percentage is higher, nearly 10%. In 2010, for example, 690,504 businesses closed (some of which may have been public firms), while 56,282 businesses (less than 10%) went into bankruptcy. See Quarterly Business Filings by Year (1994-2012), http://www.abiworld.org/AM/Template.cfm?Section=Home&TMPTE=CM/ContentDisplay.cfm&CONTENTID=65641 (describing number of business bankruptcies) and Business Dynamics Statistics, http://www.census.gov/ces/dataproducts/bds/data_firm.html (U.S. Census data on 2010 business closures).

153 WILLIAM BLACKSTONE, 2 COMMENTARIES *381, n. c (Wayne Morrison, ed.).
But markets are also the place where those most directly affected by distress—debtors and creditors—are likely to resolve those problems. Private reordering has for many years been strongly preferred to political or judicial choices for dealing with financial distress, which suggests that in many ways it is broadly participatory. If debtors and creditors do not agree to make a change—the “work out” described in the Prologue—market-based renegotiation cannot occur. Institutional analysis reveals that the participatory nature of the workout probably explains the historic prevalence of this form of resolution.

Consider a simple example. D, a business, owes money to A, B and C. A has a perfected, first-priority security interest in all of D’s assets. B is an unsecured creditor (or, for simplicity, a group of unsecured creditors); it has no conventionally recognized interest in D’s property. C has preferred stock issued by D. Although D is contractually obligated to recognize C’s right to some payment (e.g., through a fixed dividend stated in the corporate charter), it cannot realistically expect payment before (or in lieu of) A or B. Assume further that D has also raised funds by issuing common shares to friends, family and accredited investors.

We can further imagine that, depending on valuation (a problem discussed below), D’s assets could be sufficient to pay some but not all stakeholders. Assume, for example, that D has $100 million in assets (present book and fair value, to keep it simple). Due to a series of reversals in the market, D’s revenue is projected to be much lower than previously predicted. D already owes $40 million (on a secured basis) to A and $70 million to B (unsecured). D had raised $10 million in venture capital financing from C on a preferred basis and had issued common stock to founders, friends, family and other early investors for about $20 million.

Based on the simplest model of generally accepted priority in right of payment, it is clear that D is in some kind of financial distress. Its declining revenues show that D cannot service all of its
obligations according to their terms, and so will have to make hard choices about who gets paid and who does not. D will likely do what most debtors do in these circumstances: Its management will have hard conversations about this with A and B, and possibly C. The conversations will be an attempt to determine whether (or to what extent) D can fix the problem in a way that A and B (and possibly C) find acceptable.

The contours and outcomes of these conversations will be determined by a complex mix of factors. The parties will assess their relative rights against D and one another; they will assess D’s assets as currently valued, as well as its prospects for continued survival (and possibly genuine revival); they will assess their own commitments to others (e.g., if B is a private equity fund, what are its investors going to want); they will assess their sense of general conditions in the marketplace today and, for what it is worth, what they think is likely to happen in the future; they will, most assuredly, assess the legal environment in which these obligations would (or would not) be enforced.

The institutional key is not what D and its stakeholders do—the variations are nearly endless—but instead the fact that they can, and should, do something at all. Even the crudest economic analysis would tell them that if they want to minimize the pain from this distress, they had better do something—that is, participate in a resolution of D’s problems.

Participation in this broad form presents a number of normative virtues. First, it reflects a fair amount of stakeholder autonomy. The fact that A and B are likely to use the market to renegotiate means that they have greater discretion and control over this decision than anyone else. The decision to renegotiate depends not on other institutional actors (e.g., courts or regulators), but instead on their preferences and the effect their choice has on other relationships they may have.

Indeed, an important class of constraints on party autonomy in renegotiation may be those that are self-imposed. A or B may want to renegotiate with D, but A and B may also have
commitments to other contract parties which would be affected by a workout with D. In some cases, those other relationships may be reflected in formal contracts a term of which would be breached by a new deal with D. In other cases, the workout may threaten less formal arrangements. Either way, the complexity of these interrelationships—the ripple effect that a workout between A, B and D can have on other parties—can be an important constraint on the effectiveness of workouts.

The workout process can be seen as an individuated version of stakeholder participation captured by institutional analysis. If, as these facts suggest, A is an oversecured lender, it will have greater leverage than other stakeholders to influence the outcome. Assuming its security is good, it will have the power to seize collateral which may well spell the end of D. Some assets—roughly $60 million, in our hypothetical—might remain for D’s unsecured creditors to share, but given the dynamics of fire sales, it is unlikely that B would recover even that much. Moreover, in the absence of some other institutional choice (i.e., bankruptcy), individual unsecured creditors (the many “Bs”) would be left to fend for themselves in state court, running the so-called “race of diligence,” which is well known to be costly and value-destroying.

Why would A ever agree to anything less than payment in full? Depending on the nature of its collateral, etc., it may not. So, in order to remain viable, D may have to obtain concessions from B, C and the common stockholders. Those concessions might come in the form of reduced monthly payments; the addition of personal guarantees; perhaps issuance of new preferred or common stock to the unsecured creditors (thereby diluting existing shareholders); and so on. D may have to make significant changes in its management, business or operations in order to

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154 See Lipson, Governance, supra note 10 (discussing fire sales outside of bankruptcy); Lipson Shadow Bankruptcy, supra note 10 ,at [XX] (discussing fire sales in bankruptcy).
persuade A (and B and C) that it can make good on whatever new promises it has made in the workout.

Enabling D to create new arrangements with B (and possibly C) to effectively buy off A is not necessarily a bad result. It avoids serious minoritarian bias in favor of A, which would occur if A were permitted to foreclose its security interest and thereby shut down an otherwise viable business. It also avoids serious majoritarian bias, if we assume (as is likely) that B actually consists of a large number of unsecured creditors (or at least a larger number than secured creditors, represented by A).

Problems with participation also characterize what is likely the single most important impediment to workouts: holdouts. In general, a market-based renegotiation can modify debt if and only if the debtor and creditor so agree. For example, A and B cannot effectively agree to modify B’s claims against D without B’s consent. Holding out can occur for several reasons. First, if D has publicly traded bonds, special rules regarding the modification of bond indentures may make it difficult, if not impossible, to obtain the required number of bondholder consents.155 As in other contexts, numbers and complexity can stymie all institutions, and financial distress is no exception.

Second, and more insidious, is the possibility that some stakeholders have claims that create perverse incentives. The purest example will be a credit default swap coupled with an oversecured claim. If A held an oversecured claim and a credit default swap as to which D was the reference entity, then A would have every incentive to see D liquidate (preferably outside bankruptcy) because it may collect twice: Once on the full amount of its secured claim (with fees and costs) and again on

155 See Lipson, Governance, supra note 10, at 1054 (discussing bond voting restrictions).
the swap. Even if D has otherwise plausible reorganization prospects, A would have virtually no incentive to compromise its claim, or go along with any sort of workout. \footnote{See Lipson, \textit{Shadow Bankruptcy}, supra note 10, at 1651 (describing general form of this problem); Lipson \textit{Governance}, supra note 10, at 1051-1059 (discussing some potential examples of this). I have argued elsewhere that behavior of this sort would evidence a kind of bad faith for which courts should provide a remedy. But this makes the (possibly mistaken) institutional assumption that other stakeholders (e.g., B, C, and D) would be in a position to shift institutions, and ask a court to provide a remedy.}

Third, and perhaps most interesting, government may create incentives that distort negotiations that might otherwise occur. If, for example, A or B believe, or plausibly hope, that the government will provide some sort of bailout, their incentives to renegotiate with D would be reduced. If the government will make you whole, why bother to compromise with the debtor?

This, in part, explains the distorting effects of government involvement in the credit crisis. In the case of automakers General Motors and Chrysler, for example, it was not enough that government provide subsidies to the firms in order to help them finance their reorganizations. It also had to corral enough other stakeholders to produce a reorganization plan that would obtain the stakeholder (creditor) vote required by the Bankruptcy Code. And, of course, the crucial point is that this workout was not possible in the marketplace, with or without the government: It occurred only through a carefully orchestrated pair of bankruptcy cases.

More dramatic, of course, was the apparent effect that the Bear Stearns bailout had on market participants. Or, more accurately, did not have. As explained in the Prologue, very little workout activity occurred during the crucial six months between mid-March 2008, when the federal government subsidized and facilitated JP MorganChase’s acquisition of Bear and September 15, 2008, when Lehman Brothers filed for bankruptcy.

Markets are hardly perfect institutional solutions to financial distress. They are extremely costly, even when some stakeholders are broke. Corporate restructurings may involve armies of...
lawyers and bankers who are unlikely to provide a discount simply because the transaction involves a financially distressed firm.

Moreover, there may be social costs not internalized by the principal parties to the workout. Some stakeholders may have little or no say in the outcome of the restructuring, but are nonetheless affected by it. The classic examples will be non-union employees and smaller trade and tax creditors of the corporate debtor. Thus, if A and B agree that in order to restructure, D should replace domestic workers or vendor with cheaper foreign labor or suppliers, those employees and vendors will suffer losses that, in some cases, cascade throughout larger communities creating costs for social service agencies in terms of lost revenue, welfare payments, retraining programs, and so on.

