Bankruptcy 2.0 versus Bailouts

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

As we try to learn the right lessons from the 2008 financial crisis, a debate has emerged as to the merits of bailouts versus bankruptcy. Although the chaotic days when Lehman and AIG were failing are starting to fade into financial history, ongoing news on European bailouts reminds us that this debate is still very much alive. *Bankruptcy or Bailouts* by Kenneth Ayotte and David Skeel, provides an excellent Law and Finance discussion that unpacks the key issues of moral hazard underlying rescues of financial institutions and the systemic risk considerations. They identify cases where bankruptcy has been surprisingly effective, discuss how it avoids various distortions resulting from bailouts, and challenges the common view that Chapter 11 bankruptcy is an inappropriate vehicle for resolving distress in financial institutions.

This article confronts head-on the difficulties in this area – the difficult choices for policymakers, and the difficulty in establishing causality between past events (e.g., the Lehman filing and the AIG bailout) and the volatility and illiquidity in the market. As Ayotte and Skeel remarked, questions such as whether a Lehman rescue loan could have reduced the severity of the financial crisis that followed are "impossible to answer with certainty." (P. 490.) They then proceed to present some data, which provides us reason to be skeptical about the conventional wisdom that Lehman's Chapter 11 filing was the singular cause of the resulting credit crunch.

Given these difficulties, it is interesting to contrast this article with another recent paper, In Defence of Bailouts, by Adam Levitin, where systemic risk is described in terms of political accountability and legitimacy. It appears that Ayotte and Skeel differed from Levitin on whether moral hazard and systemic risk are minimized (or can be minimized) in a bailout versus in bankruptcy. In particular, Levitin argued that a bankruptcy court may not be capable of deciding upon (and enforcing) the politically acceptable distributional outcome, especially if there are systemic implications. This is consistent with what George Akerlof and Robert Shiller opined in Animal Spirits (2009) – that the creditors' focus in bankruptcy proceedings is mainly on the institution in question and there needs to be a reconsideration of bankruptcy law to take special account of the fact that the public has an interest in such distress situations.

Nonetheless, the article by Ayotte and Skeel has complicated the usual assumption that nothing good can come from the bankruptcy of a large financial institution through an examination of the firm-specific costs, corporate governance distortions, and downsides of the prompt corrective action approach by regulators. They have made a convincing argument that the bankruptcy regime should play a role in resolving financial institution distress with a handful of changes, especially those pertaining to derivatives. There is, however, an open issue that we are reminded of by their article: the 900,000 derivative contracts to which Lehman was a counterparty. An issue, seldom discussed in this debate but one that can affect our assessment of the choice between bankruptcy and bailouts, is the extent of public disclosure in bankruptcy, as compared to bailouts. Just as a bank's supervisory CAMELS ratings are kept confidential to prevent a bank's customers and investors from losing confidence and potentially mounting a bank run, significant counterparty exposures to financial institutions disclosed in bankruptcy dockets could have spillover effects in terms of affecting market confidence in these counterparty institutions.

Flexibility and open-mindedness would seem to be the best course, and this is a recurring theme in this article. Ayotte and Skeel have adopted a realistic position in stating that "[i]f regulators conclude that systemic risk concerns are so great that intervention is necessary, [regulators] could use an intermediate strategy of allowing the firm to file for bankruptcy, while selectively guaranteeing certain 'dangerous' liabilities as an alternative to a rescue loan." (P. 491.) At the end of the day, Ayotte and Skeel are essentially advocating Bankruptcy 2.0, where there may be pockets of government intervention alongside the bankruptcy regime, as opposed to the oft-cited view of bailouts without bankruptcy being an inevitable part of modern financial markets.

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