SHADOW BANKING AND FINANCIAL DISTRESS: THE TREATMENT OF "MONEY-CLAIMS" IN BANKRUPTCY

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Despite the panic in the money market in 2008 that required a $3 trillion Treasury guarantee to stave off a full-fledged run on money market funds, Dodd-Frank did not shut down shadow banking, nor did it make shadow banking safe. After Dodd-Frank, distressed financial institutions are subject to a number of conflicting legal regimes, one of which continues to be the Bankruptcy Code. This Article is the first to suggest that the Bankruptcy Code in its current form does not adequately account for the unique nature of claims in the money market (or "money-claims"). Investors in the money market are similar to depositors in a traditional bank—individuals, corporations, and municipalities store funds that will need to be used in the near term for payroll, municipal services, or other operational needs. In other words, money market investors make short-term loans for the purpose of cash management rather than investment. Because of this crucial difference between money-claims and ordinary debt obligations, defaults on money-claims are uniquely problematic—corporations may not be able to make payroll or pay suppliers; municipalities may be forced to cut planned services.

This Article explains the treatment of money-claims under the current bankruptcy rules, argues that these rules exacerbate the risks associated with money-claims in the shadow banking sector, and proposes that bankruptcy rules

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be altered to better reflect the unique nature of money-claims. Specifically, it proposes an abbreviated stay for money-claimants as well as an alternative opportunity for prompt payment of money-claims.

I. INTRODUCTION

A number of scholars have expressed alarm that financial institutions are engaged in bank-like activities, but with neither the risk constraints nor the official liquidity backstop or guarantee that apply to banks.[1] According to a number of economists, the short-term debt obligations in the shadow banking system—money market obligations—are similar in nature to depositary obligations, and entail many of the same risks.[2] Such risks include the bank runs that paralyzed the financial sector at the onset of the Great Depression, and the temporary halting of the commercial paper and repurchase agreement ("repo") markets in the financial crisis of 2008. Investors in the money market (whether individuals, corporations, or municipalities) are, like depositors, actually setting aside funds ("transaction

[1] *See, e.g.*, Morgan Ricks, *Regulating Money Creation After the Crisis*, 1 HARV. BUS. L. REV. 75 (2011); Gary Gorton & Andrew Metrick, *Regulating the Shadow Banking System*, BROOKINGS PAPERS ON ECON. ACTIVITY, Fall 2010, at 261, 264, 280; Gary Gorton, *The Panic of 2007* (Yale Sch. Of Mgmt. Int'l Ctr. For Fin., Working Paper No. 08-24, 2008); PAUL KRUGMAN, THE RETURN OF DEPRESSION ECONOMICS AND THE CRISIS OF 2008 (2009); FINANCIAL SERVS. AUTH. ("FSA"), THE TURNER REVIEW: A REGULATORY RESPONSE TO THE GLOBAL BANKING CRISIS 21 (2009).

[2] Jeffrey N. Gordon & Christopher Muller, *Confronting Financial Crisis: Dodd-Frank's Dangers and the Case for a Systemic Emergency Insurance Fund*, 28 YALE J. ON REG. 151, 160 n.10, 161–65 (2011) ("For investment banks, short-term credit suppliers are the functional equivalent of bank depositors."); Ricks, *supra* note 1, at 79, 92; GARY GORTON, SLAPPED IN THE FACE BY THE INVISIBLE HAND: THE PANIC OF 2007 14–15 (2010) (arguing that the distinction between shadow banking and depositary banking is artificial); *see also* WALTER BAGEHOT, LOMBARD STREET: A DESCRIPTION OF THE MONEY MARKET (John Wiley & Sons 1999) (1873). Certain components of the shadow banking system are backed by indirect or implicit liquidity availability or guarantee, to a greater degree now that the remaining investment banks have been converted to bank holding companies. ZOLTAN POZSAR ET AL., FED. RESERVE BANK OF N.Y., STAFF REP. No. 458, SHADOW BANKING 52 (2010). Goldman Sachs and Morgan Stanley have been transformed to bank holding companies. Andrew Ross Sorkin & Vikas Bajaj, *Shift for Goldman and Morgan Marks the End of an Era*, N.Y. TIMES, Sept. 22, 2008, at A1.

reserves") that they plan to be able to access in the near term. For example, municipalities or corporations may place cash in the money market that they will soon draw upon to make payroll or pay for key services. And the scale of this money market is equally as great as the commercial banking sector, if not greater. For example, in 2007, U.S. bank deposits amounted to between $6.2 trillion and $6.9 trillion, whereas the amount of near-cash obligations ("money-claims") in these other financial institutions has been estimated to be between $6.2 and $7 trillion.[3]

In a crisis, money-claims matter, but current bankruptcy rules do not adequately address them. Since money-claims remain in the shadow banking sector, along with their attendant risks, legal regimes and rules that impact money-claims should be carefully considered—especially if it is correct that a run on the money market could result in a repeat of the Great Depression. Financial institutions in the money-claim business, whether as debtors or creditors (or both), may be subject to a number of conflicting regulatory regimes.[4] However, no scholar to date has specifically explored the treatment of money-claims in the bankruptcy system. This paper tackles the challenge of considering the fate of money-claims in bankruptcy.

Risk in the money market exists because these short-term debt obligations, like depositary obligations (which together

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[3] Pozsar ET AL., *supra* note 2, at 52 (comparing $6.3 trillion in bank deposits with $7 trillion in money market intermediaries and investors); Ricks, *supra* note 1, at 86 fig. 1 (listing $6.9 trillion for bank deposits, $4.3 trillion for [Federal Deposit Insurance Corporation ("FDIC")]-insured bank deposits, and $6.2 trillion in various types of short-term obligations); *see also* Adam B. Ashcraft, Fed. Reserve Bank of N.Y., Discussion at the Jacques Polak Research Conference: Do Global Banks Spread Global Imbalances?, at 3 (Nov. 6, 2009), http://www.imf.org/external/np/res/seminars/2009/arc/pdf/ashcraft1.pdf (estimates as of July 2007); INV. CO. INST., 2010 INVESTMENT COMPANY FACT BOOK 162 tbl. 39 (2010), *available at* http://www.ici.org/pdf/2010_factbook.pdf (showing 2007 levels); *Quarterly Banking Profile: Fourth Quarter 2007*, 2 FDIC Q., no. 1, 2008, at 17 tbl. III-B.

[4] *See generally* Stephen J. Lubben, *Financial Institutions in Bankruptcy*, 34 SEATTLE U. L. REV. 1259 (2011).

have been called money-claims[5]), are invested in assets with long-term maturities, meaning that if all money-claimants demand repayment at once, there will be an insufficient reserve of liquid assets to satisfy all claims.[6] On a microeconomic level, defaults on money-claims can cause serious damages, apart from any investment loss. For example, a company that cannot access cash it expected to access may face operational disruption or may default on its obligations, causing additional impairments.[7]

In addition, some economists argue that defaults on money-claims in the shadow banking sector, like defaults on money-claims in the traditional banking sector, contract the money supply, and, if they occur on too large a scale, may trigger a depression.[8] Indeed, during the most recent financial crisis, substantial government resources were deployed to preserve liquidity and insure certain types of money-claims in an effort to avert economic collapse. For example, the Federal Reserve ("the Fed") served as a lender of last resort to troubled institutions (extending about $1 trillion in liquidity), and the U.S. Treasury issued over $3 trillion in guarantees of financial firm liabilities to stem a run on money market mutual funds.[9] In essence, the government sought to take measures it failed to take for

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[5] Ricks, *supra* note 1, at 97.

[6] FIN. CRISIS INQUIRY COMM'N ("FCIC"), PRELIMINARY STAFF REPORT: SHADOW BANKING AND THE FINANCIAL CRISIS 9 (2010), *available at* http://fcic-static.law.stanford.edu/cdn_media/fcic-reports/2010-0505-Shadow-Banking.pdf [hereinafter FCIC, SHADOW BANKING]; Gordon & Muller, *supra* note 2, at 158 n.6, 158–59; POZSAR ET AL., *supra* note 2, at 8.

[7] Ricks, *supra* note 1, at 83.

[8] *Id.* at 80; Gorton & Metrick, *supra* note 1, at 261, 264, 279. The Federal Reserve includes retail money market mutual fund balance in M2 (cash and close substitutes), and institutional money market mutual fund balances, repurchase agreements, and Eurodollars in M3 (M2 plus large and long-term deposits). BD. OF GOVERNORS OF THE FED. RESERVE SYS., THE FEDERAL RESERVE SYSTEM: PURPOSES AND FUNCTIONS 22 (9th ed. 2005).

[9] Ricks, *supra* note 1, at 88.

depository banks at the onset of the Great Depression.[10] Yet, in the wake of the financial crisis, shadow banking was neither dismantled nor substantially regulated. In addition, the Dodd-Frank legislation endeavors to *strip* the federal government of its ability to respond to monetary concerns in a similar fashion in the event of a subsequent panic in the money market sector.[11] Crucially, after Dodd-Frank, insurance of money market mutual funds ("MMMFs") is now impermissible absent congressional approval.[12]

For some time, bankruptcy scholars and policymakers have debated whether the current distribution scheme in bankruptcy is either appropriate or efficient—in particular, with respect to the so-called "safe harbors" for certain types of financial creditors.[13] Many of these arguments center on

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[10] Ricks, *supra* note 1, at 106. For detail on the bank failures at the onset of the Great Depression, see, for example, Mark Carlson et al., *Arresting Banking Panics: Federal Reserve Liquidity Provision and the Forgotten Panic of 1929*, 119 J. POL. ECON. 889 (2011); EUGENE NELSON WHITE, THE REGULATION AND REFORM OF THE AMERICAN BANKING SYSTEM, 1900–1929 (1983). Of course, the cause of the Great Depression is also a subject of debate among economists. *See generally, e.g.*, BEN S. BERNANKE, ESSAYS ON THE GREAT DEPRESSION (2000); BARRY EICHENGREEN, GOLDEN FETTERS: THE GOLD STANDARD AND THE GREAT DEPRESSION, 1919–1939 (1992); PETER TEMIN, LESSONS FROM THE GREAT DEPRESSION (1989); MILTON FRIEDMAN & ANNA JACOBSON SCHWARTZ, A MONETARY HISTORY OF THE UNITED STATES, 1867–1960 (1963).

[11] Ricks, *supra* note 1, at 129–33 (citing Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203 ("Dodd-Frank Act"), § 1101(a)(2), (6), 124 Stat. 1376, 2113–15 (2010) (imposing restrictions on Federal Reserve last-resort lending to shadow banks)). *See* Dodd-Frank Act § 1105(c)(1), 12 U.S.C. § 5612(c)(1) (2011) (requiring congressional approval before the FDIC can insure money market mutual funds ("MMMFs") and other money-claims).

[12] Dodd-Frank Act § 1105(c)(1), 12 U.S.C. § 5612(c)(1) (2011).

[13] David A. Skeel, Jr. & Thomas H. Jackson, *Transaction Consistency and the New Finance in Bankruptcy*, 112 COLUM. L. REV. 152 (2012); Stephen J. Lubben, *Transaction Simplicity*, 112 COLUM. L. REV. SIDEBAR 194 (2012), http://www.columbialawreview.org/wp-content/uploads/2012/08/194_Lubben.pdf; Stephen J. Lubben, *The Bankruptcy Code Without Safe Harbors*, 84 AM. BANKR. L.J. 123 (2010) [hereinafter Lubben, *Bankruptcy Code*]; Michael Simkovic, *Secret Liens and the Financial Crisis of 2008*, 83 AM. BANKR. L.J. 253 (2009); Franklin R. Edwards & Edward R. Morrison,

whether the current scheme mitigates or exacerbates "systemic risk," particularly in light of the financial crisis.[14] However, none of the proposals for repealing, modifying, or retaining the current distribution structure explicitly differentiates between money-claims and other debt obligations.[15]

Derivatives and the Bankruptcy Code: Why the Special Treatment?, 22 YALE J. ON REG. 91, 101–03 (2005); Edward R. Morrison & Joerg Riegel, *Financial Contracts and the New Bankruptcy Code: Insulating Markets from Bankrupt Debtors and Bankruptcy Judges*, 13 AM. BANKR. INST. L. REV. 641 (2005). The derivatives industry has long argued that market concerns require that swaps and other derivatives be exempt from bankruptcy protections. *See* Skeel & Jackson, *supra* at 160–62; Brief for Int'l Swaps and Derivatives Ass'n, Inc. as Amici Curiae Supporting Respondents at 7, *In re* Nat'l Gas Distrib., 556 F.3d 247 (4th Cir. 2009) (No. 07-2105), 2008 WL 412344. Systemic risk justifications have also been raised in legislative hearings related to the safe harbors. *Bankruptcy Reform Act of 1999 (Part III): Hearing on H.R. 833 Before the Subcomm. on Commercial and Admin. Law of the H. Comm. on the Judiciary*, 106th Cong. 352 (1999) [hereinafter *1999 House Hearing*] (statement of Oliver Ireland, Assoc. Gen. Counsel, Bd. of Governors of the Fed. Reserve Sys.) ("The right to terminate or close-out protects . . . the markets from systemic problems of 'domino failures.'"). Policymakers have evidently been persuaded, because the safe harbors have only been expanded. Stephen J. Lubben, *Derivatives and Bankruptcy: The Flawed Case for Special Treatment*, 12 U. PA. J. BUS. L. 61, 67 (2009) [hereinafter Lubben, *Flawed Case*] (explaining that under the 2005 Bankruptcy Code amendments, "virtually every conceivable derivative transaction is now exempt from the automatic stay and the debtor's power to assume and reject").

[14] *See* Skeel & Jackson, *supra* note 13, at 162–63; Stephen J. Lubben, *Systemic Risk & Chapter 11*, 82 TEMP. L. REV. 433, 441 (2009); Mark J. Roe, *The Derivatives Market's Payment Priorities as Financial Crisis Accelerator*, 63 STAN. L. REV. 539, 566, 582 (2011). In addition, scholars have noted that while Dodd-Frank calls for some additional regulation in the shadow banking sector, the bankruptcy distribution scheme is not altered. Skeel & Jackson, *supra* note 13, at 154–55.

[15] As discussed in greater detail below, Stephen Lubben proposes modifying the safe harbors to provide for a brief window in which the debtor can determine whether to terminate a financial contract. *See* Lubben, *Bankruptcy Code, supra* note 13, at 141. Lubben also acknowledges that repurchase agreements need protection inasmuch as the Federal Reserve uses them for monetary policy. However, his proposal does not include differentiation based on whether a claim would qualify as

In this paper, I explain the treatment of money-claims under the current bankruptcy rules, I argue that these rules exacerbate the risks associated with money-claims in the shadow banking sector, and I propose that bankruptcy rules be altered to better reflect the unique nature of money-claims. Specifically, I join other scholars in advocating for repeal of the safe harbors, but I differ in proposing that the bankruptcy distribution rules include an alternative opportunity for prompt payment of money-claims. This could take the form of an abbreviated stay (one to three days) for secured parties, parties with setoff rights, and money-claimants not otherwise protected. In addition, money-claimants could be awarded a pro rata portion of their claim immediately, with an opportunity for additional payment upon a showing of necessity to avoid consequential damages.

The current distribution structure immunizes (and thus arguably encourages)[16] certain types of financial contracts (derivatives and certain types of money claims, such as repos and some commercial paper claims),[17] while leaving some money-claimants unduly exposed (for example, certain commercial paper obligations owed to money-market mutual funds, which, in turn, expose the investors in the fund). Derivatives and repo counterparties, as well as those commercial paper counterparties able to net out their claims pursuant to the safe harbors, are not barred from seizing assets on the eve of bankruptcy or after bankruptcy, resulting in rapid diminution of the estate[18] and the inability of remaining money-claimants to be timely paid on any portion of their claims. This depletes debtors' liquidity,

a "money-claim," and does not suggest increased protection for money-claims currently not covered under the safe harbors, such as unsecured commercial paper not subject to netting.

16 *See generally* Roe, *supra* note 14.

17 11 U.S.C. § 362(b)(6)–(7), (17) (2011) (exempting derivatives and repurchase agreement ("repo") counterparties from the automatic stay); 11 U.S.C. §§ 555–56, 559–60 (2011) (termination of contract upon bankruptcy not voidable as ipso facto clause for derivatives and repo counterparties).