The market cannot correct for all of these costs. Indeed, the presence of these costs—from holdouts to externalities—is good reason to resort to other institutions. Yet, the important question is not whether market-based solutions are optimal or costly, but how the costs and benefits of this choice compare to other available choices. When stakeholders can participate in the resolution in some meaningful way that produces, in Hart and Sacks’ terms, an “institutional settlement,” it is not obvious why other institutions would do a better job. Rather, other institutions will outperform the market only when participants are, in aggregate, unable to come to some consensual resolution of financial distress.

2.2 Courts

Which of course happens, and is one of the most important justifications we have for the peculiar sub-institution of bankruptcy courts. Since at least 1978, when the current Bankruptcy Code was enacted, bankruptcy courts have been an important institutional choice when market

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efforts at debt restructuring fail. From an institutional perspective, they are an attractive choice because of their capacity to channel stakeholder participation in reasonably fair and efficient ways.

Bankruptcy as a process presents essentially two models: straight liquidation (usually under chapter 7 of the Bankruptcy Code) or reorganization (usually under Chapters 11 or 13), which are in essence moderately coerced workouts. From a participatory perspective, they are different, and the differences are organized largely (although not exclusively) around the type of debtor involved. Cases involving consumers (chapter 7 or 13) provide fewer meaningful opportunities for stakeholder (e.g., creditor) participation than does chapter 11, where unsecured creditors will, in large cases, be represented by a committee of unsecured creditors, and (in many cases) have a right to vote on a reorganization plan.

Thus, if D were a consumer debtor, a trustee (T) would likely be appointed for D. T’s job would be to maximize the value of the estate consistent with the various procedural mechanisms available. If D is eligible for chapter 7, this means T will liquidate D’s non-exempt assets (if any) and distribute them in order of priority. If A is a secured creditor, it will receive its collateral. B would receive any excess value. If D is not eligible for chapter 7 (because D has income that is too high under the so-called “means test” enacted in 2005 amendments to the Bankruptcy Code), it would probably proceed under chapter 13, where a trustee would also be appointed, although not to liquidate D’s assets, but instead to insure that D’s income (net of approved expenses) was devoted to paying A and B under a chapter 13 plan. While some negotiating might occur in this context, unsecured creditors have no vote on the plan; secured creditors may “accept” a plan that provides
less than full payment (or the value of their collateral), although they likely have little incentive to do so in most cases.\textsuperscript{158}

If instead D is a corporate debtor that has commenced a case under chapter 11, the participatory dynamics will be different. D may well have engaged in some negotiations with A, B and C. If so, those negotiations will likely influence the contents of a reorganization plan for D. If all goes reasonably well, the parties will then propose the plan to stakeholders and the court for consideration and approval.\textsuperscript{159}

From an institutional perspective, bankruptcy can be understood as making certain reasonable choices about stakeholder participation. In cases where a debtor’s case is likely simple, or where the debtor is less sophisticated than creditors, there is less room for participatory maneuvering. A chapter 7 liquidation or a chapter 13 wage-earner plan gives creditors some say in the process, but far less than they would have in a market-based workout or a chapter 11 case. Presumptively, chapter 11’s more elaborate disclosure and voting rules create opportunities for greater stakeholder participation. We tolerate—and, in fact, may expect—this because the number of creditors is likely larger in corporate cases; their claims are likely more complex than in consumer cases; and they are likely better able to fend for themselves than would be low stakes creditors in a small case.

This last point—about the bankruptcy court’s institutional capacity to manage large, complex cases—is of special significance to comparative institutional analysis. As discussed in Part 1, when problems grow in numbers and complexity, all institutions tend to respond poorly, but


\textsuperscript{159} Under 11 U.S.C. § 1126(c), “impacted” classes of creditors are entitled to vote on the plan. Under 11 U.S.C. § 1129, a court cannot approve the plan unless it has the requisite number and amount of creditor support. There are, of course, variations on this, but the details are unimportant the institutional analysis presented here.
courts may respond more poorly than others. They lack expert fact-finding agents (e.g., bureaucrats). As a largely adversarial system, courts (even bankruptcy courts) are likely to be limited in the extent to which they independently inquire about the viability of a settlement (i.e., a plan). As an institutional choice, in other words, asking courts to resolve the financial problems of large, complex firms is somewhat surprising.

Yet, we have long asked bankruptcy courts to do this, despite the somewhat exceptional nature of this decision. But it is for this reason that the bankruptcy process can be seen as an institutional hybrid: It does not typically involve one institution—courts—but instead two or maybe three. As noted, because the system was designed by Congress (a political institution) to promote bargaining outside of court—which in fact appears routinely to occur—we see two institutions braiding with a third: government, courts and markets.

The market here is becoming more robust because, as I have observed elsewhere, advances in transaction and information technologies, among other things, have caused the reorganization process increasingly to resemble an unregulated securities market, in which control of distressed firms is bought and sold through “shadow” markets outside the purview of courts. While such transacting may produce good or bad results in any given case, it is evidence of institutional interactions in the bankruptcy process.

Notice what I am not claiming: I am not arguing (as some do) that courts, or bankruptcy courts in particular, are the best or only institutional choice to solve problems of financial distress. Rather, I am claiming that in order to understand whether a bankruptcy court is appropriate is determined by understanding the participation of stakeholders in the process of resolving the debtor’s distress. In some comparatively small class of cases, courts will do a better job than

markets, chiefly because there will be a failure of meaningful participation. Participation may fail because the distribution of stakes is distorted (meaning one type of stakeholder has far greater power than others), or because there are other economic failings (e.g., holdouts or externalities). The important question, however, is not whether bankruptcy courts are “good” or “bad” at resolving financial distress, but how they compare to other institutions at managing participation in dealing with financial distress.

2.3 Government

In the world of financial distress, participation can sometimes have unexpected consequences. As a general proposition, we would probably say that like free speech and voting, participation in a negotiated workout of distress is preferable to other institutional alternatives. Thus, on average, we might say that markets are likely superior to courts, and courts superior to government (unless government is in the unlikely business of improving participation). But the whole point of institutional analysis is to recognize that one institutional size does not fit all problems. And so it is with financial distress. Certain types of financial distress—in particular, those characterized by panics—are best addressed not by markets or courts, but instead by government, in particular regulators.

Government’s principal, direct role in resolving financial distress is expressed through the bank failure regime, with the goal of preventing bank runs. Bank runs—where depositors (the bank’s creditors) seek to withdraw more cash than the bank has on hand—are viewed as highly destructive, socially destabilizing events. Here, too, institutional analysis explains why: The

peculiar dynamics of panics—and the serious threat they present to social order—warrant a different institutional response. Yet, the regulatory response to financial distress brings with it special costs—characterized generally as constraints on participation—that should give us pause before exporting the model from banks to other types of firms.

2.3.1 The Example of Banks

To understand government’s role in financial distress it is useful to start with government’s role in the regulation of banks. According to Alessandri and Haldane, the relationship between banks and government has long been deep and intimate, although the valence of influence has shifted over time. Historically, banks were lenders and governments were borrowers—often quite risky ones. As government has become more powerful, and as we were willing to tolerate greater risk in the banking sector, the balance of power shifted:

For the past two centuries, the tables have progressively turned. The state has instead become the last-resort financier of the banks. As with the state, banks’ needs have typically been greatest at times of financial crisis. And like the state, last-resort financing has not always been repaid in full and on time. . . . Today, perhaps the biggest risk to the sovereign comes from the banks. Causality has reversed.

2011),

162 Piergiorgio Alessandri & Andrew G. Haldane, Banking on the State, 139 B.I.S. REVIEW (2009) available at http://www.bis.org/review/r091111e.pdf?frames=0 (visited May 29, 2012). They observe that this state of affairs reflects a profound shift in power:

Historically, the link between the state and the banking system has been umbilical. Starting with the first Italian banking houses in the 13th century, banks were financiers of the sovereign. . . . For the past two centuries, the tables have progressively turned. The state has instead become the last-resort financier of the banks. As with the state, banks’ needs have typically been greatest at times of financial crisis. And like the state, last-resort financing has not always been repaid in full and on time. . . . Today, perhaps the biggest risk to the sovereign comes from the banks. Causality has reversed.

Id. at 1.

163 Id. “As awareness of sovereign risk grew, banks began to charge higher loan rates to the sovereign than to commercial entities. In the 15th century, Charles VIII of France paid up to 100% on war loans to Italian banks, which were at the same time charging Italian merchants 5-10%. The Bank of England’s first loan to government carried an interest rate of 8½%—double the rate at which the Bank discounted trade bills.” (citations omitted).

164 Id.
How has this inversion occurred? Mechanically, it has occurred because government has become willing to shoulder increasing shares of bank risk. Because banks were central to sovereign survival, sovereigns created various “safety nets” to protect banks as they grew and diversified both their risk and return. Among other things, governments created their own banks—“central banks”—which assured private banks, through various mechanisms, that they could make good their obligations due, if nothing else, to the sovereign’s power to tax the populace and spend. In the United States, we supplemented this with direct insurance of retail deposits, through the Federal Deposit Insurance Act (“FDI Act”).

The details of the bank failure system are somewhat complex, but from an institutional perspective reflect a decided resistance to stakeholder participation. Unlike most other nations, an insured depositary’s failure in the United States will be managed not by a court, but instead chiefly by a regulator, in most cases the Federal Deposit Insurance Corporation (FDIC). Insured depositaries are forbidden from commencing a case under chapter 11 of the Bankruptcy Code, and thus cannot use courts.