18 *See, e.g.*, Lubben, *Flawed Case*, *supra* note 13, at 75; Skeel & Jackson, *supra* note 13, at 163.

which not only reduces the funds available to other creditors (including money-claimants), but also can cause severe operational disruptions for the debtor.[19] For example, while many of Lehman's derivatives and repo counterparties were able to close out their positions and avoid immediate losses, Lehman's inability to promptly honor its commercial paper obligations resulted in the Reserve Primary Fund "breaking the buck," which triggered a run on the fund, stemmed only by the Fed's decision to provide temporary insurance to money market mutual funds' accounts.[20]

Since defaults on money-claims carry potentially grave negative externalities that do not flow from defaults on other kinds of debt, we should consider whether bankruptcy rules can mitigate such damages. At the same time, as scholars have previously suggested, it is clear that reliance on short-term funding is an inherently unstable endeavor, and fully immunizing money-claimants may increase reliance on such funding, and thus, ex ante risk.[21]

It may be possible to craft a distribution scheme that provides for some protection to existing money-claimants, while maintaining sufficient uncertainty as to the timing and likelihood of payout to deter short-term financing. For example, repealing the safe harbors (making the automatic stay and preference period applicable to all claims), while at the same time providing for prompt payment—after an abbreviated stay—of some portion of money-claims (perhaps upon a showing of consequential damages), could address the goal of mitigating the damages associated with defaults on money-claims without unduly encouraging reliance on short-term funding. Thus, derivatives and repo counterparties, in addition to other parties with financial contracts that can be "netted" against obligations owed under the current safe

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19 Ricks, *supra* note 1, at 83.

20 *The Orderly Liquidation of Lehman Brothers Holdings Inc. Under the Dodd-Frank Act*, 5 FDIC Q., no. 1, 2011 at 4 [hereinafter FDIC, *Orderly Liquidation*].

21 *See* Roe, *supra* note 14, at 565; *see also* Skeel & Jackson, *supra* note 13, at 163.

harbor provisions,[22] could be prohibited from closing out their positions or otherwise seizing firm assets after or on the eve of bankruptcy filing. This, in turn, could permit money-claimants to be timely paid on at least some portion of their claims.

I proceed as follows: First, I explain the nature of money-claims in the shadow banking sector—what money-claims are, who owes them, and to whom they are owed. Second, I review the current bankruptcy distribution scheme and discuss what these rules mean for money-claims—ultimately arguing that these rules aggravate and magnify the risks stemming from money-claims. Third, I argue that it is both proper and useful for bankruptcy rules to reflect consideration of money-claims. Finally, I begin to suggest alternative approaches to the resolution of money-claims in bankruptcy.

II. MONEY-CLAIMS AND MONEY-CLAIMANTS

A. Overview of Money-Claims in Banks and Shadow Banks

Historically, banks were the only institutions whose obligations included money-claims in the form of depositary obligations. Consumers and businesses deposited in the bank accounts funds that they had accumulated and wanted to be able to access when needed, but which they did not want to store in the form of physical cash (under mattresses or in safes). At the same time, other consumers and businesses that needed money borrowed from banks to purchase cars, homes, equipment, or factories. Such borrowers preferred to be able to pay the money back over a

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[22] U.S. rules are unique in this respect. In Europe, for example, netting is only permitted when the contract explicitly provides for "settlement on a net basis under all circumstances." *See* Simon Johnson, Op-Ed., *U.S. Banks Aren't Nearly Ready for Coming European Crisis*, BLOOMBERG (June 24, 2012, 6:30 PM), http://www.bloomberg.com/news/2012-06-24/u-s-banks-aren-t-nearly-ready-for-coming-european-crisis.html.

long period of time, rather than right away. Banks serve the dual function of satisfying the needs of both lenders and borrowers by pooling and deploying depository funds in the form of long-term loans to consumers and businesses. Because banks pay depositors much less than they make by lending long, much of financial institutions' profits depends upon borrowing short and lending long. This process of issuing short-term liabilities and then pooling and deploying the funds to make long-term loans is called "maturity transformation."[23]

While this process is arguably a valuable social good, it is also inherently risky.[24] Having made long-term loans by

[23] FCIC, SHADOW BANKING, *supra* note 6, at 9; Ricks, *supra* note 1, at 95–98, 101; POZSAR ET AL., *supra* note 2, at 8, 10–12. Maturity transformation is an important part of "financial intermediation" or "credit intermediation," which is the broader process of recycling deposits into loans, and includes—in addition to maturity transformation—liquidity transformation (transforming liquid instruments to illiquid assets) and credit intermediation (enhancing the credit quality of debt through use of priority of claims). POZSAR ET AL., *supra* note 2, at 5; Gordon & Muller, *supra* note 2, at 158 n.6. Economists describe this situation—lenders wanting funds available to them in the short-term matched with borrowers who prefer to borrow for a longer duration—as a "constitutional weakness" of the financial system. JOHN HICKS, VALUE AND CAPITAL 146–47 (2d ed. 1946).

[24] Shadow banks attempt to reduce risk by seeking private insurance in a variety of ways (through hedging, liquidity puts, and swaps), but, as the events in 2008 revealed, such insurance is only valuable as long as the insurance provider remains solvent—or appears to be solvent. FCIC, SHADOW BANKING, *supra* note 6, at 17. This private insurance can take many forms. One example of this is "liquidity puts," in which the seller of collateralized debt obligations ("CDOs") may promise to repurchase the CDOs if the buyer is unable to sell them. Citigroup lost $14 billion when it offered to repurchase shaky CDOs. Bradley Keoun et al., *Citigroup "Liquidity Puts" Draw Scrutiny from Crisis Inquiry*, BLOOMBERG (Apr. 13, 2010, 12.21 PM), http://www.bloomberg.com/news/2010-04-13/citigroup-s-14-billion-liquidity-put-loss-is-focus-of-u-s-crisis-panel.html. AIG also provided insurance to shadow bank players who invested in mortgage-backed securities; its insolvency and inability to honor its obligations led to its bailout. During the financial crisis, when the solvency of private shadow banks and their insurers was questioned, holders of money-claims rushed to demand repayment—a run on the shadow banks. *See* Ricks, *supra* note 1, at 87–88; KRUGMAN, *supra* note 1; POZSAR ET AL., *supra* note

pooling short-term depository funds, in the event that all of their depositors demand repayment at once, banks will not have sufficient cash reserves to meet all of their depositors' demands.[25] The inability of a bank to fully honor its money-claims, such as its depository obligations, can have serious consequences, both in individual cases (because defaults on money-claims can cause individuals or corporations to be unable to pay for necessary goods and services) and on a macro level, as a number of economists believe was evidenced by the Great Depression.[26] After the Great

2, at 2; Gordon & Muller, *supra* note 2, at 164–65. In response, the government, in essence, took measures that it failed to take for depository banks in 1929. Ricks, *supra* note 1, at 88. The Federal Reserve served as a lender of last resort to troubled institutions (extending about $1 trillion of liquidity), issued over $1 trillion in guarantees of financial firm liabilities, and issued a temporary guarantee of MMMFs worth $3 trillion. *Id.*

[25] FCIC, SHADOW BANKING, *supra* note 6, at 9 (discussing the risks associated with maturity transformation); Gordon & Muller, *supra* note 2, at 158–59 (explaining that banks maintain only fractional reserves); FSA, TURNER REVIEW, supra note 1, at 21. For other accounts of the fragility of the banking system, see FRANKLIN ALLEN & DOUGLAS GALE, UNDERSTANDING FINANCIAL CRISES (2007); MARKUS BRUNNERMEIER ET AL., THE FUNDAMENTAL PRINCIPLES OF FINANCIAL REGULATION (2009); JEAN-CHARLES ROCHET, WHY ARE THERE SO MANY BANKING CRISES? THE POLITICS AND POLICY OF BANK REGULATION (2008); Douglas W. Diamond & Philip H. Dybvig, *Bank Runs, Deposit Insurance, and Liquidity*, 91 J. POL. ECON. 401 (1983). A run can occur even if the bank is solvent—all that is necessary is that depositors believe that most *other* depositors doubt the ability of the bank to honor its obligations. In that case, it is in each depositor's best interest to be first in line, even though all would be better off if they could be bound by an agreement not to run. Gordon & Muller, *supra* note 2, at 159.

[26] FRIEDMAN & SCHWARTZ, *supra* note 10, at 351; Ricks, *supra* note 1, at 106–07. As Ben Bernanke has explained, bank failures also result in the disruption of credit flow, but such nonmonetary consequences are in addition to, not separate from or more significant than, monetary consequences. Ricks, *supra* note 1, at 107 (citing Ben S. Bernanke, Governor, Fed. Reserve, Address at the Conference to Honor Milton Friedman: On Milton Friedman's Ninetieth Birthday (Nov. 8, 2002)). Of course, economists continue to debate the cause of the Great Depression, just as they debate the cause of the 2008 financial crisis. I am persuaded by economists who have argued that defaults on depositary and short-term

Depression, in order to prevent panics and runs, banks became subject to extensive regulatory restraints (including capital requirements, cash reserve requirements, and the separation of investment banking from traditional banking) in exchange for government insurance.[27] This regulation was necessary due to a collective action problem: the inability of depositors to agree in advance not to run in the event of an actual or perceived bank insolvency.[28] Thus, in the official banking sector, the risks associated with maturity transformation have been substantially mitigated because the bank's Federal Deposit Insurance Corporation ("FDIC") insurance assures depositors that they will be repaid even if the bank fails.[29]

However, FDIC-insured banks are no longer the only institutions that engage in this useful but risky business of maturity transformation. Other financial institutions also fund themselves with short-term debt obligations that are then pooled and ultimately deployed in the form of long-term debt in capital markets.[30]

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debt obligations have severe repercussions for the real economy. *See supra* text accompanying notes 7–10. In any event, even if we are unsure as to whether defaults on money-claims caused these crises, it certainly cannot be assumed that such defaults are benign.

[27] Ricks, *supra* note 1, at 78. *See also* Michael A. Perino, *Crisis, Scandal and Financial Reform During the New Deal* (St. John's Legal Studies Research Paper No. 12-0004, 2012), *available at* http://ssrn.com/abstract =2054806; WHITE, *supra* note 10. In addition to the unique consequential harms that can result from defaults on money-claims in the shadow banking sector, some economists also argue that defaults on short-term loans that function just like money deposits "carry monetary implications, just like defaults on deposits." Ricks, *supra* note 1, at 79. That is, defaults on money-claims in the shadow banking sector can contract the money supply, just like defaults on depositary obligations.

[28] Ricks, *supra* note 1, at 109–10; Gordon & Muller, *supra* note 2, at 159, 161–62.

[29] Ricks, *supra* note 1, at 119–20, 123; Gordon & Muller, *supra* note 2, at 161–62.

[30] Gordon & Muller, *supra* note 2, at 160 n.10, 161–65 ("For investment banks, short-term credit suppliers are the functional equivalent of bank depositors.").

Whereas traditional banks' short-term liabilities include money-claims in the form of FDIC-insured depository obligations, shadow bank institutions' liabilities are not government insured. Without access to direct deposits, shadow banks instead fund themselves with various short-term debt instruments, which are primarily funded by other financial institutions (in the case of repurchase agreements), and retail or institutional investors in MMMFs (in the case of commercial paper).[31] As these instruments are *short-term* obligations, like bank deposits, investors who hold them expect their short-term loans to be easily redeemable for cash, just as bank depositors expect to be able to withdraw cash when needed.[32] That is, investors in money market mutual fund shares, and lenders of commercial paper and repurchase agreements, are similar to bank depositors in that they expect the money with which they have parted to be available to satisfy their cash obligations in the near term.[33] Money-claims are sufficiently similar to deposit obligations to lead the financial institutions that issue such instruments to describe them as, and liken them to, "cash equivalents" under U.S. generally accepted accounting principles ("GAAP").[34] Individuals and companies who hold

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[31] FCIC, SHADOW BANKING, *supra* note 6, at 18.

[32] Ricks, *supra* note 1, at 79, 92 (citing, inter alia, Gorton, *supra* note 2, at 3). *See also* BAGEHOT, *supra* note 2.

[33] Gordon & Muller, *supra* note 2, at 160 n.10.

[34] For more on shadow banking and money market instruments, see FED. RESERVE BANK OF RICHMOND, INSTRUMENTS OF THE MONEY MARKET 1 (7th ed. 1993) [hereinafter RICHMOND FED. RESERVE REPORT], *available at* http://www.richmondfed.org/publications/research/special_reports/instruments_of_the_money_market/pdf/full_publication.pdf (stating that money market instruments carry no liquidity or price risk). Paul McCulley was apparently the first to describe such institutions as "shadow banks." Paul McCulley, *Teton Reflections*, GLOBAL CENT. BANK FOCUS, Aug./Sept. 2007, at 2, *available at* http://media.pimco.com/Documents/GCB%20Focus%20Sept%2007%20WEB.pdf. On "cash equivalents," see FIN. ACCT. STANDARDS BD., FIN. ACCT. FOUND., STATEMENT OF CASH FLOWS, STATEMENT OF FIN. ACCT. STANDARDS No. 95, 96 (1987) (on file with the Columbia Business Law Review); INT'L ACCT. STANDARDS BD., CASH FLOW STATEMENTS, INT'L ACCT. STANDARDS No. 7 (1997) (on file with the

short-term debt obligations have chosen to sacrifice yield for the ability to access cash quickly.[35] Of course, money market accounts have historically offered *slightly* higher yields than checking or savings accounts[36] by virtue of money market funds not having to purchase FDIC insurance and being free to invest in higher-yield (and riskier) assets. But this increased risk does not alter the reality that money market investors expect to be able to access their cash reserves on demand.

Indeed, banks offer different rates of return for different accounts, and we do not suggest that depositors who have chosen a higher-yield checking account lack the expectation that they will be able to access their funds on demand. To say that money market investors simply *should not* have the expectation does not eliminate the expectation. For example, one could say that pre-FDIC-insurance depositors should not have expected to be able to access their deposits on demand, but, of course, they *did* hold such an expectation, though the bank may have been a "riskier" place for cash reserves than under the mattress. Indeed, the U.S. Securities and Exchange Commission ("SEC") has recognized that money market investors use money market accounts in the same manner as traditional bank accounts, with the expectation that their funds can be redeemed on demand, at par.[37]

Columbia Business Law Review); MARCIA STIGUM & ANTHONY CRESCENZI, STIGUM'S MONEY MARKET (4th ed. 2007).

[35] Robin Greenwood, Samuel G. Hanson & Jeremy C. Stein, *A Comparative-Advantage Approach to Government Debt Maturity* 35 (Harv. Bus. Sch. Working Paper No. 11-035, 2010). *See also* RICHMOND FED. RESERVE REPORT, *supra* note 34, at 1 ("Holding these [cash] balances, however, involves a cost in the form of foregone interest.").

[36] Evidence suggests that this difference in yield is diminishing; indeed, some banks offer higher-yielding accounts than many MMMFs. *See* Laura Bruce, *Rough Times for Money Market Funds*, BANKRATE.COM, (Feb. 3, 2009), http://www.bankrate.com/finance/investing/rough-times-for-money-market-funds-1.aspx; *High Yield Reward Checking Accounts*, DEPOSITACCOUNTS.COM, http://www.depositaccounts.com/checking/reward-checking-accounts.html (last visited Mar. 8, 2013).

[37] Floyd Norris, *Funds and Allies Defend the Buck*, N.Y. TIMES, June 29, 2012, at B1. As a result, the SEC is seeking to impose regulations that

Because money market mutual fund sponsors typically bail out funds when they are at risk of breaking the buck, investors assume—not unreasonably—that they will be able to access their cash when needed.[38] With money market accounts, as with banks, if depositors feel they soon may *not* be able to access their funds on demand, they will demand immediate payment, triggering a run.[39]

By virtue of being available to meet short-term cash needs, like bank deposits, short-term debt obligations or money-claims in the shadow banking sector are "a component of an economic agent's *transaction reserve*—the set of assets that the agent holds primarily to facilitate desired exchanges."[40] In fact, money market "investors," ironically, typically consider the portion of their funds in the money market to be "precisely the set of assets they are *not* investing,"[41] but rather, temporarily holding for cash management purposes.

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clarify such funds are not risk free, but the proposals face strong opposition from financial institutions, as discussed below.

[38] *Perspectives on Money Market Mutual Fund Reforms: Hearing Before the S. Comm. on Banking, Hous., & Urban Affairs*, 112th Cong. (2012) (statement of Mary Shapiro, Chairman, SEC) [hereinafter *Shapiro Testimony*], *available at* http://sec.gov/news/testimony/2012/ts062112mls.htm ("Recurrent sponsor support has taught investors to look beyond disclosures that these investments are not guaranteed and can lose value.").

[39] On the subject of money market funds' susceptibility to runs, Shapiro explained:

> [W]hen a fund breaks a dollar, investors lose confidence and rush to redeem. Not only did large numbers of investors redeem their shares from The Reserve Primary Fund that held Lehman Brothers commercial paper, they also redeemed from other Reserve money market funds that held no Lehman Brothers paper, including a government fund.

Id.

[40] Ricks, *supra* note 1, at 91.

[41] *Id.* at 95.

Because investors—both individuals and corporations[42]—rely on the "redeemable-on-demand" feature of their money market accounts, in the same way that bank depositors rely on their bank accounts, in the shadow banking system money market funds play the role of deposit accounts.[43] As such, for individuals, corporations, and municipalities, MMMFs serve cash management functions: municipalities and corporations often use their accounts to accumulate cash in advance of projects,[44] and individuals store funds in their money market accounts when they need to access cash in the near-term in an amount that exceeds the FDIC insurance coverage limit.[45] Mary Shapiro, the former chairman of the SEC, described MMMFs as "facilitat[ing] efficient cash management for both retail and institutional investors, who use them for everything from making mortgage payments and paying college tuition bills to the short-term investment of cash received through business operations until needed to fund payrolls or pay tax withholding."[46]

Since individuals and companies that invest in the money market expect to be able to access their cash on short notice for a variety of purposes, defaults on such obligations carry consequential damages that can be considerably more severe

[42] Households and small investors put their savings with retail money market funds, while corporations and other large clients put their money with institutional money market funds. FCIC, SHADOW BANKING, *supra* note 6, at 24.

[43] FCIC, SHADOW BANKING, *supra* note 6, at 24.

[44] Bob Ivry et al., *Missing Lehman Lesson of Shakeout Means Too Big Banks May Fail*, BLOOMBERG (Sept. 7, 2009, 7:01 PM), http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aX8D5utKFuGA.

[45] *See Deposit Insurance Summary*, FDIC, http://www.fdic.gov/deposit/deposits/dis/ (last modified Jan. 1, 2013) ("The standard insurance amount is $250,000 per depositor, per insured bank, for each account ownership category."). Another popular place to store cash reserves is short-term U.S. Treasuries. Money market accounts typically yield more, but again, this does not change the expectation that the funds be available on demand.

[46] *Shapiro Testimony*, *supra* note 38.

than mere investment losses.[47] An individual or company that makes a long-term loan has very different expectations from one who expects to be able to redeem funds at any time for cash. In the event of default, holders of money-claims suffer losses above and beyond investment losses, such as "opportunity costs, operational disruption, reputational damage, or even default."[48] For example, in the case of companies that have invested in the money market, defaults on money-claims can disrupt operations, and can result in missed opportunities for growth since those companies may have relied on these money-claims to make payroll, pay suppliers, or meet other short-term cash needs.[49] Similarly, municipalities that have invested excess cash in the money market with the expectation that it would be available to fund projects or other "planned expenditures"[50] may also suffer consequential damages.

King County, Washington, for example, experienced severe hardship when the value of its $50 million commercial paper investment was reduced to zero.[51] The county purchased the commercial paper on behalf of its $4 billion investment pool, which holds excess tax income until the funds are needed for county expenditures, such as the funding of schools and police departments.[52] Merrill Lynch had marketed the paper as a cash-equivalent, but the entity issuing the paper was actually backed by subprime mortgages.[53] When the issuing entity collapsed, the county

47 Ricks, *supra* note 1, at 83. Indeed, those that hold money market instruments sacrifice investment yield for the "instrumental purpose" of "moneyness." *Id.* at 95 (citing Greenwood et al., *supra* note 35, at 6–7).

48 *Id.* at 83.

49 *Id.*

50 RICHMOND FED. RESERVE REPORT, *supra* note 34, at 1.

51 Chris Grygiel, *Lawsuit: Merrill Lynch Sold King Co. "Toxic" "Junk,"* SEATTLEPI.COM (July 20, 2010, 10:00 PM), http://www.seattlepi.com/local/article/Lawsuit-Merrill-Lynch-sold-King-Co-toxic-897241.php.

52 *Id.*

53 *Id.*

suffered severe budget shortfalls, and was forced to make spending cuts to its criminal justice system.[54]

Individual money market investors also place into the money market funds that they expect to access in the near term. For example, one Reserve Primary Fund investor was a man who was preserving cash in his account to pay for his son's lung transplant.[55] To be sure, many, if not most, money market players are sophisticated financial institutions. What distinguishes money-claims from other debt obligations is the *function* of the loan and expectation of the lender. Defaults in the money market—even debt obligations owed to sophisticated financial institutions—are particularly likely to disrupt the operations of municipalities and corporations, as well as individual money market investors who may not be particularly sophisticated.

In the shadow banking system, then, money market accounts are used for the same purpose as depository accounts. However, unlike depository banks, which typically conduct maturity transformation under one roof, shadow banks involve a number of different non-bank financial intermediaries and financial products (i.e., money market mutual fund shares, commercial paper, and repurchase agreements).[56] In the shadow banking system, individuals and companies store their cash in MMMFs or similar funds, which, in turn, invest these funds in the short-term liabilities of shadow banks that, in turn, fund long-term loans such as mortgages through a complex securitization process involving a number of financial institutions, each playing a different role.[57] In summation, non-bank financial

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[54] Grygiel, *supra* note 51.

[55] Ivry et al., *supra* note 44.

[56] POZSAR ET AL., *supra* note 2, at 11–13.

[57] *Id.* at 8, 11–13 (detailing both the traditional banking system and the multi-step shadow credit intermediation and securitization processes). *See also* Gordon & Muller, *supra* note 2, at 162–63 (describing the resulting volatility and fragility in the banking system after banks in the early to mid-2000s created financial vehicles to finance long-term mortgage-related assets with short-term liabilities, in order to fund the growth of mortgage-based assets).

institutions have for some time, indeed, engaged in substantially the same bank-like activity called maturity transformation: borrowing short and lending long. And, *like* traditional banks that borrow short from their depositors (money-claims in banks), these other non-bank financial institutions borrow short from their investors (money-claims in shadow banks), who also expect their cash to be redeemable on demand, and use their accounts in the money market for the same purpose as depository accounts at FDIC-insured banks. However, *unlike* depository banks that also lend long under one roof, these institutions—neither subject to regulatory restraints nor protected by government insurance—have evolved and proliferated into a complex web of intermediaries and financial products that pool (warehouse) and deploy (issue) long-term loans; hence the name "shadow banking system."

It is precisely the difference in *function* between money-claims and other debt obligations—primarily cash management versus investment—that suggest a rare instance in which differential treatment of creditors may be warranted. And it is precisely the lack of regulatory infrastructure sufficient to safely unwind money-claims in the shadow banking system (in contrast to the FDIC resolution of depository claims) that forces consideration of money-claims in the bankruptcy context.

B. Money-Claim Issuers and Money-Claimants

Before elaborating upon the importance of considering money-claimants in crafting bankruptcy rules, it is necessary to further specify what exactly is meant by money-claimants and money-claim issuers; that is, who constitutes the borrowers and lenders of money-claims.

1. Borrowers in the Money Market/Money-Claim Issuers

Borrowers in the money market include the U.S. Treasury (which issues Treasury bills), state and municipal governments (which issue short-term municipal bonds), the government-sponsored entities ("GSEs"), and financial borrowers such as broker-dealers, money center banks, and other private financial institutions.[58] Bear Stearns, Lehman Brothers, and MF Global were all financial institutions that borrowed in the money market; that is, they each issued money-claims. Two of the most common money market instruments through which these types of borrowers obtain funding are commercial paper and repurchase agreements.[59]

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[58] RICHMOND FED. RESERVE REPORT, *supra* note 34, at 4–5; POZSAR ET AL., *supra* note 2, at 47–48. It is important to note at the outset that ultimately not all of these money-claim issuers will necessarily be subject to bankruptcy rules in the event of distress; some issuers may be subject to both bankruptcy *and* another regime; or it may not be clear how a given issuer would be resolved in the event of failure. *See* Lubben, *supra* note 4, at 1260–63. Failing banks would be resolved under an FDIC receivership regime rather than bankruptcy. Broker-dealers such as MF Global would be subject to both the Securities Investor Protection Act ("SIPA"), 15 U.S.C. §§ 78aaa-78lll (2011), and bankruptcy; if the institution is deemed systemically important it may also be subject to the Orderly Liquidation Authority, Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. No. 111-203 §§ 201–17, 124 Stat. 1376, 1442 (codified at 12 U.S.C. §§ 5381–94 (2011)). *Id.* Municipalities and corporations may be resolved in bankruptcy proceedings. *See generally* 11 U.S.C. § 901 (2011) (applying Chapter 9 generally to the "Adjustment of Debts of a Municipality"). The uncertainty regarding which resolution regime applies is discussed further in Part V.

[59] *See* RICHMOND FED. RESERVE REPORT, *supra* note 34, at 3 (explaining that the principal borrowers of commercial paper are non-financial and financial businesses, and that the principal borrowers of repurchase agreements are securities dealers, banks, non-financial corporations, and governments). Another key instrument in the money market are Auction-Rate Securities ("ARS"). ARS are in fact long-term debt obligations, but they are treated like short-term debt obligations because they are presented at an auction at short intervals, and are expected to find a buyer in the event that the holder of the ARS needs to access cash. Jenny Anderson & Vikas Bajaj, *New Trouble in Auction-Rate Securities*, N.Y. TIMES, Feb. 15, 2008, http://www.nytimes.com/2008/02/15/business/15place.html. *See also* FIN INDUS. REGULATORY AUTH. ("FINRA"), AUCTION RATE SECURITIES: WHAT HAPPENS WHEN AUCTIONS FAIL (2011), *available at* http://www.finra.org/web/groups/investors/@inv/@protect/@ia/documents/investors/p125856.pdf. During the crisis, a number of auctions failed because the broker-dealers that typically bid at auctions failed to bid. This left investors holding longer-term debt securities when they expected to be able to access cash. The lack of a

i. Commercial Paper

Commercial paper is a short-term obligation that can be issued by a financial institution (financial commercial paper) or non-financial institution (corporate commercial paper).[60] State and local governments, corporations, and non-bank financial institutions all raise money by issuing commercial paper.[61] The vast majority of commercial paper is issued by financial institutions—only thirteen percent of outstanding commercial paper in 2010 was issued by non-financial institutions.[62] Commercial paper is often defined as short-term promissory notes that expire within 270 days, though it typically expires in less than thirty days.[63] Commercial paper can also be backed by specific collateral, in which case it is called "asset-backed commercial paper."[64] In some cases, commercial banks agree to provide back-up lines of credit to commercial paper.[65]

In the run up to the financial crisis, financial institutions created special purpose entities or "vehicles" ("SPEs" or "SPVs") that issued short-term commercial paper to investors, and then used the funds to purchase mortgage-backed securities ("MBS"), which would then serve as security for the commercial paper.[66] Parent institutions would provide "liquidity puts"—essentially guarantees—promising to repurchase the commercial paper if no buyers

market for ARS also harmed the issuers of ARS—principally municipalities and other tax-exempt institutions, such as student loan corporations and the Port Authority of New York & New Jersey—because, pursuant to the ARS contracts, the interest rates on the securities skyrocketed when the auctions failed. Anderson & Bajaj, *supra*.

60 FCIC, SHADOW BANKING, *supra* note 6, at 18.

61 RICHMOND FED. RESERVE REPORT, *supra* note 34, at 4.

62 Ricks, *supra* note 1, at 81 n.8 (citing data from *Commercial Paper Outstanding*, FED. RESERVE, http://www.federalreserve.gov/releases/cp/outstandings.htm (last modified Mar. 25, 2011)).

63 RICHMOND FED. RESERVE REPORT, *supra* note 34, at 105–06.

64 FCIC, SHADOW BANKING, *supra* note 6, at 18.

65 RICHMOND FED. RESERVE REPORT, *supra* note 34, at 3.

66 FCIC, SHADOW BANKING, *supra* note 6, at 18.

for the paper could be found.[67] Although the banks did not have to reflect these guarantees on their balance sheets, the positions were extremely risky for banks: if the commercial paper could not be rolled over, there would be no way for the SPV to meet the obligation, because its assets consisted of long-term mortgages.[68]

ii. Repurchase Agreements

Repos are also important sources of short-term funding for shadow banking institutions. Repos allow institutions with assets, including U.S. Treasuries and agency securities (such as mortgage-backed securities, or notes issued by GSEs), to sell the assets and repurchase them at a specified, later date for a slightly higher price, constituting de facto interest.[69] Repos are substantively equivalent to short-term secured loans,[70] but are given additional protection under current bankruptcy rules.[71] As with commercial paper, repos are also commonly owed to MMMFs and direct money market investors (such as securities lenders).[72] Repos can extend up to six months, but are most commonly extended for a period of days, or even overnight.[73]

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[67] KATHLEEN C. ENGEL & PATRICIA A. MCCOY, THE SUBPRIME VIRUS: RECKLESS CREDIT, REGULATORY FAILURE, AND NEXT STEPS 54–55 (2011).

[68] ENGEL & MCCOY, *supra* note 67, at 53–54. *See also* Simkovic, *supra* note 13, at 283–84 (explaining that the increased use of derivatives to extend credit created a collective action problem among creditors, making it easier for debtors to increase their off-balance sheet leverage and less likely that they would maintain sufficient liquidity to meet margin calls).

[69] Roe, *supra* note 14, at 546. *See also* RICHMOND FED. RESERVE REPORT, *supra* note 34, at 2.

[70] Roe, *supra* note 14, at 546.

[71] *Id.* at 547 ("[Repos and derivatives] are treated more favorably in bankruptcy than are other loans, trades, and investments.").

[72] POZSAR ET AL., *supra* note 2, at 13. *See also* Roe, *supra* note 14, at 546 (describing higher price as de facto interest).

[73] RICHMOND FED. RESERVE REPORT, *supra* note 34, at 60.

2. Lenders in the Money Market/Money-Claimants

Individuals and corporations who purchase the liabilities of shadow banks are the "lifeblood of the shadow banking system."[74] These investors can be either direct money market investors or money market intermediaries.[75] Direct money market investors include institutional investors, local government investment pools, and securities lenders' cash collateral reinvestment accounts.[76] Money market intermediaries include: (1) regulated money market intermediaries, which are SEC Rule 2a-7 MMMFs; and (2) unregulated money market intermediaries such as sweep accounts and "enhanced cash" portfolios.[77] Money market intermediaries such as MMMFs and enhanced cash portfolios pool the funds of households, corporations, and governments and invest them in money market instruments such as Treasury bills, commercial paper, and repos.[78] Thus money market intermediaries, such as MMMFs, participate as both money-claim issuers and money-claimants by purchasing pools of money market instruments and selling shares of these instruments to investors.[79] Dealers and brokers market new issues of money market instruments and provide secondary markets where outstanding issues can be sold prior to maturity.[80] MMMFs are often used as temporary holding accounts for funds that are between

[74] POZSAR ET AL., *supra* note 2, at 50.

[75] *Id.* at 51.

[76] *Id.*

[77] *Id.*; 17 C.F.R. § 270.2a-7 (2012).

[78] INV. CO. INST., 2009 INVESTMENT COMPANY FACT BOOK 49 (2009), *available at* http://www.ici.org/pdf/2009_factbook.pdf.