An insured depositary is most likely to be seized when regulators conclude that it is “critically undercapitalized,” a minimum of two percent equity capital to total assets. When a bank is insolvent, the bank’s charter will be revoked and the primary regulator will appoint a conservator.

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165 Id.


167 See Rosalind L. Bennett, Failure Resolution and Asset Liquidation: Results of an International Survey of Deposit Insurers, 14 FDIC BANKING REV. 1, 9 (2001) (“Outside the United States, most failed banks go through a regular corporate bankruptcy process.”).

168 See 11 U.S.C. §§ 109(b), (d) (2006) (banks may not be debtors under Bankruptcy Code). American banks have been barred from commencing a case under the Bankruptcy Act of 1898. See Bankruptcy Act of 1898, ch. 541 § 4(b), 30 Stat. 544, 547 (explaining “who may become bankrupt” under the Act). As noted above, prior to 1898, bankruptcy laws were only rarely in force. See Lipson, Debt and Democracy, supra note 35 at 125 (discussing history of bankruptcy laws).

169 Bliss & Kaufmann, supra note 166, at 156.
or receiver to administer the insolvency proceedings. If the FDIC is appointed receiver, it has complete power over the assets and liabilities of the failed bank. These powers are largely outside the judicial system and only some FDIC decisions are subject to judicial review.

When appointed receiver, the FDIC must decide what to do with the failed institution. In theory, it has a range of options. It can “liquidate the institution, organize a new bank or a temporary bridge bank, take over some or all of the assets and liabilities, or arrange a merger or purchase of assets and assumption of liabilities.” In fact, federal law requires the FDIC to choose a resolution method that imposes the “least cost on the insurance fund, unless the FDIC determines that doing so is necessary to avert systematic risk.” Data suggest that in most cases, the FDIC found a bank that was willing to assume some or all of the failed bank’s liabilities and purchase some or all of the failed bank’s assets, typically through a transaction known as a “purchase and assumption” (P&A).

In a P&A, the government secures the commitment of a “healthy” bank to take over the assets of the troubled bank. This is how the FDIC is able to “seize a failed bank of business on a Friday, and some of the failed bank’s office reopen as part of the acquiring bank the following Monday.” This means, in essence, that the government and markets must work together quickly and quietly to resolve the bank’s distress. Courts effectively have no role here.

172 Bliss & Kaufmann, supra note 166, at 160.
173 Lubben, supra note 149, at 1266.
175 Id. at 1002.
176 Hynes & Walt, supra note 174, at 989.
Commentators on bank insolvency procedures have suggested various policy reasons for the procedures outlined above. In theory, they create a resolution before an “actual event of economic insolvency or financial default.”\footnote{Bliss & Kauffman, supra note 166, at 152.}

Nevertheless, alacrity has one very obvious—and vital—policy goal: the prevention of bank runs.\footnote{See Diamond & Dybvig, supra note 161; Peter P. Swire, Bank Insolvency Law Now That it Matters Again, 42 DUKE L.J. 469, 474 (1992).} While it is easy to exaggerate the severity of bank panics, they nevertheless have a long history of worrying public officials. One observer characterized the English bank panic of 1825 as follows: “A panic seized upon the public, such as had never been witnessed before: everybody begging for money—money—but money was hardly on any condition to be had.”\footnote{KINDLERBERGER & ALIBER, supra note 161, at 105 (quoting Thomas Joplin, Case for Parliamentary Inquiry into the Circumstances of the Panic, in a Letter to Thomas Gisbourne, Esq. M.P. (London: F. Ridgeway & Sons, n.d. [after 1832], pp. 14-15).}

Common images of bank panics include lines of anxious depositors clamoring to withdraw their savings from banks that suffer from what economists euphemistically call a timing problem: Banks fail because they lend long (e.g., 30 year mortgages) but borrow short (e.g., demand deposits). The model cannot permit banks to keep on hand sufficient cash to pay all depositors in full, so if more than a small percentage withdraw their funds at once, the bank itself faces a liquidity crisis. This liquidity crisis, if known publicly, leads other depositors to withdraw their funds, and so on.

Another major policy goal is the need to protect the FDIC’s insurance fund.\footnote{Swire, supra note 178, at 474.} This policy goal is reflected in Congress’ requirement that the FDIC choose a resolution plan that has the lowest impact on the fund unless the FDIC determines that doing so is necessary to avert systemic risk.\footnote{12 U.S.C. § 1823(c)(4)(A) (2006) (providing the limited circumstances under which the least-cost resolution method will not be required).}

Foreshadowing Dodd-Frank’s distributed authority resolution procedures, the FDIC may deviate
from the least-cost method only with the approval of the Chairman of the Federal Reserve and the Treasury Secretary, and they must consult with the President. Not surprisingly, it has been invoked rarely.

From an institutional perspective, it would appear that the bank failure system is an imperfect but reasonably effective institutional choice given the alternatives. If the goal in the first instance is to instill confidence in the banking system, and thus to broaden participation in it at the retail level, deposit insurance was probably the most effective mechanism available. While markets could have invented this, it appears that they either did not do so in the 1930s, or simply lacked government’s credibility as insurer of last resort. While markets are secondarily important in the event a failed bank is the subject of a P&A, government will call the shots, acting chiefly as proxy for the retail depositors it is assigned to protect.

So, too, for courts. While courts certainly could supervise bank failures, there are sound institutional reasons for leaving that choice with government. Among other things, the bank regulatory system appears to depend on a very constricted flow information and prompt corrective action. Unlike courts, regulators do not generally make reports about troubled banks available in real time (although they will do so after the fact). Nor should they: to release information about

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182 See id. § 1823(c)(4)(G) (stating that “the Corporation may take other action or provide assistance under this section as necessary to avoid or mitigate such effects” with the approval of the Board of Directors, the Board of Governors of the Federal Reserve System, and the Secretary of the Treasury).

183 It appears to have been used twice since 1995 in order to provide assistance to Citigroup, Bank of America and their subsidiaries. The FDIC also invoked this exception when approving financing for Citibank’s bid to buy Wachovia. See Editorial, Who’s Too Big to Fail?, WALL ST. J., Sept. 13, 2009, at A14 (“To provide assistance, the [FDIC] board had to invoke the ‘systemic risk’ exception in the Federal Deposit insurance Act ...”). However, this transaction was not consummated as Wells Fargo purchased Wachovia instead. See id. (“Yet days later, Wachovia cut a better deal to sell itself to Wells Fargo, instead of Cit.”).

troubled banks in real time would risk inducing the very thing—panicked withdrawals—the system seeks to avoid.

Courts, by contrast, depend to a much greater degree on transparency. In theory, pleadings filed in court are public records. Transparency, in turn, facilitates participation in the bankruptcy process, chiefly by creditors who make various outcome-influencing decisions, in particular by voting on a reorganization plan in the case of a chapter 11 reorganization (which is the most likely analogue here). While a bankruptcy system could be modified to exempt retail depositors from the stay (in order to preserve their liquidity), the optical effect of a bank’s bankruptcy may be quite damaging to the bank's reputation and to individual depositor confidence in it and the banking system as a whole.

This limit on stakeholder participation is not without costs. The quality of decision-making by regulators is only as good as the regulators and the institutional construct in which they operate. Thus, as Agarwal and others recently found, timing and choice of regulator seem to matter.\(^\text{185}\) They found “inconsistent implementation of identical rules by federal and state regulators” that could delay resolution with potentially catastrophic consequences:

Several anecdotes suggest that inconsistent oversight by regulators could hinder regulatory effectiveness, none clearer than the demise of Washington Mutual Bank (WaMu), a $300 billion thrift and the sixth largest US bank at the time of its failure. According to a formal congressional investigation, WaMu’s failure—the largest bank failure in US history—was, to a large extent, due to delayed corrective action that resulted from inconsistent oversight by its regulators, the Office of Thrift Supervision (OTS) and the Federal Deposit Insurance Corporation (FDIC). . . . Absent a deal between the FDIC and JP Morgan Chase to take over WaMu’s assets, this failure would have exhausted the entire Deposit Insurance Fund.\(^\text{186}\)

\(^{185}\) Agarwal, supra note 184, at 1.

Moreover, and perhaps more troubling, the government wants to export the bank failure model to a broader context, through Dodd-Frank. As Michael Barr said in testimony on behalf of the legislation that became Dodd-Frank: “Our proposal does little more than apply to” systemically important non-bank institutions “the same model that Congress has developed, that the FDIC has executed, and that courts have respected, over the course of more than three-quarters of a century.” Yet, institutional analysis shows that stakeholder behavior and institutional construction may in fact call for very different institutional choices and mechanisms.

2.3.2 Generalizing from Banks—The Problem of Debt Subsidy

If commercial banks were the only (or principal) locus of debt subsidy and administrative failure resolution, we may have less to worry about. This was, after all, the system that existed for the roughly forty years before government began aggressively to expand this model—especially the subsidy aspects—in other directions. Government contributes to financial distress when it subsidizes private debt, which it does in at least three ways.