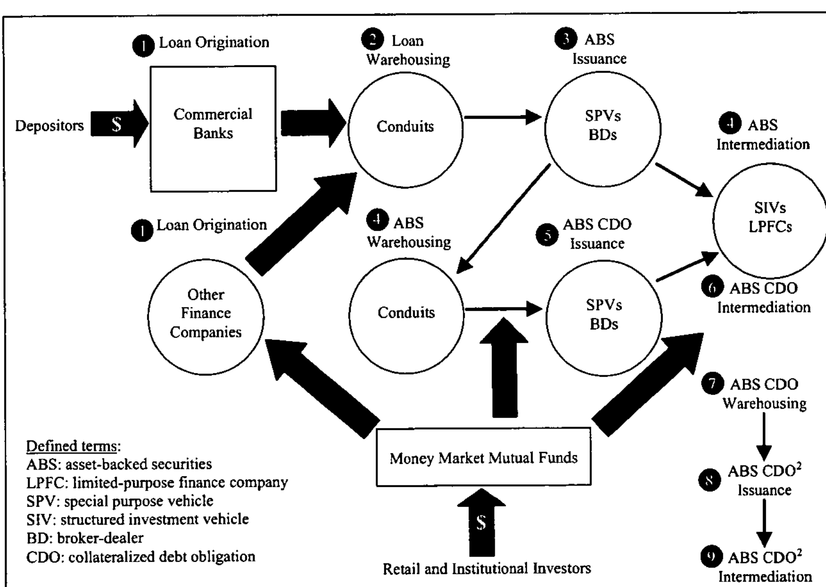
[79] RICHMOND FED. RESERVE REPORT, *supra* note 34, at 4.

[80] *Id.* at 5. Not every transaction in the shadow banking sector involves maturity transformation. Broker-dealers often fund themselves with short-term debt, but purchase assets for resale—not to hold until maturity. However, the cumulative function of the shadow banking system is the conversion of demand obligations into long-term debt obligations. In addition, broker-dealers and their affiliates do in fact retain some of the long-term assets and attendant risk.

investments, such as uninvested cash on hand in a stock brokerage account, or as interest-bearing checking accounts.[81]

Investors in MMMFs are closest to deposit obligations in that they can be redeemed on demand, just like money in a bank account. Ultimately, then, in the run up to the financial crisis, debt obligations on mortgages made their way through shadow banking institutions until they were transformed into MMMF shares—accomplishing the "transformation of long-term assets into demandable obligations, redeemable at any time at the holder's option."[82] Figure 1 below illustrates this maturity transformation process that ran rampant in the shadow banking sector during the most recent housing and mortgage securitization boom (and bust).

FIGURE 1. ILLUSTRATION OF SHADOW BANKING MATURITY TRANSFORMATION PROCESS: MORTGAGE-BACKED SECURITIZATION



[81] RICHMOND FED. RESERVE REPORT, *supra* note 34, at 159.

[82] Ricks, *supra* note 1, at 85.

The term money-claimant encompasses those individuals and corporations that invest in money market instruments, funds, and, albeit indirectly, the shadow banking system. We can thus define "money-claimants" as individuals or organizations who are owed a short-term debt obligation, which they reasonably expect to be able to redeem for cash at the time of their choosing. A question then arises: How quickly must a short-term obligation come due in order to qualify as a money-claim? By some definitions, the money market refers to borrowing and lending for periods of one year or less.[83] Maturities for money market instruments range from one day to one year; most commonly such instruments mature in three months or less.[84] Some economists equate money market instruments with the term "cash equivalents."[85] However, not all money market instruments can be designated as cash equivalents under GAAP. Cash equivalents are defined by both GAAP and International Financial Reporting Standards ("IFRS") as highly liquid, short-term investments that mature within three months. Shares in MMMFs will always meet this definition, as they are redeemable on demand.[86] Commercial paper and repos, however, will only qualify as money-claims if they mature within three months.[87] But remember, money market instruments can and do make their way into MMMFs even if they mature in a longer period—though the portion of MMMFs that can be invested in longer-term commercial paper has been sharply circumscribed by recent

[83] RICHMOND FED. RESERVE REPORT, *supra* note 34, at 1.

[84] *Id.* *See also Money Market Instruments*, REFERENCEFORBUSINESS.COM, http://www.referenceforbusiness.com/small/Mail-Op/Money-Market-Instruments.html#b (last visited Mar. 8, 2013).

[85] Ricks, *supra* note 1, at 80.

[86] Shares in non-MMMFs are also typically redeemable on demand, but they are not money-claims because they are not comprised of short-term, highly liquid instruments, and investors accumulate funds in non-MMMFs for investment rather than cash management purposes.

[87] To the extent that longer-term money market instruments make their way into MMMFs, it may be desirable to include such claims; however, new rules for MMMFs limit the percentage of longer-term commercial paper such funds may hold. 17 C.F.R. § 270.2a-7 (2012).

SEC reforms.[88] It is thus sensible to limit the definition of money-claim to those claims that institutions themselves treat as cash equivalents on their balance sheets (maturing within three months).

Each of these instruments—MMMF shares, repos, and commercial paper—is an instrument typically used for cash management purposes rather than investment purposes. Although there may be instances in which individuals or other entities use a money market fund for investment purposes (such as the risk averse, seeking slightly higher return than that which depository institutions offer), and although many money market players are sophisticated financial institutions, none of this alters the *nature* or the *assumed function* of the claims. Obligations in this segment of the financial sector are assumed to carry characteristics of "moneyness," in contrast to loans and investments outside the money market.

III. TREATMENT OF MONEY-CLAIMS IN BANKRUPTCY

Having reviewed what money-claims mean in the shadow banking sector, it is now possible to begin to see how such claimants fare under the current bankruptcy rules. Part III begins with an overview of the current bankruptcy distribution system, and then discusses the specific consequences for money-claimants.

A. Bankruptcy Distribution Scheme

As originally crafted, the purpose of the Bankruptcy Code was to *avoid* any creditor receiving special treatment.[89]

88 Rule 2a-7 provides that forty percent of the securities in a MMMF must mature in seven days or less, and reduces the weighted average of the maturity of the portfolio from ninety to sixty days. *Id.*

89 *See, e.g.*, THOMAS H. JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAW 125 (1986) (describing policy justifications for the trustee's avoidance powers); Skeel & Jackson, *supra* note 13, at 158 (describing the automatic stay and preference-avoidance powers of the trustee as the "heart and soul" of bankruptcy; explaining that the

Bankruptcy was designed to combat a collective action problem not entirely dissimilar from the run-on-the-bank problem: when a firm faces financial distress, creditors rush to seize cash and collateral from a company, resulting in assets being sold at fire-sale prices, and ultimately, resulting in low returns for creditors overall. To address this collective action problem, a bankruptcy filing triggers an automatic stay, prohibiting most creditors from demanding or receiving payment on their claims.[90] To prevent creditors from rushing to demand payment as soon as the company appears financially troubled—in the period preceding bankruptcy—creditors cannot receive any payments or additional security interests during a ninety-day preference period preceding bankruptcy.[91] In bankruptcy, all creditors would be expected to take a loss, but the company's value would be maximized. The company can use the breathing room that the automatic stay provides to negotiate with creditors, and to decide which contracts are valuable and should be retained, and which are burdensome and should be rejected.[92] In addition to the automatic stay and the avoidance of preferential transfers, the Bankruptcy Code forbade creditors from terminating contracts with the debtor solely because of a bankruptcy filing.[93]

That is not to say that all creditors have always been treated equally without exception; secured creditors are protected up to the value of their collateral, for example.[94] But even secured creditors are subject to the automatic stay, and are only permitted to seize property if it is not adequately protected, or if the debtor has no equity in the

automatic stay is the "key to bankruptcy's collective proceeding" as it halts the "race of diligence" that would result in a "piecemeal liquidation of the debtor's assets," and that preference power is designed to prevent favored treatment of certain creditors).

[90] 11 U.S.C. § 362 (2011).

[91] *See id.* § 547.

[92] *See id.* § 365. If rejected, such contracts are treated as unsecured claims. *Id.*

[93] *Id.*

[94] *See id.* § 506.

property and does not need the property for an effective reorganization.[95] Creditors with whom the debtor has a bank account are also deemed secured up to the amount the debtor keeps in a bank account with the creditor. This is important, and more controversial than the protections for other secured creditors,[96] because cash that the debtor may rely on to meet daily expenses becomes encumbered. Because of this, setoff rules can have the effect of greatly reducing the liquidity available to the estate. In addition to the protections given to secured creditors and creditors with setoff rights, the Bankruptcy Code includes a priority scheme for the distribution of remaining assets; administrative claims, employee wage claims, and tax claims are all entitled to be paid before unsecured creditors.[97] But all creditors are subject to the automatic stay and the trustee's avoidance power.

However, Congress was persuaded that when it came to most kinds of financial contracts, "systemic risk" concerns—among other justifications[98]—required that firm value be sacrificed in favor of immunization from bankruptcy for financial counterparties, lest a cascading series of defaults occur.[99] Congress justified these safe harbors on the grounds that they were necessary to preclude the "insolvency of one commodity or security firm from spreading to other firms and possibly threatening the collapse of the affected market."[100] Thus, while the general rule is that creditors

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95 11 U.S.C. §§ 362(d) (2011).

96 *See, e.g.*, Lawrence Kalevitch, *Setoff and Bankruptcy*, 41 CLEV. ST. L. REV. 599, 605 (1993).

97 11 U.S.C. § 507 (2011).

98 Other rationales include the complexity of derivatives markets, the adverse effects of debtors "cherry-picking" among contracts, and, historically, the role of clearinghouses rather than counterparties as middlemen. *See, e.g.*, Skeel & Jackson, *supra* note 13, at 160–62.

99 *See 1999 House Hearing*, *supra* note 13, at 352.

100 H.R. REP. NO. 97-420, at 1 (1982). *See also* 128 CONG. REC. S15,981 (daily ed. July 13, 1982) (statement of Sen. Robert J. Dole) [hereinafter *Dole Statement*] (arguing that stockbrokers and securities clearing agencies must be exempt from the automatic stay because "market fluctuations in the securities markets create an inordinate risk

may not seize assets or terminate contracts upon bankruptcy filing, large financial institutions received special protection. By 2005, the safe harbors were broadened, such that any counterparty holding a "derivatives contract"—including forward contracts, commodity contracts, repos, and swaps—were permitted to seize collateral and terminate contracts irrespective of a debtor's bankruptcy filing, and irrespective of whether the debtor was otherwise in default.[101] Margin payments through seizure of collateral in the ninety-day period pre-bankruptcy would normally be voidable as preferential transfers or fraudulent conveyances, but the safe harbors protect them when the transferee is a derivatives contract counterparty.[102] As Professor Lubben has explained:

> The 2005 amendments to the Bankruptcy Code enhanced this special treatment by adding section 561 that specifically preserves the contractual right to terminate, liquidate, accelerate or offset under a "master netting agreement" and across a broad range of derivative contracts. In addition, now a master agreement and several other derivative-related

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that the insolvency of one party could trigger a chain reaction of insolvencies of the others who carry accounts for that party and undermine the integrity of those markets"); Edwards & Morrison, *supra* note 13, at 97–98 (explaining that Congress feared that "the insolvency of a party to a derivatives contract might expose a counterparty . . . and that counterparty's counterparties . . . to financial distress, which would destabilize financial markets"). Safe harbors regarding the special protection of derivatives have historically been justified as means of protecting markets that are "particularly vital and sensitive to the delay and dislocation that can attach to bankruptcy proceedings." Lubben, *Flawed Case*, *supra* note 13, at 77 (citing Brief for Int'l Swaps and Derivatives Ass'n, Inc. as Amici Curiae Supporting Respondents at 7, *In re* Nat'l Gas Distrib., 556 F.3d 247 (4th Cir. 2009) (No. 07-2105), 2008 WL 412344).

[101] 11 U.S.C. § 362(b)(6)–(7), (17) (2011) (exempting derivatives and repo counterparties from the automatic stay); 11 U.S.C. §§ 555–56, 559–60 (2011) (termination of contract upon bankruptcy not voidable as ipso facto clause for derivatives and repo counterparties).

[102] *See id.* §§ 546(c), (f), (g), 548(d)(2)(B)–(D); Edwards & Morrison, *supra* note 13, at 96.

agreements can also be deemed "swap agreements" within the meaning of the Bankruptcy Code.[103]

Because the vast majority of derivatives contracts are documented under the International Swaps and Derivatives Association ("ISDA") Master Agreement, they are thus protected from a debtor's attempt to assume or reject any individual contract under the ISDA.[104] In other words, "virtually every conceivable derivative transaction is now exempt from the automatic stay and the debtor's power to assume and reject."[105] Thus, for debtors like Lehman Brothers and MF Global, who had a substantial number of creditors entitled to this immunity—or superpriority[106]—bankruptcy results in the immediate dismemberment of the firm.[107]

Some of these creditors entitled to immunity from bankruptcy are money-claimants, but many are not. Derivatives, whether used for hedging or speculation, will not themselves constitute money-claims, though they may be hedges on transactions that do involve money-claims. Counterparties to repos will always be entitled to retain their collateral in the event of filing, and may receive preferential payments without having to disgorge them.[108] Commercial paper is protected in much more limited circumstances. Commercial paper may be netted against offsetting obligations,[109] but this is only helpful to those

103 Lubben, *Flawed Case*, *supra* note 13, at 67 (citing 11 U.S.C. §§ 101(38A), 561 (2006)).

104 *Id.* at 68 (citing Robert F. Schwartz, *Risk Distribution in the Capital Markets: Credit Default Swaps, Insurance and a Theory of Demarcation*, 12 FORDHAM J. CORP. & FIN. L. 167, 178–79 (2007)).

105 *Id.* at 67 (citing Morrison & Riegel, *supra* note 13, at 651–52).

106 Roe, *supra* note 14, at 548.

107 This is also true for Bear Stearns and AIG, of course, but in those instances dismemberment was avoided due to government intervention.

108 *See* sources cited *supra* note 101.

109 11 U.S.C. § 362(b)(17) (2011) (netting of securities contract does not violate stay); 11 U.S.C. § 546(e) (2011) (settlement payments made by or to a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency are not voidable preferences).

counterparties who have obligations to set off against. This may be helpful when large broker-dealers or other financial institutions are counterparties, but not when MMMFs are counterparties. If a debtor elects to redeem commercial paper prior to maturity during the preference period, this will also be protected from classification as a voidable preference, by virtue of the safe harbor for "settlement payments," at least in the Second Circuit.[110] But, again, this is only helpful to those counterparties with enough clout to convince the debtor to redeem their paper.

After filing, creditors who are unprotected by the safe harbors must wait in line to be paid. Some may have the right to be paid or to seize collateral early in the case; for example, secured creditors and creditors with setoff rights will be entitled to seize collateral or cash if their claims are not adequately protected.[111] In addition, certain unsecured creditors entitled to priority (such as tax authorities) or who are particularly critical counterparties (such as utilities) may be entitled to early repayment of their claims.[112]

B. What Does the Distribution Scheme Mean for Money-Claimants?

The current bankruptcy system provides immunity to some creditors, and priority payments for others, but does not consider money-claimants to comprise a unique category of creditors meriting special treatment. Some types of money-claimants (repos and certain commercial paper obligations) are immunized from bankruptcy, but others (such as commercial paper obligations that cannot be offset pursuant to a master agreement) are not. Repos and commercial paper are thus treated differently under the

[110] 11 U.S.C. § 546(e) (2011); Enron Creditors Recovery Corp. v. Alfa, S.A.B. de C.V., 651 F.3d 329, 335 (2d Cir. 2011) (holding that Section 546(e), which states that settlement payments are not voidable preference, applies to debtor's redemption of commercial paper).

[111] 11 U.S.C. §§ 362(d), 551 (2011).

[112] *See id.* § 507(a)(8) (providing for priority payment of taxes); *see also id.* § 366 (2011) (entitling utilities to adequate protection).

Bankruptcy Code even though they are used for the identical cash management function. Obviously, unprotected money-claimants do not benefit from the current immunities, but even money-claimants ostensibly "protected" by the safe harbors may be imperiled because, as other scholars have suggested, the safe harbors foster runs on financial institutions.[113] Although no scholar to date has specifically explored the treatment of money-claims under the Bankruptcy Code, several scholars have persuasively argued that the safe harbor provisions of the Code encourage run behavior, and thus increase, rather than mitigate, systemic risk.[114] Bankruptcy scholars have suggested that the safe harbors may foster runs by permitting (and thus encouraging) derivatives counterparties to rush to close out their positions upon any sign of financial distress.[115] That is, the safe harbors "encourage simultaneous liquidation of debtors' assets in a financial crisis."[116] Such a result is

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113 Skeel & Jackson, *supra* note 13, at 155 ("[I]nsulation from bankruptcy's core policies exacerbates the risk of runs by removing the debtor's ability to temporarily halt them."); Roe, *supra* note 14, at 565.

114 Skeel & Jackson, *supra* note 13, at 155, 167–68; Roe, *supra* note 14, at 565; Stephen J. Lubben, *Repeal the Safe Harbors*, 18 AM. BANKR. INST. L. REV. 319, 330 (2010); Frank Partnoy & David A. Skeel, Jr., *The Promise and Perils of Credit Derivatives*, 75 U. CIN. L. REV. 1019, 1049 (2007). *See also* Simkovic, *supra* note 13, at 259 (arguing that the market for derivatives increased prior to the financial crisis because these products "received favored treatment in bankruptcy and were not transparent to third parties"); Edwards & Morrison, *supra* note 13, at 101–03 (using Long Term Capital Management ("LTCM") as an example).

115 Roe, *supra* note 14, at 565; Lubben, *Bankruptcy Code*, *supra* note 13, at 123.

116 Roe, *supra* note 14, at 545. Roe argues that the safe harbors, or "superpriorities," as he describes them, exacerbate both "information contagion" and "collateral-value contagion." *Id.* Roe defines information contagion as the spreading of doubt as to counterparty financial strength, resulting in the halting of lending. *Id.* Collateral-value contagion "arises when financiers simultaneously sell similar assets, depressing their prices if the market is not fully liquid, thereby compromising the immediate value of their assets." *Id.* "The Bankruptcy Code allows derivatives and repo creditors, but not most others, to immediately seize and sell off their collateral, and to demand and keep eve-of-bankruptcy collateral, thereby facilitating collateral contagion." *Id.* at 546.

obviously detrimental to creditors of the issuer who are not protected by the safe harbors, in addition to some who are protected but do not move quickly enough. These arguments are important for our purposes because a run on an issuer of money-claims has unique adverse consequences. This is true not only from the viewpoint of those economists who believe defaults on shadow bank-issued money-claims contract the money supply, but also because of the increased harm to defaults on cash-like claims as distinct from investment claims, as discussed above.

Bear Stearns provides an example of a run on a money-claim issuer. Bear Stearns repo counterparties "ran" when uncertainty emerged with respect to Bear's solvency. The safe harbors did not and could not have prevented a run in the event of bankruptcy filing; regulators attempting to resolve the Bear Stearns crisis appeared principally concerned about the run risk *created by* the safe harbors—that creditors would sell repo collateral en masse, driving down the value of the securities and destabilizing financial markets.[117] The safe harbors not only permit such a fire sale—because there is no automatic stay—but also encourage a fire sale in the event of doubt as to the issuer's solvency, because counterparties bear no risk that the payments will be clawed back as a preferential transfer. The situation leading up to the Lehman Brothers Chapter 11 filing was similar, as discussed below.

The first evidence of the run-exacerbating nature of the safe harbors came long before Bear Stearns; scholars suggested it was the safe harbors that created the need for government intervention in the bank-sponsored rescue of Long Term Capital Management ("LTCM") in 1998. Indeed, they suggest that the orderly wind-down was similar to the

[117] DAVID WESSEL, IN FED WE TRUST: BEN BERNANKE'S WAR ON THE GREAT PANIC 166–68 (2009); Skeel & Jackson, *supra* note 13, at 163 ("This calculus suggests that the very exclusions that were justified as reducing systemic risk—allowing counterparties to terminate (and sell collateral) notwithstanding the automatic stay—can actually exacerbate it through the very sale of that collateral when the troubled institution is a large player in the relevant markets . . . .").

result that would have been achieved under the Bankruptcy Code *absent* the safe harbors.[118] Officials involved in LTCM believed that the rescue was necessary to avoid "an abrupt and disorderly close-out of LTCM's positions" posing serious risks to the economy.[119] Such a situation, it was argued, would be "analogous to a 'bank run'" and would create "systemic illiquidity."[120] These risks, of course, are not limited to LTCM, Bear, and Lehman; any company with derivative counterparties faces similar risk. Any leveraged firm with illiquid assets is susceptible to a run, just like uninsured banks.[121] This is unlikely to optimize value for money-claimants; such runs may swiftly deplete the firms' value, which could have been preserved absent a run.[122] Derivative parties who are exempt from the automatic stay may represent crucial value for the firm, which the safe harbors permit to be depleted.[123]

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118 Edwards & Morrison, *supra* note 13, at 101. *See also* Kenneth C. Kettering, *Securitization and Its Discontents: The Dynamics of Financial Product Development*, 29 CARDOZO L. REV. 1553, 1651 (2008).

119 *Hedge Fund Operations: Hearing Before the H. Comm. on Banking and Fin. Servs.*, 105th Cong. 30 (1998) (statement of William J. McDonough, President, Fed. Reserve Bank of N.Y.) [hereinafter *McDonough Statement*].

120 Edwards & Morrison, *supra* note 13, at 101. Indeed, the Federal Reserve Bank justified the rescue of LTCM on the grounds that derivatives counterparties would rush to seize assets, resulting in liquidation and fire sale prices. *Id.* at 100–01 (citing *McDonough Statement*); SOO J. YIM & WILLIAM J. PERLSTEIN, WILMER HALE, THE EFFECT OF PROPOSED AMENDMENTS TO U.S. INSOLVENCY AND BANKING LAWS ON TRANSACTIONS INVOLVING SECURITIES, COMMODITIES AND OTHER FINANCIAL CONTRACTS 14 n.17 (2001), *available at* http://www.wilmerhale.com/uploadedFiles/WilmerHale_Shared_Content/Files/Editorial/Publication/Bankruptcy%20%20Derivatives%20outline%20-%20_final_.pdf. *See also* Franklin R. Edwards, *Hedge Funds and the Collapse of Long-Term Capital Management*, J. ECON. PERSP., Spring 1999, at 189.

121 Roe, *supra* note 14, at 565.

122 *Id.*

123 Lubben, *Flawed Case*, *supra* note 13, at 75 (explaining that "in the money" derivatives contracts, particularly those used for hedging, represent an "integral part of the firm's going concern value").

Critics of the safe harbors have persuasively argued that such runs may pose systemic risk by triggering information contagion (whereby firms doubt each other's solvency and refuse to lend to each other) and collateral contagion (whereby simultaneous fire sales of assets sharply reduce their value, or may even make them impossible to sell).[124] Absent the safe harbors, a creditor is discouraged from running and, in fact, encouraged to forgo its immediate rights against the debtor firm to permit time for negotiating a collectively beneficial solution.[125]

What is important for our purposes is that—because only a subset of the protected creditors are money-claimants—the safe harbors are particularly likely to imperil some money-claims. Many obligations protected under the safe harbors are not money-claims. Most derivatives are not money-claims; some may represent protection that financial institutions have obtained to hedge investments, but others represent speculative investments. Insolvent debtors, meanwhile, are sapped of funds on losing financial contracts, on both in-the-money derivative investments and short-term debt obligations running to them from other financial institutions. Thus, even if *all* money-claimants were permitted to seize collateral or demand payments under the safe harbors, the very existence of the safe harbors makes it more likely that a run to demand payment will occur, which in turn, makes it less likely that all money-claimants will be paid.

The consequences for those money-claimants who do not benefit from the safe harbors are detrimental, as safe harbors for derivatives counterparties push many money-claimants further back in line, decreasing the likelihood that they will be able to recover, and increasing the likelihood of

124 Roe, *supra* note 14, at 565 (citing Edwards & Morrison, *supra* note 13, at 101).

125 *Id.* Roe gives the example of AIG and suggests that, absent the safe harbors, collateral demands likely would not have occurred (because they could have been undone in a bankruptcy proceeding) and firm value would thus have been preserved. *Id.* *See also* Skeel & Jackson, *supra* note 13, at 155, 167–68.

consequential damages. Parties to repos are protected in that they may keep collateral or net obligations: but if such mechanisms fall short of the obligation owed, they must await repayment of the remaining obligation with unsecured creditors.[126] Holders of commercial paper are only protected to the extent that they can net against obligations owed—and the only types of commercial paper holders who will be able to do so are those who also issue commercial paper.[127] Thus, holders of commercial paper that are not also issuers of commercial paper are not afforded much protection by the safe harbors. MMMFs, for example, where the most "money-like" money-claims are held, typically will not be entitled to any special treatment. While MMMFs would be able to seize assets held under repos, they would not be entitled to immunity or, indeed, any priority treatment for unsecured commercial paper.

Lehman's defaults on its commercial paper obligations provide a striking example of the consequential damages of defaults on money-claims.[128] As Lehman's exposure to subprime losses became evident, and the market began to question its ability to honor its obligations, derivatives counterparties and clearing banks demanded more collateral.[129] In addition, providers of commercial paper and counterparties to repos declined to roll over funding, causing Lehman to be unable to honor its obligations.[130] Lehman filed for bankruptcy after failing to find a buyer in the absence of a government-sponsored rescue. After Lehman's filing, the Reserve Primary Fund, a $62 billion fund that held $785 million in Lehman's unsecured commercial paper was forced to write down the value of that paper to zero, causing the fund to ultimately break the buck.[131] This

126 Because counterparties to repos are overcollateralized, such losses may be rare, but are possible in environments where certain kinds of collateral are rapidly deteriorating.

127 *See* 11 U.S.C. §§ 101(38A), 561 (2011).

128 *See, e.g.*, Gordon & Muller, *supra* note 2, at 164–65.

129 FDIC, *Orderly Liquidation*, *supra* note 20, at 3.

130 *Id.* at 4.

131 *Id.*

triggered a run on the Fund, which suffered redemption requests totaling $40 billion over the two days following Lehman's bankruptcy filing.[132] Over the course of that week, money market funds everywhere became targets of runs, with a total of $310 billion in withdrawals, constituting fifteen percent of the funds' aggregate total assets.[133] The run on money market funds was stemmed only after Treasury's decision to temporarily guarantee MMMFs.[134]

Meanwhile, derivatives and repo counterparties frantically rushed to close out their positions—activity not barred by bankruptcy's automatic stay.[135] J.P. Morgan, to whom Lehman owed approximately $20 billion on the eve of bankruptcy, froze $17 billion in Lehman securities and cash it held, and demanded an additional $5 billion payment.[136] Lehman had no leverage for challenging or preventing such seizures and demands since bankruptcy protected these transactions.[137] Termination by derivatives counterparties also caused severe asset losses for Lehman and its subsidiaries.[138] For example, Lehman Brothers Inc. ("LBI"), Lehman's U.S. broker-dealer, had hedged pricing risk in its affiliates' energy business by entering into swaps.[139] Lehman Brothers Holdings Inc. ("LBHI"), the parent company, had served as guarantor of these swaps, and its bankruptcy filing constituted a default.[140] For regular

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[132] FDIC, *Orderly Liquidation*, *supra* note 20, at 4.

[133] *Id.*

[134] PRESIDENT'S WORKING GRP. ON FIN. MKTS., MONEY MARKET FUND REFORM OPTIONS (2010), *available at* http://www.treasury.gov/press-center/press-releases/Documents/10.21%20PWG%20Report%20Final.pdf.

[135] Trustee's Preliminary Investigation Report and Recommendations at 66, *In re* Lehman Bros. Inc., No. 08-1420 (Bankr. S.D.N.Y. 2010) (on file with the Columbia Business Law Review).

[136] Skeel & Jackson, *supra* note 13, at 165 (citing Darrell Duffie, *The Failure Mechanics of Dealer Banks*, J. ECON. PERSP. Winter 2010, at 51, 67–68).

[137] *Id.* (citing Susanne Craig & Robin Sidel, *J.P. Morgan Made Dual Cash Demands*, WALL ST. J., Oct. 8, 2008, at C2).

[138] FDIC, *Orderly Liquidation*, *supra* note 20, at 3.

[139] *Id.*

[140] *Id.*

creditors of a bankrupt debtor, bankruptcy does *not* entitle the counterparty to terminate its contract.[141] However, derivatives counterparties are permitted to terminate contracts upon the bankruptcy filing of a debtor counterparty.[142] Thus, when Lehman filed for bankruptcy, its counterparties to its energy hedges terminated their losing contracts, leaving Lehman with its "naked hedges," and exposing LBI to pricing risk because it could not offer both sides of the hedge when selling related assets.[143] Worse, two of Lehman's clearing houses refused to complete transactions absent a third party willing to assume Lehman's positions, resulting in the seizure of $468 million in customer assets.[144] Although the assets were ultimately returned, this did not occur until February 11, 2009—in many cases, likely too late for the funds to be put to their intended use.[145] Ultimately commercial paper counterparties will likely receive between 48.4 and 55.7 cents on the dollar under Lehman's liquidation plan.[146] However, because the *function* of these short-term loans was cash management rather than investment, the negative externalities may have been far greater.

In sum, if the purpose of the safe harbors is indeed to mitigate "systemic risk," the safe harbors are both too narrow and too broad. Although defaults on money-claims are uniquely likely to present negative externalities, not all money-claims are given protection in the Bankruptcy Code. Even though repos and commercial paper serve an identical cash management function, commercial paper is not protected to the same extent as repos. At the same time,

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141 11 U.S.C. § 365(b)(2) (2011).

142 *See id.* § 560.

143 Trustee's Preliminary Investigation Report and Recommendations at 66, *In re* Lehman Bros. Inc., No. 08-1420 (Bankr. S.D.N.Y. 2010).

144 *Id.* at 73.

145 FDIC, *Orderly Liquidation*, *supra* note 20, at 4.

146 Linda Sandler, *Lehman Says It May Give Creditors $8.1 Billion to $10.7 Billion*, BLOOMBERG NEWS, Feb. 3, 2012, http://www.businessweek.com/news/2012-02-03/lehman-says-it-may-give-creditors-8-1-billion-to-10-7-billion.html.

derivatives are wholly protected regardless of whether a default on the claim would cause serious negative externalities. In addition, the protection afforded money-claimants is too broad to inure to the overall benefit of money-claimants, because, as currently crafted, the safe harbors permit—and thus encourage—protected money-claimants to close out their positions as quickly as possible.

IV. BANKRUPTCY RULES SHOULD REFLECT CONSIDERATION OF MONEY-CLAIMS

A. Current Proposals Do Not Consider the Unique Nature of Money-Claims

The current bankruptcy rules do not reflect any special consideration of money-claimants, and no scholar or policymaker has proposed any such special consideration. Although scholars have proposed modifying or repealing the safe harbors, the discourse lacks consideration of the fate of money-claimants as distinct from other creditors.[147] Scholars thus far have not considered whether changes to the bankruptcy system can help ameliorate the peculiar harms resulting from a firm's inability to honor money-claims. I agree that the safe harbors should be repealed, but not without mitigation of damages stemming from defaults on money-claims—the automatic stay and preference period must be preserved, but money-claimants should receive at least partial payments within three days of bankruptcy filing. This opportunity for prompt payment is necessary because the *function* of the money-claim is distinct from other claims in that it serves a cash management purpose rather than an investment purpose. Because of this distinction, defaults on money-claims are more likely to carry

[147] Edwards and Morrison, for example, conclude that cash collateral should not be subject to the automatic stay because it is "fungible" with subsequently acquired financing—thereby ignoring the crucial distinction between the ability to access cash on demand and the substantially more attenuated ability to acquire credit. Edwards & Morrison, *supra* note 13, at 95.

consequential damages such as disruption of business operations. It is not that money-claimants are inherently more *deserving* of prompt payment—many may be sophisticated financial institutions. But the problem is that defaults on such claims, due to the *function* of the claims, are uniquely likely to carry damages beyond investment loss.