2.3.2.1 The Doom Loop of Debt Subsidies

First, as with deposit insurance, it can explicitly guarantee private debt (in deposit insurance, the FDIC effectively guarantees banks’ demand debts to depositors). As set forth in Table 1, on a fairly conservative basis, it is not hard to see that, even excluding any implicit guarantee of money


In what could be seen in hindsight as a political misstep, the Treasury Department noted in its press release that the new authority was modeled on the FDIC’s existing resolution authority for depository institutions and on the Federal Housing Finance Agency’s resolution authority for government sponsored entities. The indirect allusion to the conservatorship of treatment of Fannie Mae and Freddie Mac exposed the Treasury to the criticism that its proposal would provide a source of ongoing federal assistance to other companies on financial life support.

Id. at 784 (quoting Ben Bernanke).
market funds, the federal government appears to guarantee private debts equal to about 95% of U.S. gross domestic product in 2011. Of course, many government guarantees are not explicit. Alan Greenspan, for example, long disclaimed that the federal government guaranteed the home-mortgage-related obligations of Fannie Mae and Freddie Mac. The market, however, refused to believe him, in effect giving those entities a discount based on this implicit guarantee. “I used to go up and testify,” he has said,

up until Fannie and Freddie essentially went into conservatorship, that the law said that full faith in credit does not -- is not backing Fannie and Freddie. And I could say with a straight face, with my fingers crossed, that that's what the law says. I presume the law will be enforced. The Wall Street practitioners didn't believe it. And they gave essentially a 20-basis-points subsidy, to Fannie and Freddie, because they believed that it was not risky debt. They turned out to be right, and the government turned out to be wrong. It's going to be very difficult to reproduce that credibility again. Because when push came to shove, they didn't stand up to the pledge.

These are, it should be noted, only the most obvious ex ante guarantees of private debt. Government can also subsidize private debt through guarantees ex post (i.e., “bailouts”). Perhaps the most notorious example of this involved the Primary Reserve Fund (“Reserve Fund”) “one of the country’s oldest and largest money funds,” which “broke the buck,” showing a net-asset value of $0.97, rather than $1.00. In the two days following Lehman's failure, and before the Reserve Fund halted redemptions, the Reserve Fund suffered a net loss of assets of $27.3 billion, taking total assets from $62.6 billion to $35.3 billion. The Reserve Fund had held approximately $785 million of


Lehman debt instruments, or about 1.3%. The fund immediately halted redemptions by fund investors, thus indicating that—unlike an administrative procedure—there was no guarantee that those with shares in the Primary Reserve Fund would be able to get any of their money back.\footnote{Fund Watch, Money Market Breaks the Buck, Freezes Redemptions, available at http://www.marketwatch.com/story/money-market-fund-breaks-the-buck-freezes-redemptions (visited Oct 28, 2011).}

On September 19, 2008 and faced with a real panic—the withdrawals of trillions of dollars in uninsured money market funds—the federal government made explicit what had previously been treated as an implicit guarantee: It assured money market investors that the federal government would guarantee their investments, just as the FDIC insures the deposits of banks.\footnote{Press Center, Treasury Announces Guaranty Program for Money Market Funds, available at http://www.treasury.gov/press-center/press-releases/Pages/hp1147.aspx (visited Oct. 28, 2011) (“The U.S. Treasury Department today announced the establishment of a temporary guaranty program for the U.S. money market mutual fund industry. For the next year, the U.S. Treasury will insure the holdings of any publicly offered eligible money market mutual fund – both retail and institutional – that pays a fee to participate in the program.”).} The program expired on September 18, 2009.

The problem with both ex ante and ex post subsidies through guarantees is that they appear to function as a one-way ratchet: Political actors may say, as President Obama has said, that government will never again “bail out” troubled financial institutions. But SF\textsuperscript{3}s do not believe it. As Alessandri and Haldane observe of banks, in particular:

> the ex-post costs of crisis mean such a statement [no more bailouts] lacks credibility. Knowing this, the rational response by market participants is to double their bets. This adds to the cost of future crisis. And the larger these costs, the lower the credibility of ‘never again’ announcements. This is a doom loop.

This is an acute example of institutional interaction effects going awry. Government in effect braids with markets to produce debt that the market itself would not. The problem is not necessarily that government will be on the hook for these debts. In most cases, it probably will not. Rather, the problem again involves stakeholder participation. Government guarantees of debt

\footnote{See Alessandri & Haldane, supra note 162, at 7.}
distort incentives in three ways that affect stakeholder participate. First, they will encourage parties to borrow when they might not otherwise do so. Second, the presence of government guarantees may distort efforts to renegotiate the debt if the primary obligor defaults. If lenders believe that government will in effect pick up the tab, they may have little incentive to compromise the debtor’s debt. Instead, they exhaust their litigation (or bankruptcy) remedies against the debtor without need to compromise, only to turn to the government to be made whole. This dilutes the participatory nature of workouts that is generally considered the most effective way to resolve distress.

Third, in the long term, large-dollar guarantees are likely incompatible with an electoral political system. This is because, at some point, those who lend to the government—in particular the bond market—will start to push back against their borrower. The problem then is that bond markets should be expected to demand of government something like that which creditors generally demand of failing borrowers: concessions, control, renegotiation. Yet, government debt is not like other debt. As Richard Shragger explains:

Capital markets are obviously useful tools for governments. But democratic theory favors citizens over bondholders. Sometimes their respective interests will coincide; other times they will not. How to ensure public, democratic rule when capital is highly mobile is a question that is beyond the scope of this Essay. Nevertheless, it is important to remember not to confuse access to the debt markets with democratic legitimacy. When the bond market becomes a despot, we have lost the balance between democracy and debt.194

2.3.2.2 Safe Harbors as Subsidies

A second form of government debt subsidy comes from law itself. For example, the Bankruptcy Code provides special treatment for derivatives, swaps and other debt-like transactions. In essence, this special treatment assures that the automatic stay will not prevent non-debtor counterparties from seizing collateral posted by a debtor.195 As Mark Roe has observed, this in

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194 See Shragger, supra note 34, at 885-86.
195 See, e.g., 11 U.S.C. § 362(b). See also Lee, supra note 187, at 793.
effect means that these safe harbors provide better treatment for debt-like instruments than transactions that do enjoy these special designations. Roe has observed that these safe harbors for derivatives have the potential to “reduce[ counterparty] pre-bankruptcy incentives for market discipline in dealing with counterparties. . . . When we subsidize derivatives and repo [transactions] via bankruptcy benefits unavailable to other creditors, we get more of that subsidized activity than we otherwise would. . . .”

To the extent one believes that law as such leads private actors to enter into these transactions when, in the absence of special treatment they would not, government is in effect subsidizing debt.

2.3.2.3 Innovation and Subsidy

A third, and perhaps more subtle, example involves the role government plays in financial innovation. Among the more important financial innovations that contributed to the credit crisis was the advent of asset securitization. As is now well known, securitization is a reasonably complex transaction form in which an originator of financial assets (e.g., mortgages or student loans) sells those financial assets to a special purpose entity which, directly or indirectly, purchases them with funds raised by issuing securities into the capital markets.

What is less well known, but perhaps just as important, is that the government facilitated the creation of this transaction form. Securitization originally developed in the early 1970s as a way for Fannie Mae and Freddie Mac, government sponsored entities, to move mortgages off their balance sheets. It received a significant boost from the government after the savings and loan crisis of the 1980s, when the Resolution Trust Corporation, which had assumed over $400 billion in loans from failed savings and loans, used

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197 See Lipson, Re: Defining, supra note 119, at 7-14.
securitization to sell “non-prime” loans into transactions that were the forerunners of subprime securitizations often blamed for the financial crisis.\(^{198}\)

As with guarantees of private debt (and to a lesser extent safe harbors), helping to develop this transaction form in effect subsidized the creation of new forms of debt because it relieved the markets of the research and development costs they would otherwise have spent in creating the structures. Indeed, but for government initiative, it is not clear the markets would ever have developed them.

The broader institutional effects of these debt subsidies are complex. If we focus on participation, it is clear that this has enabled many individual consumers to have access to funds and goods that would not otherwise have been available. They were able to participate in the market in ways that would likely not have been possible but for the government subsidy. On the other hand, these subsidies are very difficult for government to resist. They shift the costs of public access to the public fisc to some future generation of voters. Nor is it always clear ex ante how great the costs will be, or how to discount for the intergenerational consequences of these subsidies. It would appear, however, that government’s power to subsidize the creation of debt is an example not only of institutional interaction, but also of government’s growing power to displace other institutions in the process of creating financial distress. While there are obviously many legitimate reasons to impose long-tail obligations on the future, it is clear, from an institutional perspective, that future stakeholders have no say in today’s decisions about financial distress. Even though they may be the ones left to the ultimate resolution.

\(^{198}\) See FCIC REPORT, supra note 7, at 68-69.
2.3.3 Government Encroachment on Distress Resolution—Dodd Frank

Government does not only create financial distress through unchecked debt subsidies. It also increasingly arrogates to itself the power to resolve distress ex post. This is equally problematic for the institutional reasons described above: It destabilizes the balance of stakeholder participation most likely to produce fair and efficient results of distress resolution.

The most prominent example of this involves the so-called “orderly liquidation authority” (OLA) created by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank). Under the OLA a series of government regulators—not markets or courts—can determine that a “systemically important” entity threatens the financial system and place it in a “resolution” proceeding of uncertain scope, duration or result.