Those scholars who recognize that the safe harbors create systemic risk have proposed the partial or wholesale repeal of the safe harbors, but have not suggested any specific protection for money-claimants.[148] For example, Professor Roe supports the wholesale repeal of the safe harbors, but does not consider counterparties of short-term debt obligations as meriting special treatment.[149] He concludes: "Someone had to lose money when Lehman failed. If not the Reserve Fund, then someone else."[150] Similarly, although Professor Lubben proposes repealing the safe harbors, and recognizes that certain large financial firms may need special protection, he does not propose any special consideration for money-claims specifically.[151] Others have suggested modification of the safe harbors: for example, differentiating between derivatives used for speculation and those used for hedging,[152] or exempting seizure of "cash-like collateral" but not other assets from the stay.[153] Michael Simkovic suggests requiring greater disclosure to third parties in return for priority.[154] Yet, no partial repeal or distribution scheme that accounts for the unique nature of money-claims has been proposed.

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[148] Roe, *supra* note 14, at 584–85; Lubben, *Bankruptcy Code*, *supra* note 13, at 123; Lubben, *Flawed Case*, *supra* note 13, at 67; Simkovic, *supra* note 13, at 253.

[149] Roe, *supra* note 14, at 554. Indeed, as further discussed below in Part IV.D, Roe concludes that such special treatment accelerates systemic risk.

[150] *Id.*

[151] *See* Lubben, *Safe Harbors*, *supra* note 114, at 333.

[152] *See generally* Bryan G. Faubus, Note, *Narrowing the Bankruptcy Safe Harbor for Derivatives to Combat Systemic Risk*, 59 DUKE L.J. 801 (2010).

[153] Skeel & Jackson, *supra* note 13, at 156–57, 179.

[154] Simkovic, *supra* note 13, at 290.

However, it is both appropriate and necessary for bankruptcy rules to reflect consideration of the distinction between money-claims and other debt obligations. This analysis requires consideration of two separate issues: First, whether it is *proper*, given bankruptcy policy and goals, for bankruptcy rules to take into account the "specialness" of money-claims. Second, whether bankruptcy is *capable* of addressing such concerns from a practical standpoint.

B. Bankruptcy Policy Permits Consideration of the "Specialness" of Money-Claims

Although special treatment for creditors in bankruptcy should be extremely rare, an opportunity for prompt payment of some portion of money-claims is not inconsistent with bankruptcy policy. First, lawmakers have come to expect that bankruptcy rules reflect an effort to mitigate "systemic risk." Second, the distinct function of money-claims is consistent with an opportunity for prompt payment. Finally, such treatment does not undermine bankruptcy goals.

Although some scholars have rejected systemic risk considerations in bankruptcy,[155] or have suggested that systemic risk concerns are "not high on the list of bankruptcy goals,"[156] the current bankruptcy rules *do* reflect a preoccupation with systemic risk. While bankruptcy was originally designed to maximize enterprise value, rather than address issues of systemic risk,[157] it is now expected that bankruptcy rules will mitigate systemic risk where possible. Indeed, a key justification for the safe harbors was—and continues to be—the prevention of systemic risk.[158] Congress justified the safe harbors on the grounds that they were necessary to prevent the "insolvency of one commodity

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155 Edwards & Morrison, *supra* note 13, at 90.

156 Gordon & Muller, *supra* note 2, at 182.

157 Bankruptcy is designed to preserve the value of a firm's assets, not to protect money-claimants from consequential losses. *See* Ricks, *supra* note 1, at 112.

158 *1999 House Hearing*, *supra* note 13, at 352.

or security firm from spreading to other firms and possibly threatening the collapse of the affected market."[159] It was believed that the safe harbors protected the markets from both "systemic problems" and "domino failures."[160]

Although the safe harbors were purportedly concerned with systemic risk, as currently designed they inure primarily to the benefit of large financial institutions, without due regard to the negative externalities associated with defaults in money-claims. If it is correct that bankruptcy is to be concerned with systemic risk, bankruptcy rules must reflect consideration of the uniqueness of money-claims. As one reporter noted:

> It was commercial paper and the $3.6 trillion money market industry that traded the notes that came close to sinking the global economy—not a breakdown in credit-default swaps or bank-to-bank lending. The bankers were focused on saving themselves, and commercial paper, as invisible as the air they breathed, never came up at the meetings, according to one of the two dozen executives invited to the New York Fed . . . .[161]

The ramifications of a default on money-claims, such as the Reserve Fund commercial paper obligation, carried substantially more import from a systemic risk perspective than defaults on obligations that represented investments. The Reserve Fund's breaking the buck triggered a run on MMMFs—not dissimilar from the runs on banks that occurred in the financial crisis at the onset of the Great Depression. While the government stepped in to insure MMMFs in order to stem the run, there is no guarantee that it will do so in the future. Indeed, Dodd-Frank purports to

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159 H.R. REP. NO. 97-420, at 1 (1982). *See also supra* note 100 and accompanying text.

160 *1999 House Hearing*, *supra* note 13, at 352.

161 Bob Ivry et al., *Sleep-At-Night-Money Lost in Lehman Lesson Missing $63 Billion*, BLOOMBERG (Sept. 8, 2009, 7:01 PM), *available at* www.bloomberg.com/apps/news?pid=newsarchive&sid=aLhi.S5xkemY.

prohibit such action.[162] Thus, contrary to Roe's implication that it would make no difference whether the Reserve Primary Fund or some other creditor lost money, defaults on money-claims—such as commercial paper claims of MMMFs—carry vastly increased risk of consequential damages.

Even in cases where systemic risk is not a concern (or does not appear to be a concern), the unique function of money-claims warrants an opportunity for prompt payment. Indeed, even under the current version of the Code, certain creditors may be paid early on in the proceedings, upon certain showings to the court. For example, employees receive priority, because failing to protect employees would encourage employees to stop providing services the moment bankruptcy filing appears possible. Indeed, payroll obligations to employees have much in common with money-claims, while not a loan of cash, the *expectation* of employees is that the labor they provide will be compensated *in the short term*. Employees' calculations involving upcoming payments of financial obligations include the *expectation* that their pay will be timely delivered, and disruption of this expectation may have serious consequential damages (inability to make mortgage or rent payments, leading to foreclosures or evictions). Because money-claims serve a cash management purpose rather than an investment purpose, and because defaults on money-claims are uniquely likely to carry additional damages beyond investment loss, it is sensible to provide an opportunity for prompt payment that may mitigate such damages.

Prompt payment for money-claimants does not conflict with bankruptcy goals. As a general rule, special treatment for creditors violates key bankruptcy principles of equality,

[162] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 1105(c)(1), 124 Stat. 1376, 2121 (2010) (to be codified at 12 U.S.C. § 5612(c)(1) (requiring congressional approval before FDIC can insure MMMFs and other money-claims); *Shapiro Testimony*, *supra* note 38 ("The tools that were used to stop the run on money market funds in 2008 are either no longer available or unlikely to be effective in preventing a similar run today.").

and must be curtailed. Creditors are expected to share the pain equally, for the collective gains in an effective reorganization.[163] Special interest groups—including financial institutions—have succeeded in eroding this principle of equality, interfering with debtor rehabilitation and the recovery of unsecured creditors.[164] However, rehabilitation is unlikely to be an option for financial institutions in bankruptcy—their ability to transact depends upon their credit rating, which a Chapter 11 rating would not improve, to say the least.[165] With respect to principles of equality, an opportunity for prompt payment of money-claims would be a *reduction* in special treatment for most financial counterparties as compared to the current rules. Appropriately, it would further take into consideration key differences in *function* between long-term loans and money lent on a short-term basis designed to serve a cash-management purpose.

C. Bankruptcy Is Capable of Addressing Concerns Related to Money-Claims

To the extent that bankruptcy scholars have considered bankruptcy's role in the shadow banking system, they have concluded that bankruptcy is not the proper place to address concerns associated with shadow banking. Scholars have correctly noted that bankruptcy, in its *current* form, cannot protect against the risks associated with maturity transformation in the shadow banking sector. Gordon and Muller point to Lehman and explain that the safe harbors will "rapidly unravel" the businesses of a financial firm, and deplete valuable contracts.[166] In addition, they note that a

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163 *See* Lubben, *Flawed Case*, *supra* note 13, at 63.

164 *See id.* at 63–64; *see also* Richard Levin & Alesia Ranney-Marinelli, *The Creeping Repeal of Chapter 11: The Significant Business Provisions of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005*, 79 AM. BANKR. L.J. 603 (2005) (arguing that special treatment passed at the urging of special-interest lobbyists interferes with corporate rehabilitation).

165 *See* Lubben, *supra* note 14, at 442.

166 Gordon & Muller, *supra* note 2, at 181–82.

bankrupt firm will be required to stop paying pre-petition creditors that are not safe harbored.[167] Finally, Gordon and Muller note that bankruptcy is ill equipped to address systemic concerns, as discussions about bankruptcy would trigger a run and would likely not keep pace with rapidly deteriorating market conditions.[168] Ricks similarly posits that bankruptcy is not helpful because protecting money-claimants from consequential damages is not in bankruptcy's purview.[169] Roe joins Ricks in concluding that a regulatory structure akin to the structure currently in place for depository institutions is the proper venue for addressing these concerns.[170] Lubben also concludes similarly: "[C]hapter 11 is ill-suited to the broader questions of policy and ex ante prevention of crisis that are better achieved through capital requirements and financial regulation."[171]

On the one hand, it is entirely correct to conclude that bankruptcy is not well equipped to resolve monetary concerns.[172] The moment an issuer of money-claims is

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[167] Gordon & Muller, *supra* note 2, at 181–82.

[168] *Id.*

[169] Ricks, *supra* note 1, at 112.

[170] Roe, *supra* note 14, at 581–82. Roe concludes that extending bankruptcy "super-priorities" to such "sophisticated financial players" is not the proper purview of bankruptcy—parties unprotected by safe harbors are likely to be the least sophisticated. *Id.*

[171] Lubben, *supra* note 14, at 440.

[172] Some argue that derivatives and repo markets are "like banking" and thus provide social good, and should be protected. Roe, *supra* note 14, at 581–82.

> Just as check-clearing and savings activities should be safe and fully transparent so that depositors need not fear bank failure, for Wall Street to function in the twenty-first century, it needs repos, and both Main Street and Wall Street now need credit derivatives to manage risk. These instruments are vital for finance, this view would have it, and players using them need additional protection because they cannot be concerned with their counterparties' creditworthiness.

Id. at 583 (summarizing the like-banks justification). Roe responds by pointing out that these are "not naïve retail bank depositors," but "sophisticated financial players." *Id.* at 582. Further:

financially insecure, money-claims are jeopardized; neither a run nor a temporary freeze on collection can preserve the moneyness of such claims. In addition, bankruptcy rules cannot force existing creditors to extend additional credit, so the "rollover risk" associated with maturity transformation in the shadow banking sector cannot be reduced. Finally, in a situation similar to the financial panic triggered by subprime losses, where creditors suddenly and simultaneously doubt the strength of nearly every financial institution and thus stop lending, bankruptcy is not going to prevent a crisis—but then again, neither will OLA's receivership regime, which envisions a liquidation of all such institutions. Just because bankruptcy cannot be the *complete* solution to concerns about money-claim defaults does not mean that bankruptcy lacks the potential to mitigate the damages associated with such defaults. Instead, it may be possible for bankruptcy rules to prevent some of the damages associated with defaults on money-claims. In fact, with changes, bankruptcy may be able to do a *better* job of mitigating systemic risk associated with money-claim defaults than OLA receivership.

While bankruptcy—in its current form—does not mitigate risks associated with potential money-claims defaults, the Bankruptcy Code could be modified to satisfy many of these concerns. First, as discussed above, other bankruptcy scholars have already proposed repealing the

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> [T]he proper regulatory reaction would not at all be ad hoc bankruptcy priorities. Rather, Congress would need to complete the regulatory and contractual loop by recognizing that the United States is that market's missing creditor and that the United States needs to complete its contingent, de facto contract status with a regulatory structure that approximates that which we use for deposit banking. There would be greater risk controls and regulation. The derivatives and repo players would be charged for the government guarantees. We now get the costs of favoring derivatives, but without the full panoply of benefits and controls.

Roe, *supra* note 14, at 582–83.

safe harbors, which reduces the likelihood of a run and prevents the sudden depletion of a money-claim issuer's assets. Absent the safe harbors, many valuable contracts could be preserved. In addition, changes to other types of special treatment could make liquidity available to other creditors, including money-claimants. For example, unsecured bank creditors need not be permitted to set off their claims against debtors' cash bank accounts; eliminating these setoff rights would, in turn, greatly increase the likelihood that funds would be available for money-claimants. Finally, although bankruptcy does not currently provide for prompt payment of all money-claims, it is possible, as discussed above, to amend the Code to provide for an abbreviated stay for money-claimants needing to exercise setoff rights, and to provide for prompt payment of at least some portion of currently unprotected money-claims. If money-claimants can be assured that they will receive at least partial payment of their claims promptly after filing (even one to three days after filing), this would sharply reduce the likelihood of consequential losses for money-claimants. For example, if the Reserve Primary Fund had been able to be paid even fifty percent of its outstanding commercial paper within a day of Lehman's bankruptcy filing, it could have valued its paper and avoided breaking the buck. In addition, with the automatic stay Barclays would have been able to assume more of Lehman's assets, and may have chosen to hold its commercial paper, to continue a relationship with those funding providers.[173] Preservation of liquidity is key to reducing the harm of defaults on money-claims. An opportunity for prompt payment preserves liquidity and could also boost counterparty confidence, thus mitigating rollover risk.

D. The Problem with Protecting Money-Claims

It thus appears plausible for changes to the bankruptcy rules to reduce at least some of the risk associated with defaults on money-claims in some circumstances. The

[173] *See* FDIC, *Orderly Liquidation*, *supra* note 20.

question is whether such changes would *increase* systemic risk in other ways; that is, whether bankruptcy can protect money claimants without also encouraging institutions to rely exclusively on short-term funding. Although the unique nature of money-claims makes them suitable for special consideration in bankruptcy, it is not clear what kind of distribution structure would best reduce the risk associated with defaults on money-claims. The difficult part about proposing changes to the Bankruptcy Code that affect the payment of claims is that these changes affect creditor decision making far in advance of bankruptcy filing, and can even affect contracts that will never be exposed to bankruptcy. Bankruptcy is a worst-case scenario for creditors, and how they fare in bankruptcy certainly plays a role in whether and to whom they choose to lend. The problem for our current discussion is this: funding the activity of financial institutions with money-claims is an inherently risky endeavor. Therefore, we want to discourage institutions from funding themselves in this way, and discourage creditors from lending in this way. The fear is that if such creditors are given bankruptcy protection, they may feel it is safer to provide this type of lending. Roe uses precisely this argument to support the repeal of the safe harbors: he concludes that the safe harbors incentivize risky lending by signaling to creditors that they will be repaid even if the debtor files for bankruptcy.[174] In addition, he

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[174] Roe argues that "bankruptcy priority perniciously weakens market discipline in the derivatives and repo markets because the stronger counterparties know that they often enough will be paid even if their derivatives or repo counterparty fails." Roe, *supra* note 14, at 542.

> Were the superpriorities not in the Code, each failed firm would itself have been incentivized to substitute away from their own risky, often overnight financing and toward a stronger balance sheet to better attract trading partners. Were the superpriorities not in the Code, the [Lehman, AIG, and Bear Stearns]'s counterparties would have had reason to diversify away from some trades with the failed firms into trades with other financial firms. Were the superpriorities not in the Code, the extra risk borne by counterparties would be more accurately priced and, at the

suggests that the safe harbors also disincentivize counterparties from acquiring information about the financial position of the firm.[175] He points out that, although the safe harbors were originally justified by a "fear of contagion," the Treasury Department indicated in 1983 that it was systemically safer *not* to provide special protections to derivative counterparties.[176] The Treasury Department suggested that "[t]he perception of increased risk in the repo market is healthy, because it forces more responsibility in repo transactions by causing lenders to securities dealers to evaluate the financial condition of their borrowers, as creditors must in every other type of secured lending transaction."[177] In other words, short-term lending *is* risky, and it is not beneficial for short-term lenders to assume they will be protected in the event of the insolvency of a debtor financial institution.

Scholars have suggested that Bear Stearns and Lehman Brothers—both of which were money-claim issuers—would not have relied so heavily on short-term funding in the absence of the safe harbors.[178] Roe argues that Bear and Lehman would have been in a stronger position absent the safe harbors, since they would not have derived such an excessive portion of their funding from short-term debt obligations. With respect to Bear, he points out that a full quarter of Bear's capital derived from the repo market, with much of the borrowing done on an overnight basis. Roe states: "Without the Code's priorities, such a precarious capital structure would not have been viable."[179] Indeed, as

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> higher pricing, we'd have had less systemically risky activity.

Roe, *supra* note 14, at 542.

175 "[B]ankruptcy superpriority discourages early counterparty information acquisition." *Id.* at 545.

176 *Id.* at 567.

177 *Id.* (quoting Letter from Roger W. Mehle, Assistant Sec'y of Domestic Fin., Dep't of the Treasury, to Senator Robert J. Dole (Mar. 16, 1983)).

178 *See id.* at 542.

179 *Id.*

the safe harbors expanded, Bear's reliance on repo financing rose—from seven percent of its liabilities and twice its equity in 1990 to twenty-five percent of its liabilities and eight times its equity in 2008.[180] Moreover, counterparties also might not have agreed to lend short-term without the Code's assurance that they could keep the collateral provided (that is, seize and sell their security) if Bear ultimately filed for bankruptcy.[181] Absent the safe harbors, Bear's counterparties would have been required to return the assets as an eve-of-bankruptcy preference. Roe thus argues that as a result of the safe harbor, counterparties failed to monitor Bear's soundness. He suggests that absent the safe harbors Bear would not have been able to obtain such cheap financing in the overnight market.[182]

These examples are important for our purposes because they have implications for all institutions that issue money-claims. Roe concludes that absent the safe harbors, repo financing would have been much more expensive, and this would have lead to alternative and "more stable" financing.[183] That is, the market would have shifted "from

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[180] Skeel & Jackson, *supra* note 13, at 163–64 (citing Roe, *supra* note 14, at 552).

[181] Roe, *supra* note 14, at 552.

[182] At the time of filing, overnight borrowing reached $100 billion; Bear had $400 billion in assets at time it failed, and one quarter of its value was in the repo market—an amount that represented eight times the total equity capital at risk. *Id.*

[183] Roe argues that

> The priorities reduce counterparty risk, inducing stronger players to accept a higher, perhaps imprudently higher, level of derivatives and repo financing with weak counterparties. If they bore more risk of counterparty failure, they might demand better-capitalized counterparties. Or they would demand better counterparty portfolio information, so that they could better price that risk. They would charge the risky counterparty more and the sound one less. The weak counterparty would be incentivized to become financially stronger (so as to be charged less) and, at least to the extent prices rose, the parties would do less derivatives and repo business.

overnight repos to longer-term financing," and counterparties would have monitored these short-term lenders more carefully, reducing exposure to a single counterparty and obtaining earlier margin coverage (with enough time in advance of bankruptcy filing to fall outside any potential "preference period").[184] Roe points to the financial market participants' own statements that repeal of the safe harbors would "have a chilling effect on the 'repo' market and thus on broader credit availability."[185]

But repealing the safe harbors without providing any other protection for money-claimants is problematic. Although the safe harbors may provide additional incentives for unstable funding, or may cause creditors to monitor borrowers insufficiently, changes to bankruptcy rules alone would likely neither put an end to this type of lending nor guarantee creditor monitoring. If financial institutions elected to fund their activity exclusively with long-term loans, this would, of course, eliminate the maturity mismatch and the attendant risk of runs, but it would also eliminate most of their profits.[186] In addition, many parties

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Roe, *supra* note 14, at 555 (footnote omitted).

> [W]e are subsidizing the production of derivatives and repos via the Code's favored treatment. When we subsidize an activity, we get more of it than we otherwise would. Worse, as economic and financial activity gravitates to the favored sector, the sector becomes more important to the economy, making change hard because it would disrupt ongoing ways of doing business.

Id. at 589.

184 *Id.* at 552, 560–65 (contending that repealing superpriorities would make stronger counterparties more aware that weaker counterparties could fail, thus strengthening market discipline mechanisms).

185 *Id.* at 577 (citing Tom Braithwaite & Michael Mackenzie, *Creditors to Foot Bill in U.S. Risk Regulation*, FIN. TIMES (Dec. 3, 2009, 1:04 AM), http://www. ft.com/cms/s/0/558799be-df9c-11de-98ca-00144feab49a.html).

186 *See* Morgan Ricks, *A Regulatory Design for Monetary Stability*, 65 VAND. L. REV. 1289, 1324–25 (2012) (explaining that, under the maturity transformation model, the difference between the yield earned by a firm on its investment portfolio and its weighted average cost of funds equals a

who ultimately bear the loss on short-term defaults are not sufficiently organized or informed to monitor the financial institution. Indeed, those commercial paper creditors who were not sufficiently protected by the safe harbors nevertheless continued to lend, and those defaults had serious consequences. The MMMF investors who were ultimately exposed to such losses arguably did not have the capacity to adequately monitor the investments of their fund manager, much less the financial stability of institutions in which the fund chose to invest.

While Roe suggests that lessons from the crisis will be sufficient to discourage this type of lending,[187] it is important to keep in mind that 2008 was not the first incident of default on commercial paper. For example, Penn Central Railroad, a major commercial paper issuer, failed and defaulted on its commercial paper obligations in 1970.[188] This caused severe disruptions in the commercial paper market and nearly triggered a financial crisis.[189] Yet commercial paper markets blossomed subsequently. Thus history has shown that the commercial paper market will not halt after defaults. In fact, it has only grown to constitute a tremendous portion of the funding of financial institutions, in addition to corporations. Indeed, it was only with the Second Circuit's *Enron* decision in 2011 that it was made clear to market actors that commercial paper is afforded protection by the safe harbors; commercial paper usage reached its peak far in advance of that decision.[190]

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firm's economic profit, which represents an economic surplus from maturity transformation).

187 Roe, *supra* note 14, at 557–58 (explaining that post-crisis commercial paper players may demand repo protection to benefit from safe harbors).

188 *See* Adam J. Levitin, *In Defense of Bailouts*, 99 GEO. L.J. 435, 454 (2011) (describing how systemic risks are enhanced when nonfinancial firms act as financial firms).

189 *Id.* (citing Paul A. Volcker, *Financial Crises and the Macroeconomy*, *in* THE RISK OF ECONOMIC CRISIS 174, 176 (Martin Feldstein ed., 1991)).

190 Enron Creditors Recovery Corp. v. Alfa, S.A.B. de C.V., 651 F.3d 329, 335 (2d Cir. 2011).

History also suggests that financial players will continue to find ways to mimic the role of traditional banks without the associated regulatory constraints. Dodd-Frank—in spite of its massiveness, and in spite of the shock of the financial crisis that prompted its enactment—did not prohibit or even circumscribe short-term lending, nor does it adequately protect money market investors.[191] The SEC is attempting to regulate the MMMF industry by preventing fund sponsors from signaling to investors that such funds are risk-free, but such proposals are facing stiff opposition from the financial industry, and carry risks of their own: if rules change, causing money market investors to doubt their ability to withdraw their funds on demand, a run could ensue.[192]

Because our financial reforms have neglected to impose bank-like regulations on these bank-like institutions, the risk of a run on these institutions and the attendant consequences will remain. We do not deny emergency room care to motorcycle riders who fail to wear helmets, though perhaps failure to provide such care would deter some number of motorcycle riders from going helmetless. That it may not be *reasonable* to assume that money market accounts carry the same protections as depository accounts does not change the fact that such accounts are used for just this purpose; neither does it reduce the likelihood that a run on money market funds would have similar macroeconomic consequences to a run on depository banks. If withdrawing bankruptcy protection from money-claimants wholesale would ensure an end to shadow banking, it might be the correct course of action.[193] However, this cannot be guaranteed, or even assumed to be the likely result. And while it is certainly true that ex ante regulation is the preferred resolution to many of these concerns, it does not appear to be forthcoming. If changes to bankruptcy rules

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[191] *See* sources cited *supra* note 11.

[192] Norris, *supra* note 37.

[193] Even then, many economists might argue that shadow banking is too crucial a component of our economy, and that eliminating it would have precisely the same consequences (economic slowdown, high unemployment, etc.) that pro-regulatory scholars hope to avoid.

cannot ensure an end to short-term funding, then bankruptcy rules must address defaults on money-claims in a manner most likely to mitigate systemic risk.

Still, it is also not sensible to ignore the incentives created by providing protection for money-claimants. If financial institutions lend short-term rather than long-term because of increased protections for short-term lenders, this undermines the goal of increasing stability in the financial sector.[194] The question then becomes whether it is possible to protect money-claims *without* unduly incentivizing risky funding for financial institutions. I believe that such a proposal is possible, although it would be strengthened by ample regulation of such institutions, and in the event that regulation is meaningful—insurance of such claims. Ideally, such a proposal would provide for maximum protection of outstanding money-claims, while simultaneously creating sufficient uncertainty regarding the repayment of money-claims in the event of issuer default to deter overreliance on short-term funding. In other words, at the time of the funding decision, we do not want short-term creditors, or money-claimants, to assume they will be able to obtain their funds on demand in the event of issuer distress; this would encourage financial institutions to choose short-term lending over more stable (longer-term) funding sources. At the same time, we do not want to risk serious consequential damages for money-claimants, particularly where there is potential for macroeconomic impact.

[194] *See* Manuel A. Utset, 45 GA. L. REV. 779, 816–21, 838 (2011) (explaining that short-term debt creates a "race to shorten maturities" that creates systemic risk).

V. PROTECTING MONEY-CLAIMS AND REDUCING RISK IN MATURITY TRANSFORMATION

A. Resolution of Money-Claims Under Dodd-Frank's Orderly Liquidation Authority

It may be possible to craft bankruptcy rules that both prevent a run on the firm's assets and mitigate the consequential damage resulting from defaults on money-claims. In exploring rules that are better suited to protecting money-claims without unduly encouraging short-term financing, it is important to examine another regime that handles varying types of money-claims: the new Orderly Liquidation Authority ("OLA") established under Dodd-Frank.[195] This exercise is important because it will often not

[195] As Lubben and others have pointed out, there are a number of overlapping regimes responsible for resolving the claims of financial institutions, including FDIC receivership for banks, Securities Investor Protection Corporation ("SIPC")—under SIPA—for broker-dealers, and bankruptcy for any non-bank financial institution to the extent not covered by OLA or SIPC. *See, e.g.*, Stephen J. Lubben, *Resolution, Orderly and Otherwise: B of A in OLA*, 81 U. CIN. L. REV. (forthcoming Apr. 2013), *available at* ssrn.com/sol3/papers.cfm?abstract_id=2037915. Even FDIC receivership for banks does not perfectly protect money-claimants. In some situations, derivatives counterparties may be entitled to assets ahead of depositors: "[I]f the bank lacks enough assets to pay off all of its creditors, the secured derivatives counterparties come first and the depositors second." Roe, *supra* note 14, at 558. Banks are required to spin off their swap trading into broker-dealer affiliates. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 716, 124 Stat. 1376, 1648–51 (2010) (to be codified at 15 U.S.C. § 8305). Such contracts will continue to receive favored treatment under the safe harbors. Lubben, *supra* note 4, at 1261 n.12, 1264. Unless a "specialized regime" (such as OLA or SIPA) applies, the bankruptcy rules will apply. Institutions that may be subject to bankruptcy include hedge funds, investment banks, and their parent organizations. *Id.* at 1265. Broker-dealers are resolved under SIPA, though Chapters 1, 3, and 5 of the Bankruptcy Code are incorporated to the extent not inconsistent with SIPA. Broker-dealers will continue to be subject to SIPA, which provides for a liquidation procedure and gives priority to the broker-dealer's customers over general unsecured creditors. *Id.* (citing 15 U.S.C. §

be clear at the outset whether a financial institution will be subject to OLA or bankruptcy in the event of distress. OLA covers bank holding companies and other financial institutions (including hedge funds, private equity funds, and parent companies of banks and insurance companies) that have eighty-five percent or more of their activities in "finance."[196] Thus, if an institution has just over or just under eighty-five percent of its activities in "finance," it will not be clear which regime applies.[197] In addition, even for companies subject to the regime, OLA receivership is only triggered if the Secretary of the Treasury decides to invoke his or her authority either to place the institution into receivership before a bankruptcy filing or to remove the

78fff(b) (2006)). In an OLA proceeding, "customers still get SIPA-like treatment, but all other creditors are subject to Dodd-Frank's distribution scheme." *Id.* at 1273 (citing Dodd-Frank Act § 205(g)). *See also* Skeel & Jackson, *supra* note 13, at 197. Lubben suggests that the gap between OLA and Chapter 11 can be narrowed if regulators incorporate comparable rules from the Bankruptcy Code, and commit to following the resolution plan of the financial institution that had intended to file under Chapter 11. Lubben, *supra* note 4, at 1276–77. Lubben persuasively argues that inconsistency across regimes is problematic, explaining that "there is uncertainty across two planes: will the regulators invoke the procedure, and does the procedure even apply to the firm in question?" *Id.* at 1274.

[196] Lubben, *supra* note 4, at 1260. Lubben points out that if the problem was not merely size but also "the interconnected nature of these firms, the difference between 84% and 85% is unimportant." *Id.* at 1260–61. Even for firms that do conduct eighty-five percent of their business in finance, OLA is only triggered by approval of the Treasury Secretary and a two-thirds vote of the FDIC Board and Federal Reserve Board. *See* U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-12-735, BANKRUPTCY: AGENCIES CONTINUE RULEMAKINGS FOR CLARIFYING SPECIFIC PROVISIONS OF ORDERLY LIQUIDATION AUTHORITY (2012), *available at* http://www.gao.gov/assets/600/592318.pdf.

[197] Eighty-five percent of "total consolidated revenues" must come from activities that the oversight panel deems financial in nature, or more than eighty-five percent of consolidated assets must be financial in nature. Lubben, *supra* note 4, at 1269 (citing Dodd-Frank Act § 201(b)); Dodd-Frank Act § 201(a)(11) (noting that Dodd-Frank covers all bank holding companies).

institution from bankruptcy proceedings after filing.[198] On top of that, an institution will only be deemed "systemically important"—and thus subject to OLA—upon a two-thirds vote of both the Federal Reserve Board and the FDIC Board, or the SEC.[199] Money-claim issuers and money-claimants often will not know in advance which regime would apply to either themselves or to their counterparties.

It is worth considering whether OLA's receivership rules mitigate the consequential damages of defaults on money-claims more effectively than bankruptcy. As discussed in Part III, the safe harbors imperil money-claimants by encouraging runs. Under OLA receivership, *all* counterparties—including derivatives and repo counterparties—are subject to a one-day stay.[200] Presumably, Congress considered and rejected systemic risk concerns with subjecting derivatives and repo counterparties to a one-day stay. The one-day stay permits the FDIC to move assets and liabilities out from a failed entity, and the FDIC has the power to assume or reject derivatives contracts.[201] In addition to the one-day stay and the power to assume or reject contracts, the FDIC has the power to claw back preferential payments made prior to the invocation of receivership proceedings.[202]

In a recent report, the FDIC suggested that under OLA, the "panic selling" and asset depreciation—particularly, the decline in value of assets underlying Lehman's derivatives portfolio—would have been mitigated, the going-concern

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198 Lubben, *supra* note 4, at 1265; Dodd-Frank Act § 203.

199 Lubben, *supra* note 4, at 1269–70 (citing Dodd-Frank Act § 202(a)(1)(A)(iii)). Lubben suggests that it is unclear whether OLA would be invoked if a run on the assets of a large mutual fund began. Individually, the fund may not be systemically important, but if the run triggered runs on other funds, it could entail substantial systemic risk. *Id.* at 1274.

200 Roe, *supra* note 14, at 586.

201 Dodd-Frank Act § 210(b)(4)(B) (to be codified at 12 U.S.C. § 5390(b)(4)(B)). Thus, derivatives counterparties currently receive more protection in bankruptcy than under an OLA proceeding. Lubben, *Financial Institutions*, *supra* note 4, at 1261.

202 12 U.S.C. § 5390(b)(4) (2011).

value of the firm would have been better preserved, and creditors would have been paid immediately on some portion of their claims.[203] This suggests that it is more likely that funds would be available for distribution to money-claimants in an OLA regime—without the safe harbors—than in bankruptcy.