A financial institution will be subject to the OLA if it is a bank holding company, or if the Financial Stability Oversight Council (FSOC) created by Dodd-Frank determines that the company is chiefly (more than 85%) engaged in financial activities, or if it has been deemed a “systemically important non-bank financial institution.” This means, among other things, that while bankruptcy remains a possible institutional choice for a failing firm, OLA will trump it, if it is invoked.

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199 Pub. L. No. 111-203, 124 Stat. 1376 (2010). As President Obama explained: “We will not go back to the days of reckless behavior and unchecked excess that was at the heart of the crisis, where too many were motivated only by the appetite for quick kills and bloated bonuses . . . [T]he old ways that led to this crisis cannot stand. And the extent that some have so readily returned to them underscores the need for change and change now. History cannot be allowed to repeat itself.” Barack Obama, Remarks by the President on Financial Rescue and Reform (Sept. 1, 2009), available at http://www.whitehouse.gov/the_press_office/Remarks-by-the-President-on-Financial-Rescue-and-Reform-at-Federal-Hall (visited May 29, 2012).

200 Dodd-Frank, § 203.

201 Id. § 201(a)(11).

202 Id. §§ 201(b), 117. Under this test, 85% of the company’s total consolidated revenues must come from activities the FSOC deems financial in nature, or more than 85% of the firm’s consolidated assets are financial assets. Id. § 201(b).

203 Id. § 165.

204 Id. § 170.
The decision whether to put a financial company into the resolution regime is made by regulators, not market actors (e.g., the firm itself) or any other institutional player. If the Secretary of the Treasury concludes that a systemically important company is “in default or in danger of default,” two-thirds of the Federal Reserve Board and two-thirds of the FDIC board have recommended resolution, and he has also consulted with the President, the Secretary can initiate the new resolution process. The Treasury Secretary’s decision is subject to 24-hour, confidential review by the United States District Court in the District of Washington, D.C.\textsuperscript{205} Observers expect that judicial review is unlikely to be a meaningful check on the administrative process.\textsuperscript{206}

If a firm is subject to the OLA, it would be treated as a receivership run by the Federal Deposit Insurance Corporation (FDIC).\textsuperscript{207} The FDIC’s resolution powers authorize it to transfer some or all of the financial company’s assets or liabilities to a third party,\textsuperscript{208} or to establish a temporary “bridge” company to hold the assets until some sort of orderly liquidation or sale is possible.\textsuperscript{209} The FDIC has virtually unfettered discretion to allow or disallow claims against the firm, although a creditor can challenge the determination in the U.S. District Court where the firm is located.\textsuperscript{210}

\textsuperscript{205} Id. § 203(a)(2)(F).
\textsuperscript{207} Id. § 203.
\textsuperscript{208} Id. § 210(a)(1)(G).
\textsuperscript{209} Id. § 210(b).
\textsuperscript{210} Id. §§ 210(a)(2), (a)(7), (b).
Although enacted with (barely21) bipartisan support, Dodd-Frank, and the OLA, have been subject to withering criticism. The chief concern is that the OLA creates “uncertainty.”212 The uncertainty reflects the facts, among others, that we may not know, ex ante (1) whether a firm is subject to the OLA; (2) if it is, whether it will be upheld if invoked, and (3) how the firm’s distress will be resolved. Some have argued that OLA may be unconstitutional.213

From an institutional perspective, however, the deeper problems will involve participation and information. Unlike the FDIC’s regulation of bank solvency, for example, it is not clear who ex ante will be subject to the OLA. It is thus not clear how regulators will be able to anticipate which firms may be large enough and important enough—and troubled enough—to warrant intervention—until it is too late. Moreover, the participatory justifications for the FDIC’s resolution authority do not exist here. Firms likely to be subject to the OLA are not likely to have large numbers of widely dispersed retail stakeholders who cannot fend for themselves, as is the case with insured depositaries. Nor is that even a criterion for consideration.

Unlike bankruptcy, there will be little if any public scrutiny of regulators’ actions in real time. There will be no meaningful judicial process here once it has begun, so there will be no docket which will log pleadings. Investors and other stakeholders of a firm taken into such a proceeding will effectively have no access to information that would make participation in the process meaningful or even possible, which may be one reason the process provides them none.

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212 See, e.g., Lubben, supra note 149, at 1271.

Compared to other institutional choices, the OLA is clearly troubling. It is simply not clear why, in many cases, a market-based solution would not be the first and best. As discussed above, large, sophisticated firms are well-resourced, having access to top talent and technologies. It seems highly likely that they would be in the best position to anticipate and unwind or renegotiate losses, sell the distressed firm, or otherwise resolve the problem without direct government involvement. Even a market-based solution facilitated by the federal government, as happened with Long-Term Capital Management, would be better than the poorly conceived procedural transplant envisioned here. While a P&A is possible under an OLA, given the size of the entities involved, it is not likely.

Ultimately, OLA is likely to work symbiotically with the growth of debt subsidies to further enhance government’s role in financial distress. This is because the OLA is unlikely ever to be invoked. Instead, in cases where individual, but systemically important, firms encounter trouble, it is more likely that the Fed or Treasury will come up with some sort of funding solution, as it has done on many occasions, going back as far as the 1970 collapse of the commercial paper market in the wake of the Penn Central bankruptcy. In any case, it is not clear how the government will pre-fund such efforts, as it collects no insurance premiums, as the FDIC does in connection with bank failure resolutions. Instead, it will attempt to levy assessments against other large financial services firms for any shortfall it suffers in the resolution process. Because it is not clear whether it will succeed in collecting such levies, it is certainly possible that the government actually will end up absorbing losses from the failed firm.

214 See FCIC REPORT, supra note 7, at 57 (discussing resolution of failed hedge fund brokered by New York Fed, which “involved no government funds.”).

215 Id. at 30 (“In response” to the Penn Central bankruptcy “the Federal Reserve supported the commercial banks with almost $600 million in emergency loans and with interest rate cuts.”) (footnote omitted).
Alternatively, the lack of information and procedural regularity that accompanies FDIC review of insured depositaries, may lead regulators to delay corrective action until it is too late, as apparently happened with WaMu.\(^{216}\) This may, in turn, lead to the need to seize not one but several systemically important financial firms. In that case, it is not clear who would be left to assess for losses. Either way, markets would understand that OLA creates an extraordinary game of chicken, in which government is unlikely to hold firm. It will, instead, blink, as it has so often in the past, because the political costs of failing to do so exceed the costs of action.

It should be clear by now that I do not argue that government should have no role in resolving the distress of large, systemically important firms that are not insured depositaries. Quite the contrary. It seems inevitable that government will have some role. Rather, the important point, which seems to have gone largely unnoticed, is that government will be the appropriate institutional choice only under certain circumstances—chiefly when stakeholders are incapable of resolving the distress ex ante through negotiation or a judicial proceeding. Dodd-Frank at least potentially displaces these other institutions in the worst possible way because it is opaque and without participatory opportunities. Like the last-minute decision to allow Lehman Brothers to go into bankruptcy (while nevertheless bailing out AIG) government has in effect codified in the OLA the lawlessness that likely made the financial crisis worse than it needed to be. It has all the ingredients to produce epic failures—large, costly collapses from which we learn nothing.

If institutional legitimacy is ultimately about stakeholder acceptance—institutional settlement in Hart and Sacks’ terms—it is difficult to see how any stakeholders affected by the OLA, whether

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\(^{216}\) The government may also drag its feet because it lacks prefunding, as would otherwise happen with an insurance program like the Federal Deposit Insurance program, which is funded with premia paid by member banks. See Jeffery N. Gordon & Christopher Muller, *Confronting Financial Crisis: Dodd Frank’s Dangers and the Case for a Systemic Emergency Insurance Fund*, 28 YALE J. REG. 151, 192-193 (2011) (“The lack of any pre-funding of the Orderly Liquidation Fund will lead regulators to postpone intervention with techniques that are likely to foster financial instability.”).
those present at the time of a crisis, or future generations asked to bear the costs, could view such a system as legitimate. It may constrain chaos, but it does so at an extremely high price, one that may be more costly than other institutional alternatives.

3. Avoiding Epic Fails—Some Programmatic Solutions

To this point, we have seen that government is increasingly in the business of both creating and resolving financial distress. We have also seen that this is not always bad. Whether it is a sound institutional choice will turn on the nature of participation ex ante and ex post. The temptation to use debt subsidies is strong, and it is unlikely that there will be political will to stop it (nor would that be a good thing). Sophisticated financial firms (SFs) may skirmish about Dodd-Frank and its orderly liquidation authority, in an attempt to limit its effect and scope. But they are unlikely to see it repealed. Yet, both debt subsidies and Dodd-Frank promise more and larger failures in the future.

What, then, should we do? This part assesses several leading solutions and explains why, from an institutional perspective, they are unlikely to be effective. Instead, I offer one example of the sort of programmatic response that Congress should consider if it wishes to do a better job of preventing and managing distress in a serious way—strict liability compensation clawbacks.

3.1 Proposed Cures—And What Ails Them

There is no shortage of literature offering solutions to prevent another financial crisis. While much of this literature is thoughtful and helpful, it tends to suffer from a basic problem: It makes no effort to compare institutional efficacy at preventing or resolving financial distress. It is thus at best incomplete and, in some cases, surprisingly misguided.

3.1.1 The Bailout Debates

Much of this literature revolves around the wisdom (or not) of “bailouts,” a term with a surprisingly low light-to-heat ratio: it seems everyone has an opinion about bailouts, although no one
quite knows what they are. A conventional view of the aftermath of the financial crisis was that
government should not be in the business of “bailing out” distressed firms. According to the
Republican Party platform of 2008: “We do not support government bailouts of private institutions.
Government interference in the markets exacerbates problems in the marketplace and causes the
free market to take longer to correct itself. We believe in the free market as the best tool to sustained
prosperity and opportunity for all.”217 They did, that is, until asked to support President Bush’s
Emergency Economic Stabilization Act (EESA),218 the centerpiece of which was the Troubled Asset
Relief Program (TARP) a $700 billion “bail out.” A pretty good number of Republicans held their
noses and voted for it.219

Ambivalence about bailouts is not surprising, for several reasons. First, it is not entirely clear
what a “bail out” is. It sounds like a handout, but in many cases, it has turned out to be a temporary
loan or investment in a troubled firm by the government. “Bail out” implies that the government
made a gift. With AIG, where the government paid far more for its preferred stock than it should
have and refused to require AIG to work out the derivative contracts that caused its distress in the
first place, it was. Yet, in many cases, the government was simply making an investment that the
market was unable to make in order to keep the system from collapsing entirely. It was the “lender”
(or investor) of last resort. A bailout is problematic only if it is on below-market terms, as

217 Committee on Arrangements for the 2008 Republican National Convention, 2008 Republican Platform, available at
219 65 House Republicans voted in favor of H.R. 3997, the original House vehicle for the act. After that legislation failed,
on October 1, 2008, 34 Senate Republicans voted for H.R. 1424, the new vehicle for the act, and on October 3, 2008, 91
House Republicans voted for that bill. President Bush, a Republican, subsequently signed it into law. 56 House Vote
#position (both visited June 20, 2012).
apparently happened with AIG in the sense that AIG was not required to make “market” attempts to renegotiate its CDS obligations. While it will be difficult to calculate the total cost of the “bail out” of the crisis, it would appear to be far less than the widely touted $700 billion amount earmarked in TARP.

Concerns about protecting taxpayers, while legitimate, would appear to have been somewhat overstated, at least in the near term. Instead, the greater immediate concern about bailouts would have to be moral hazard, the belief that salvation of this sort leads to future mal- or mis-feasance. As Ayotte and Skeel have observed, “The rescue loan approach favored in the financial crisis increased uncertainty, increased the costs of moral hazard, and dampened the incentive of private actors to resolve distress before a desperate "day of reckoning" arose.”\footnote{Ayotte \\& Skeel, supra note 16, at 471} This is a problem, they argue, because “[i]f the investors who fund a financial institution by lending money or buying stock anticipate that the firm will be rescued if it runs into trouble, they may extend funding beyond what they would extend otherwise. This willingness to continue funding may enable the firm to delay a needed restructuring of operations or a merger with a healthy acquirer.”\footnote{Id. at 485} The moral hazard of bailouts, in other words, creates incentives to borrow more than is prudent and to refuse to renegotiate the debt when it becomes unserviceable.

This is doubtless true, but it is incomplete. Bailouts are at most a small part of the much larger problem of government debt subsidy. As explained above, it is that problem which creates the basic conditions for excessive leverage. Worse, being a political problem with intergenerational consequences, it is not one that we can expect to resolve easily. We can easily—perhaps too easily—leave it for the future.
And yet, while many reflexively oppose bailouts, it is clear that they are sometimes appropriate. Perhaps the best known, if not necessarily most costly, version of this, were the loans made by the federal government in connection with the bankruptcies of Chrysler and General Motors. To the extent these were “bailouts” in their most troubling form—gifts—they may nevertheless have been necessary to stave off a greater evil: The profoundly destructive cascade of job losses likely to occur if the automakers failed to reorganize. Given the conditions of the credit markets at the time, it appears that other, more traditional lenders who would fund reorganizations were simply not doing so. Moreover, unlike AIG, the government conditioned its financial support on a variety of stakeholder concessions which were effectuated through the reorganization plans overwhelmingly supported by creditors and approved by the bankruptcy courts.

Thus, the third problem with saying simply “no more bailouts” is that it is not uniformly good policy or credible. President Obama can say that “if there’s one lesson that we’ve learned it’s that an unfettered market where people are taking huge risks and expecting taxpayers to bail them out when things go sour is simply not acceptable.” But the real lesson, I believe, is a bit more complex. As Peter Conti-Brown has recently observed “Any policy reaction to bailouts must deal with [the] complexity [that] bailouts are almost always the wrong policy approach, except when they are not.”

222 Stephen J. Lubben & Ben-Ishai, A Comparative Study of Bankruptcy as Bailout, 6 BROOK. J. CORP., FIN. & COM. LAW 1, 1-2 (2011)
Thus, the reality is that bailouts will sometimes be necessary evils.\footnote{As the economist Simon Johnson put it: “TARP was an essential piece of a necessary evil—that is, it saved the American financial system from collapse—but it was implemented in a way that was excessively favorable to the very bankers who had presided over the collapse. And this sets up exactly the wrong incentives as we head into the next credit cycle.” Simon Johnson, \textit{TARP, The Long Goodbye}, N.Y. TIMES ECONOMIX, Sept. 30, 2010, \url{http://economix.blogs.nytimes.com/2010/09/30/tarp-the-long-goodbye/}.} How “evil” can only be understood in comparative institutional terms, assessing the costs and benefits of a bailout against other available alternatives. The problem with bailing out Bear Stearns, therefore, was not the cost to taxpayers, or even the moral hazard that other \textit{S}F\textsuperscript{3}s would continue to increase their leverage. By then, the damage was mostly done. Instead, the damage was participatory: It would appear that whatever workouts should have occurred in the first three quarters of 2008—and which would have occurred had markets or courts been the only institutional options—did not.

The long term effect will have even greater participatory consequences. President Obama can claim that Dodd-Frank will end bailouts, but I simply do not find such claims credible.\footnote{See Jonathan Macey & James Holdcroft, \textit{Failure is an Option: An Ersatz-Antitrust Approach to Financial Regulation}, 120 YALE L.J. 1368, 1373 (2011).} The steady growth of government debt subsidies—in good times and bad—makes clear that market actors reasonably assume that, in the end, government will come to their rescue more often than not.\footnote{See Alessandri & Haldane, \textit{supra} note 162 (“the ex-post costs of crisis mean such a statement [no more bailouts] lacks credibility.”)} Moreover, a blanket prohibition on bailouts would be foolish. If the effect of financial support from the government promotes participation in some resolution process among the parties—whether in or out of court—it is likely to be a better choice than an absolute rule. While some observers express concern about the treatment of certain bondholders in the automaker bankruptcies, no one seriously doubts that the result—abetted by government participation—was probably better than any other alternatives would have produced.
The conventional wisdom about bailouts is therefore either wrong (it was not especially costly to taxpayers) or incomplete. Bailouts will sometimes be appropriate; sometimes not. In any case, the answer involves much more complex and subtle choices than we sometimes wish to admit.

3.1.2 More Government

Another class of cures proposes to create more government. The response to the (probably exaggerated) belief that “deregulation” caused the financial crisis is, to some, “reregulation.” Eric Posner and Glen Weyl, for example, have argued that government should create an agency “like the Consumer Financial Protection Bureau . . . [that] will have the authority to screen new financial products.”

Their principal goal appears to interdict truly speculative transactions, such as a naked short credit derivatives (CDS), or other transactions in which the investor has an “insurable interest.”

There is, of course, no small irony in seeing a proposal to create a potentially enormous, market-stifling bureaucracy emanate from the University of Chicago, Professor Posner’s home institution. As is well known, that school perhaps more than any other is responsible for advocating much of the deregulation that actually occurred over the last 40 years.


229 Id. at 5. They claim, apparently unaware of the regulatory history, that “Naked credit default swaps (CDSs) were illegal in most jurisdictions until the summer of 2005. These insurance contracts on the default of debts were prohibited because insurance regulations require that one have an insurable interest. You may only purchase insurance on a bond that you actually own. Under intense lobbying from the financial services industry, these restrictions were repealed and credit default swaps quickly became a boom industry.” As discussed in text at note 77, above, the Commodities Futures Modernization Act of 2000 effectively assured that CDS—whether “naked” or “covered”—were legal and could not be the subject of any regulation

But the more important point is the institutional one: why are markets suddenly incapable of assessing risk for themselves? It is true that many market actors did misprice risk in the run up to the crisis and that ICT (as discussed above) contributed to the problem. It is equally true that government under certain circumstances may be the most institutionally effective solution to certain types of financial regulation (for example, the Consumer Financial Protection Bureau protects consumers who are likely unable to negotiate for themselves). But as explained above, regulators are likely to be comparatively effective in this context only when protecting the interests of widely dispersed, poorly-resourced stakeholders, such as retail consumer bank depositors. The Posner/Weyl proposal, by contrast, seeks to protect sophisticated market actors. If they cannot protect themselves from speculation, who can? And why would we think more government—and more law—are better at this than the actors themselves? Posner and Weyl do not say, which is the key problem.

3.1.3 More Bankruptcy

Still others are partisans of the bankruptcy process, albeit in a modified form. Perhaps the most ambitious proposal comes from Stanford’s Hoover Institute, which has proposed an entirely new chapter to the Bankruptcy Code, chapter 14, which would be available exclusively to the same systemically important financial firms that Dodd-Frank purports to regulate, but would choose a different institution—courts.231 Bowing to the political reality that Dodd-Frank is a law whose repeal is unlikely, however, it is offered “either in addition to or as an alternative to” Dodd-Frank.232

231 As Thomas Jackson, the principal author of the proposal and one of the nation’s leading experts on bankruptcy explains, the chapter 14 proposal is designed “especially for the complexity and potential systemic consequences, of the failure of [a] large financial institution[].” Thomas Jackson, Bankruptcy Code Chapter 14: A Proposal, 2 (draft of 2/28/12) (available at http://media.hoover.org/sites/default/files/documents/Bankruptcy-Code-Chapter-14-Proposal-20120228.pdf) (visited June 21, 2012).

232 Id.
The main contribution of chapter 14 can be understood in institutional terms: It would take resolution authority away from regulators, and give it (back) to (specialized) courts: “we believe it is possible to take advantage of a judicial proceeding . . . in such a way as to minimize the felt necessity to use the alternative government agency resolution process recently enacted as a part of [Dodd-Frank].”

The motivation here is curious, but perhaps laudable: judges are (probably) likely to produce decisions that are more transparent, precedent-bound, and thus predictable than regulators. The goal of chapter 14 is, according to its proponents, “to ensure that the covered financial institutions, creditors dealing with them, and other market participants, know in advance, in a clear and predictable way, how losses will be allocated if the institution fails.” The theoretical justification is that bailouts distort incentives. “If the creditors of a failed financial institution are protected (bailed out), then the strongest and most rapidly responding constraint on risk-taking by the financial institution’s management is destroyed, and their losses are transferred to others.”

While the details of the proposal need not detain us, it is worth noting two flaws in the reasoning here. First, if the goal is to create some certainty about which institution resolves distress, then the chapter 14 proposal’s political pragmatism makes it a non-starter. The authors sensibly recognize that Dodd-Frank is not likely to be repealed. So, they eagerly suggest that chapter 14 could comfortably co-exist with Dodd-Frank. But if we do not know when or to whom Dodd-Frank is to apply, why would we think creating a dual, judicial track creates greater clarity?

233 Id. at 2.
234 Id.
235 Id.
Second, they recognize that bankruptcy courts have uncertain authority. This is due to a series of Supreme Court decisions (discussed briefly above) holding that bankruptcy judges, as Article I actors, “lack authority under Article III of the Constitution to enter final judgments on claims that constitute ‘the stuff of the traditional actions at common law tried by the courts at Westminster in 1789.’”236 While it is far from clear what this means in practice, the chapter 14 proposal would avoid the problem by taking these resolutions away from bankruptcy judges, too. Instead, such cases would be “funnel[ed]” to “a limited set of pre-picked Article III district judges.”237

They may be correct that placing these decisions with U.S. District Judges avoids possible constitutional challenges over bankruptcy judges’ authority. But this is not their rationale. Rather, they argue, somewhat surprisingly, that “it is unlikely that the nation’s several hundred bankruptcy judges—all of whom can be presumed to have important knowledge of the Bankruptcy Code itself—will have the requisite financial expertise to deal, in real time, with the nation’s largest financial institutions.”238 They also question the independence of bankruptcy judges who, as Article I actors, may be susceptible to political influence (e.g., from the Congress that sets their pay). “[T]he essential need for complete independence from any perception of influence by the financial institution, the government, or a particularly significant creditor, suggests that any bankruptcy system designed for the nation’s largest financial institutions would want those institutions to have

236 Stern v. Marshall, 131 S Ct. 2594, 2609 (2011). See also Lipson, Debt and Democracy, supra note 35, at [27] (discussing structural challenges to bankruptcy court authority).

237 Jackson, supra note 231, at 9.

238 Id. at 8.
their cases and ancillary proceedings heard before an Article III judge . . . [the] ‘gold-plated’ standard of independence from government.”

This is curious for many reasons. It is, for example, hard to imagine judges with greater expertise in dealing with the failures of large financial institutions than Robert Drain, the bankruptcy judge who oversaw the Refco case, Judge Mary Walrath, who oversaw the bankruptcy of WaMu’s parent holding company, or James Peck, the bankruptcy judge who oversaw the Lehman Brothers case. There may be arguments from pragmatism for taking this work away from them—or more plausibly providing for dual bankruptcy-district judge appointments—but it is inappropriate to question their expertise or independence. Moreover, anyone who believes that Article III courts are the “gold-plated standard of independence” has not spent time in Washington D.C recently. As noted above, there is good reason to believe that the Court of Appeals for the D.C. Circuit has essentially been captured by SF’s, against whom they have not ruled in many years. A large body of empirical literature has shown that even Article III judges are as likely to vote their ideology as to follow precedent. Such bias is a simple and unavoidable fact of institutional life.

I am nevertheless sympathetic to the intuition behind this proposal. There is good reason to believe that the bankruptcy process brings with it a host of institutional and participatory virtues lacking in Dodd-Frank. As discussed in Part 2, as a judicial process, bankruptcy is probably more transparent than bank resolution, and chapter 14 responds to conditions where transparency is likely a good thing; it probably creates an environment in which a negotiated solution is more realistic; it

239 Id. at 9


would enjoy the support of a large group of seasoned bankruptcy professionals, including lawyers, accountants and bankers.

Nevertheless, the more basic question is why we need a whole new chapter of the Bankruptcy Code to do this at all? No case has been made that U.S. District Courts—or the judiciary in general—are likely to be the most effective institutional choice if an SF fails. As explained above, whether a court of any sort would be the best institutional choice will turn on participatory dynamics somewhat more subtle than simply the size of the debtor.

3.2 A Non-Epic, Pragmatic and Participatory Proposal

It is easy to poke holes in others’ proposals. Much harder still is to develop an alternative proposal that is responsive to the institutional concerns raised in this Article. I offer one here, although do so tentatively, recognizing that this paper is the start (not the end) of a new way to think about financial distress. From an institutional perspective, an effective (legal) move may be to tie executive compensation to reliance on government debt subsidies, through the creation of strict liability clawbacks. While not a perfect mechanism, linking the risk of loss to the use of debt subsidies would likely lead those who make the important decisions—firm managers—more sensitive to the liquidated costs of debt subsidies in distress.

As Miriam Cherry and Jarrod Wong explain, the term “clawback” connotes “a stunningly broad variety of contractual provisions, legislative enactments, and legal remedies.” While the technicalities can vary elaborately, their definition is sufficient for present purposes: A “clawback” is “a theory for recovering benefits that have been conferred under a claim of right, but that are

nonetheless recoverable because unfairness would otherwise result."\(^{243}\) Clawbacks appear in a variety of contexts, but are commonly associated with concerns about excessive executive compensation, and appear to be triggered by a claim that the executive was involved in some wrongdoing.\(^{244}\)

The role of executive compensation in the run-up to the financial crisis has been reasonably well studied. There is evidence that senior managers of firms that benefitted from various forms of government debt subsidies—in particular Bear and Lehman—made enormous amounts of money.\(^{245}\) Conventional accounts portray these managers as having lost money because incentive compensation they held when their firms failed lost value. But those accounts ignore the significant gains retained in the years prior to the collapse, when incentives to stoke earnings and increase compensation, based in part on debt subsidies, were greatest.\(^{246}\)

There have been many proposals to deal with concerns about perceived “excessive” executive compensation. Whether compensation is excessive is obviously a difficult question to answer in the abstract. Yet, when a firm has failed, all of its significant pre-failure expenditures should be scrutinized. Although bankruptcy courts have certain powers to avoid pre-bankruptcy transfers, they are generally viewed as ineffective to recover executive compensation.

\(^{243}\) Id. at 371-372.


\(^{245}\) See, e.g., Lucian A. Bebchuk, Alma Cohen, & Holger Spamann, The Wages of Failure: Executive Compensation at Bear Stearns and Lehman 2000-2008, 27 YALE J. REG. 257, 259-60 (2010) (“Overall, we estimate that the top executive teams of Bear Stearns and Lehman derived cash flows of about $1.4 billion and $1 billion respectively from cash bonuses and equity sales during 2000-2008. These cash flows substantially exceeded the value of the executives’ initial holdings at the beginning of the period.”).

\(^{246}\) Id. at 260 (“As a result, the bottom-line payoffs of these executives during 2000-2008 were not negative but rather decidedly positive. Our analysis has implications for the continuing debates on whether financial executives had incentives to take excessive risks and whether pay arrangements need to be restructured.”).
A strict-liability clawback would in effect recognize the political reality that debt subsidies are here to stay, but temper their use at the point where they are most likely to be abused: executive compensation. Laws that create explicit debt subsidies—for example, the Federal Deposit Insurance Act—should be amended to provide that if the government’s contingent liability (as a guarantor of the bank’s debt) becomes fixed and liquidated, officers (and perhaps directors) who participated in the decisionmaking that led to the financial failure should have to return compensation they received, whether from the bank directly, or through the exercise of options or the sale of shares. In any such case, the presumption would be that firm agents relied on debt subsidies to inflate compensation, rather than achieve some other social goals (e.g., assure depositors that the banking system is safe and sound). To be sure, firm agents should have the chance to rebut this presumption by establishing something like the fair market value of their services net of the debt subsidy. But the key is that firm managers who benefit from ex ante debt subsidies in the form of explicit guarantees should understand the ex post risk that they may not be entitled to keep gains from these subsidies if the firm fails in any formal way (i.e., a bankruptcy or administrative resolution proceeding). Amounts so recovered would be redistributed to creditors of the failed firm.

Notice what this does. First, it creates an incentive to avoid inflating firm value based on certain types of debt subsidies. While many things contributed to the credit bubble and its subsequent collapse, debt subsidies appear to have played an important and underappreciated role. In general, firm growth and executive compensation should be linked to economic performance, not government subsidies.

Second, it creates a strong incentive among executives to use market-based resolution whenever possible. An executive who knows that his or her pre-failure compensation will be scrutinized if a governmental or judicial procedure is commenced may spend more time in the market renegotiating with stakeholders. In cases where that is not possible, the executives who led
the firm for some period of time prior to failure (to be established following further study) should then expect that they will have to forfeit some (but not all) of the compensation they received.

Third, it gives government an important bargaining chip in negotiations with SFs or other firms that may threaten the financial system. Unlike AIG, where regulators apparently believed they could not (or should not) require the insurance company to renegotiate its CDS obligations with counterparties, a strict liability clawback would give regulators a simple tool to encourage executives who would otherwise benefit from debt subsidies to participate as fully as possible in the debtor’s rehabilitation, by making good faith efforts to restructure debt, even if this occurs outside bankruptcy.

The virtue of a strict liability clawback, therefore, is participatory: It is likely to produce greater participation by those who count—managers—in preventing distress ex ante and in resolving it ex post.

Those who defend current executive compensation practices would doubtless bridle at this proposal, and find many flaws with it. The first and loudest objection would be that Dodd-Frank already creates a clawback. Putting to one side the obvious problem (discussed above) that we do not know whether or when Dodd-Frank’s OLA will be invoked, strictly speaking this is true. Section 210(s) of Dodd-Frank appears to have been written to impose strict liability on executive compensation in a failed financial firm. Yet, by regulation, the FDIC has effectively imposed a

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247 Section 210(s) of the Dodd-Frank Act provides:

Recoupment of Compensation From Senior Executives and Directors.--

(1) In general.--The Corporation, as receiver of a covered financial company, may recover from any current or former senior executive or director substantially responsible for the failed condition of the covered financial company any compensation received during the 2-year period preceding the date on which the Corporation was appointed as the receiver of the covered financial company, except that, in the case of fraud, no time limit shall apply.

(2) Cost considerations.--In seeking to recover any such compensation, the Corporation shall weigh the financial and deterrent benefits of such recovery against the cost of executing the recovery.
negligence standard of care, which is of course not strict liability at all. In pertinent part, the implement regulation (12 C.F.R. 380.7) provides that managers shall be liable only if they fail to exercise their responsibilities “with the degree of skill and care an ordinarily prudent person in a like position would exercise under similar circumstances.”

It takes only a moment’s thought to realize that if this were the standard in 2008, few if any executives would have been liable because so many managers of SFs were engaged in the same behavior. If, in the future, a firm were important enough to warrant an OLA proceeding, it seems equally probable that many other executives of other firms would have been engaged in similar conduct, considerably dulling this clawback.

A strict liability clawback is, to be sure, an imperfect solution. To implement it would require answers to many questions beyond the scope of this paper. What, for example, would constitute a “debt subsidy” for this purpose? The simplest approach would limit the clawback to compensation paid by firms that benefitted from explicit financial guarantees (or payments) by government in support of private debt. But, as explained in Part 2, government subsidizes debt in other ways, such as through regulatory exemptions and financial innovation. Should compensation that is the product of those subsidies also be subject to a strict liability clawback?

And, what sort of time period are we talking about? Should it apply only to the executives in charge when the company fails, or also their predecessors? This seems problematic. In many cases, special “turnaround managers” are brought in to help fix a firm, even if doing so requires a formal bankruptcy (or other proceeding). But how far back should we reach, and on what basis? Fraudulent transfer law—which functions in many ways like a clawback—is generally limited to

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248 12 C.F.R. § 380.7.
transfers made between four and six years prior to the challenge to the transfer (which usually occurs in a bankruptcy case). Should the metric be temporal, or something else?

Nor should we ignore the costs of deterring management from seeking governmental or judicial resolution. The corporate bankruptcy system from 1938 to 1978 did this, by providing that a trustee would replace management of publicly-held firms. Few filed for bankruptcy because they did not want to lose their jobs. These constraints were thought to destroy value, by preventing otherwise going concerns from reorganizing. The Bankruptcy Code of 1978 changed this, permitting management of the chapter 11 debtor to remain in possession and control, subject to a variety of checks and balances. A strict liability clawback would be a step (perhaps a small one) back to the system as it existed prior to 1978.

Although imperfect, this may have the unusual virtue of political viability. Unlike an implausible blanket prohibition on “bailouts,” or creating a new Financial Products Review Board, as Posner and Weyl suggest, or a new chapter of the Bankruptcy Code, as the Hoover Institute suggests, there appears to be a movement in Congress to make existing clawbacks more effective by limiting the availability of directors and officer’s insurance when compensation is recovered.

Whether or not perfect, this is simply an example of the kind of solution that institutional analysis of financial distress would suggest. It would dampen the appetite for debt subsidies, and encourage greater use of markets, to create debt and to resolve distress when it cannot be repaid. It

249 See Unif. Fraud. Transfer Act. § [XX].
is keyed off of participation in the process of creating and resolving financial distress, something seems currently to happen far too little.

**Conclusion**

Financial distress is not the sort of problem we can expect to eradicate. Nor would we want to. Any system of private ordering that involves debt must contemplate the possibility that some of that debt will not be repaid. While there have been many rich theoretical and empirical contributions to understanding financial distress, none has approached the question institutionally. This paper has filled that gap. As shown above, this may be the best way to understand it. Institutional analysis reveals that government plays a far larger role in the creation and resolution of financial distress than we acknowledge. It also offers a principled basis for understanding when that will and will not be problematic. It does not offer easy solutions, but does point towards more realistic ones. It shows that, while failures may be inevitable, they need not be epic.

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**TABLE 1:**

**APPROXIMATE AMOUNTS OF GOVERNMENT-SUBSIDIZED PRIVATE DEBT**

<table>
<thead>
<tr>
<th>Government Guarantee Program</th>
<th>Nature of debt</th>
<th>Amount</th>
<th>Source</th>
</tr>
</thead>
<tbody>
<tr>
<td>Federal Deposit Insurance</td>
<td>Bank debts to retail depositors</td>
<td>$7 trillion</td>
<td>FDIC 2011 Strategic Report, p. 92&lt;sup&gt;252&lt;/sup&gt;</td>
</tr>
<tr>
<td>Fannie Mae</td>
<td>Mortgage notes held or guaranteed</td>
<td>$3.13 trillion</td>
<td>Fannie Mae 10-K filing as of December 2011 at p. 253&lt;sup&gt;253&lt;/sup&gt;</td>
</tr>
<tr>
<td>Freddie Mac</td>
<td>Mortgage notes held</td>
<td>$1.781 trillion</td>
<td>Freddie Mac 10-K filing as of December 2011 at p. 233&lt;sup&gt;254&lt;/sup&gt;</td>
</tr>
<tr>
<td>Sallie Mae</td>
<td>Student loans</td>
<td>$193 billion</td>
<td>Sallie Mae 10-K filing as of December 2011&lt;sup&gt;255&lt;/sup&gt;</td>
</tr>
<tr>
<td>Ginnie Mae</td>
<td>“Full Faith and Credit” backed MBS’s</td>
<td>$1.221 trillion</td>
<td>2011 Annual Report, p. 29&lt;sup&gt;256&lt;/sup&gt;</td>
</tr>
<tr>
<td>Pension Benefit Guarantee Corporation</td>
<td>Unfunded pension liabilities</td>
<td>$107 billion</td>
<td>2011 Annual Report, p.iv&lt;sup&gt;257&lt;/sup&gt;</td>
</tr>
<tr>
<td>Other</td>
<td>Loan guarantees or subsidies</td>
<td>$816 billion</td>
<td>2012 Federal Credit Supplement White House Budget Report&lt;sup&gt;258&lt;/sup&gt;</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td></td>
<td>$14.328 trillion</td>
<td></td>
</tr>
</tbody>
</table>


<sup>253</sup> [http://sec.gov/Archives/edgar/data/310522/000119312512087297/d282546d10k.htm#toc282546_24](http://sec.gov/Archives/edgar/data/310522/000119312512087297/d282546d10k.htm#toc282546_24)

<sup>254</sup> [http://www.freddiemac.com/investors/er/pdf/10k_030912.pdf](http://www.freddiemac.com/investors/er/pdf/10k_030912.pdf)


<sup>256</sup> [http://www.ginniemae.gov/about/ann_rep/annual_report11.pdf](http://www.ginniemae.gov/about/ann_rep/annual_report11.pdf)


<sup>258</sup> [http://m.whitehouse.gov/sites/default/files/omb/budget/fy2012/assets/cr_supp.pdf](http://m.whitehouse.gov/sites/default/files/omb/budget/fy2012/assets/cr_supp.pdf)