Of course, OLA receivership permits tools not currently available in bankruptcy, such as the creation of a bridge institution in the event a buyer is not immediately available.[204] Still, there is no guarantee that the FDIC will decide to establish a bridge institution. This is not terribly different, however, from an institution in bankruptcy: a buyer may or may not be available to purchase the institution promptly after filing.[205] Even *with* the safe harbors, Barclays purchased Lehman's core trading operations just days after Lehman filed for bankruptcy.[206] Had the safe harbors not prevented Lehman's counterparties from demanding increased collateral posting and seizing assets on the eve of bankruptcy, the deal could potentially

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203 FDIC, *Orderly Liquidation*, *supra* note 20, at 5.

204 Hollace T. Cohen, *Orderly Liquidation Authority: A New Insolvency Regime to Address Systemic Risk*, 45 U. RICH. L. REV. 1143, 1166 (2011) (citing 12 U.S.C. § 5390(a)(1)(D) (2011)) (noting that the FDIC "may sell the assets to one or more third parties or form a bridge company under § 5390(h) and transfer any asset (or liability subject to certain limitations) to the bridge financial company"). "[T]he life of a bridge financial company may be extended for up to a total of five years from the date of its charter which may or may not coincide with the date of the appointment of the FDIC as receiver." *Id.* at 1221 (citing 12 U.S.C. § 5390(h)(12)–(13) (2011)). The FDIC's resolution powers permit it to transfer all or some of the assets and liabilities to a third-party institution; if the FDIC is unable to attract a buyer, it will establish a temporary bridge financial company until it can be sold or orderly liquidated. Lubben, *supra* note 4, at 1270 (citing Dodd-Frank Act § 210(a)(1)(G), (h)).

205 11 U.S.C. § 363 (2011).

206 Ben White & Eric Dash, *Barclays Reaches $1.75 Billion Deal for a Lehman Unit*, N.Y. TIMES, Sept. 17, 2008, http://www.nytimes.com/2008/09/18/business/worldbusiness/18barclays.html?pagewanted=all.

have been consummated outside of bankruptcy, and Barclays might even have assumed Lehman's commercial paper.[207]

While the one-day stay and avoidance powers available in an OLA receivership regime make it more likely that funds will be available for distribution to money-claimants, OLA's distribution scheme does not suggest that money-claimants would be eligible for prompt payment.[208] OLA's distribution

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[207] *See* FCIC, SHADOW BANKING, *supra* note 6, at 38; FDIC, *Orderly Liquidation*, *supra* note 20, at 17–18.

[208] Ricks, *supra* note 1, at 112. OLA provides the following priorities for the payment of unsecured claims, including the undersecured portion of secured claims, against the covered financial company or the FDIC as receiver:

> (A) Administrative expenses of the [FDIC as] receiver.
>
> (B) Any amounts owed to the United States, unless the United States agrees or consents otherwise.
>
> (C) Wages, salaries, or commissions, including vacation, severance, and sick leave pay earned by an individual (other than [senior executives and directors]), but only to the extent of $11,725 for each individual (as indexed for inflation, by regulation of the [FDIC]) earned not later than 180 days before the date of appointment of the [FDIC] as receiver.
>
> (D) Contributions owed to employee benefit plans arising from services rendered not later than 180 days before the date of appointment of the [FDIC] as receiver, to the extent of the number of employees covered by each such plan, multiplied by $11,725 (as indexed for inflation, by regulation of the [FDIC]) less the aggregate amount paid to such employees under subparagraph (C), plus the aggregate amount paid by the receivership on behalf of such employees to any other employee benefit plan.
>
> (E) Any other general or senior liability of the covered financial company (which is not a liability described under subparagraph (F), (G), or (H)).
>
> (F) Any obligation subordinated to general creditors (which is not an obligation described under subparagraph (G) or (H)).
>
> (G) Any wages, salaries, or commissions, including vacation, severance, and sick leave pay earned, owed to senior executives and directors of the covered financial company.

scheme is similar to the bankruptcy distribution scheme; however, it is *possible* that the FDIC could, within the parameters of Dodd-Frank, provide prompt payment to money-claimants.[209] The focus of this Article has been on bankruptcy rather than OLA, but the concerns addressed here apply equally in both regimes, and an opportunity for prompt setoff or other recovery of money-claims ought to be considered for both regimes.

B. Protecting Money-Claims in Bankruptcy

The one-day stay provided for in OLA and FDIC receivership offers a way to deter a run, while also providing for the prompt payment that is so crucial to mitigating adverse consequences of monetary default. A one-day stay, such as that proposed under OLA—with an opportunity for prompt payments of money-claims not otherwise protected—comes closest to meeting the conflicting goals of protecting money-claims without unduly encouraging short-term funding. A stay deters a run on the assets of a financial institution; some of the creditors that are stayed would include money-claimants, such as repo lenders, that would be permitted to seize assets and receive payments on the eve of bankruptcy under the current bankruptcy rules.[210] In addition, there would be sufficient uncertainty regarding the adequacy of liquid assets available to pay money-claims,

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> (H) Any obligation to shareholders, members, general partners, limited partners, or other persons, with interests in the equity of the covered financial company arising as a result of their status as [such equity interest holders.

12 U.S.C. § 5390(b)(1) (2011).

209 The FDIC has "near unilateral" authority to allow or disallow claims. Lubben, *supra* note 4, at 1270 (citing Dodd-Frank Act § 210(a)(2) (to be codified at 12 U.S.C. § 5390(a)(2), (7), (b)); Roe, *supra* note 14, at 586.

210 11 U.S.C. § 362(b)(17) (2011) (netting of securities contract does not violate stay); *see id.* § 546(e) (settlement payments made by or to a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency are not voidable preferences).

such that money-claimants may be deterred from lending, or may be more likely to demand more stable (e.g., less leveraged) counterparty financial institutions. Some money-claimants would *not* be guaranteed as swift payment as under the current bankruptcy regime; however, they—and other creditors currently receiving the benefit of the safe harbors—would be deterred from running. The preservation of value would enable a bidder to acquire the assets of the failed institution, and would facilitate, though not guarantee, the prompt payment of money-claims.

Money-claimants needing cash to continue operations and avoid default could be paid immediately, and those willing to defer payment could be compensated with increased interest rate payments. Members of the FDIC's Systemic Resolution Advisory Committee have suggested that, had Lehman been resolved under the OLA, the FDIC could have chosen to provide the Reserve Primary Fund with advance cash, permitting the Fund to avoid writing down its Lehman commercial paper holdings.[211] In essence, the Fund would have received a priority distribution. Current bankruptcy rules do not permit priority treatment of unsecured commercial paper obligations, but the Code could be amended to prioritize these claims. In bankruptcy, of course, such a priority payment would be contingent upon sufficient liquid assets with which to make the distribution, unless a private buyer opted to hold the paper. A temporary stay precluding counterparties from terminating out-of-the-money derivatives contracts (precluding counterparties from refusing to honor losing contracts) would substantially augment the estate and increase the likelihood that short-term obligations could be promptly honored.

Some may object that the proposal is both under and overinclusive—underinclusive because (1) some parties similar to money-claimants are excluded (e.g., bondholders of short-term claims) and (2) protection of money-claimants may not be coterminous with the avoidance of systemic risk.

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[211] *Systemic Resolution Advisory Comm.*, FDIC, Meeting Minutes 14 (June 21, 2011), http://www.fdic.gov/about/srac/11June MeetingMins.pdf.

The proposal may also be overinclusive because not all those individuals and corporations holding money-claims actually use the instruments for cash management purposes. The proposed regime—an abbreviated stay in conjunction with an opportunity for prompt payment of some portion of money-claims—seeks to extend protection to those categories of claimants who are most likely to hold expectations of moneyness. Bondholders have historically enjoyed less protection than the creditor money-claimants discussed here, so it is less likely—and would be less reasonable—for such counterparties to use bonds for cash management purposes. But it is difficult to categorize the expectations of money market investors as unreasonable when the majority of such holders maintain these expectations. Further, as discussed, even if the expectation can be considered unreasonable, it is sufficiently ubiquitous among such investors as to create serious risks when unfulfilled.

The proposed regime also seeks to protect money-claims without unduly encouraging short-term lending. Under the proposed rules, short-term funding will not be overly encouraged at the expense of longer-term unsecured funding under a distribution scheme that includes a stay, because any creditor not protected by the safe harbors is likely to receive more under an OLA-type resolution, even if the resolution includes prompt payment for money-claimants. When derivative and repo counterparties are prohibited from rushing to dismember the institution, more value should be available for creditors overall, including those who are not money-claimants. Even secured creditors who are eligible to offset a portion of their claims against cash held in accounts at their banks may be better off under a regime without the safe harbors but with an abbreviated stay and an opportunity for prompt payment of money-claims. Only those creditors who are fully secured (or able to offset their entire claim) *and* who will be able to seize collateral (or offset promptly) would be treated less favorably under an OLA-type regime, with priorities for money-claimants, than under the current bankruptcy regime.

The creditors that have the most to lose under the proposed regime would be derivatives counterparties, who receive immunity from bankruptcy currently, but would not be paid ahead of money-claimants under the proposal. Some derivatives are used to hedge investments of money-claim issuers and others in the maturity transformation business,[212] in some instances essentially functioning as private insurance for issuers.[213] If private insurance for financial institutions is not protected, it may be more difficult and expensive to obtain such insurance. Derivatives counterparties may choose to provide a loan rather than structure the transaction as a derivative.[214] However, if such insurance becomes more difficult to obtain, issuers may be encouraged to establish a more stable funding structure.

On the other hand, it is also possible that issuers will double down on risky behavior to offset the added expense associated with their financial activity. Certainly the consequences of removing immunity from derivatives counterparties should be carefully considered. Still, it is notable that OLA does *not* exempt derivatives from the automatic stay that is imposed. Because the institutions subject to OLA are *most* likely to have a large number of derivates counterparties, if a one-day stay is an acceptable outcome for derivatives counterparties in the resolution of systemically important financial institutions under OLA, it should also be an acceptable resolution in bankruptcy. I

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212 *See* Edwards & Morrison, *supra* note 13, at 115. Though their focus is on hedges of non-financial enterprises, Edwards and Morrison acknowledge that firms may have entered into derivatives contracts to hedge risks, and may not be able to hedge the risk if the derivatives contract is not honored. *Id.* at 125.

213 Roe, *supra* note 14, at 546 ("Derivatives trade financial outcomes such as those of changing currency rates or of long-term for short-term interest rates. Some derivatives are effectively guarantees of financial performance of a third party.").

214 Edwards & Morrison, *supra* note 13, at 116 (arguing that the Code encourages creditors to enter into derivatives contract instead of a loan). "[T]he Code lowers the cost of hedging risk generally, by reducing costs to counterparties from entering contracts with firms that might suffer distress." *Id.*

believe Congress did not conclude that a one-day stay would have more severe systemic consequences than permitting derivatives counterparties to seize collateral and net out positions. There may be situations in which prompt payment of derivatives claims are warranted, but these parties would not be exempt from the automatic stay, and would not be permitted to terminate contracts solely because of the bankruptcy filing.

Replacing the safe harbors with an abbreviated stay and some opportunity for prompt payment of at least some portion of money-claims may be more likely to mitigate systemic risk than proposals for repealing or modifying the safe harbors alone. The current proposals for modifying the safe harbors include: (1) repealing the safe harbors wholesale,[215] (2) providing protection for derivatives used for hedging but not those used for speculation,[216] and (3) narrowing the safe harbors for repo counterparties to short-term contracts (thirty to sixty days, as opposed to up to one year) and/or repo contracts written on higher-quality collateral (Treasury bills or agency debt, as opposed to securitized collateral).[217]

The proposal for repealing the safe harbors wholesale, without providing for any prompt payment of money-claimants, relies on the lack of protection to discourage short-term funding; however, as discussed above, the lack of protection is unlikely to end short-term funding, and the risks associated with endangered money-claims will remain.[218] The proposal to protect only certain kinds of derivatives shifts risk and protects not money-claims, but claims that are used as private insurance in the maturity transformation business. If such insurance rendered maturity transformation in the shadow banking sector completely safe, it would be sensible to provide increased protection. However, such insurance has not proved

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[215] Roe, *supra* note 14, at 589.

[216] *See generally* Faubus, *supra* note 152.

[217] Skeel & Jackson, *supra* note 13, at 156–57; Lubben, *Bankruptcy Code*, *supra* note 13, at 142–44.

[218] *See* discussion *supra* Part IV.

effective, as evidenced by the financial crisis. That does not mean that *no* protection should be provided. But exempting derivatives from the stay carries all of the run risks discussed previously, and endangers not only money-claimants but derivatives counterparties as well. Whether derivatives function as insurance or speculation, money invested is *not* subject to money demand; defaults on derivatives obligations, while it may carry risks, do not carry risks of the same nature as risks associated with defaults on money-claims. Because money invested in derivatives is not expected to be available to cover immediate expenses; money-claims should be paid ahead of derivatives claims. If it is true that less-favored treatment of a given type of credit reduces the extent to which that type of credit is used, we may see less speculation in derivatives. To the extent derivatives are used for hedging, the cost of this "private insurance" may rise. But prioritizing derivatives subsidizes this insurance—and thus, the underlying activity, including maturity transformation—at the expense of other creditors.

The proposals that come closest to taking into account the distinction between demand obligations and other obligations are Skeel and Jackson's proposal (which provides for the repeal of safe harbors, with the exception of repo near-cash collateral, such as Treasuries and agency debt),[219] and Lubben's proposal (to narrow the safe harbors for repos to cover only very short-term contracts—thirty to sixty days —written on higher-quality collateral).[220] However, neither the Lubben nor the Skeel and Jackson proposals suggest that money market debt obligations be given priority over other loans or investments not subject to money demand; the focus is only on the nature of collateral securing *one* type of money market instrument—repos.

There are two problems with these proposals. First, permitting repo counterparties with near-cash collateral to seize or retain such collateral on the eve of and after bankruptcy filing carries the same run-exacerbating

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[219] Skeel & Jackson, *supra* note 13, at 156–57.

[220] Lubben, *Bankruptcy Code*, *supra* note 13, at 142–44.

consequences that Skeel and Jackson decried.[221] Such counterparties will rush to close out their positions the moment the solvency of the debtor is questioned—or the moment it is believed that other counterparties question the solvency of the debtor. This will remove highly liquid collateral from the estate at the moment it is most needed, and will decrease the likelihood that funds are available for the prompt payment of money-claims.

The second problem with exempting near-cash collateral from the stay, but not other types of money-claims, is that it reflects an artificial distinction among money-claimants. In the run up to the crisis, mortgage-backed securities were deemed to be as safe as Treasuries or agency debt—the near-cash nature of the transaction was not in the underlying collateral but in the short-term nature of the extension of credit. Repo counterparties whose collateral was MBS did not have a lesser expectation of repayment than repo counterparties whose collateral was Treasuries. In addition, commercial paper borrowers, whether asset-backed or not, invest funds with the expectation of being able to withdraw them, at par, at a near-term time of their choosing. It cannot be that bankruptcy rules generate this expectation, because commercial paper historically did not have this protection, except to the extent it could be netted against other obligations.

In determining which claims to protect, from the perspective of limiting serious negative externalities, the focus is better placed on the *function* of the instrument. Because money market instruments are typically used for cash management purposes, it may be too risky to leave them wholly unprotected. Still, the risks associated with money market instruments created from securitized collateral should not be understated. The question is, as long as such products exist and continue to serve a cash management function, whether we can afford to assume the risks associated with their default.

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221 Skeel & Jackson, *supra* note 13, at 156, 167–68.

VI. CONCLUSION

Addressing money-claims in bankruptcy is particularly important because Dodd-Frank does not attempt to regulate shadow banks. In spite of the salience of the risks posed by defaults in the shadow banking system, the legislation directed at avoiding future crises does not address this crucial concern.[222] As Ricks points out, although it is commonly accepted that money market instruments possess the fundamental characteristics of money, "we have failed to take this proposition seriously as a regulatory matter."[223] Even after the run on shadow banks, and the ensuing recession, we have chosen not to employ the essential tools utilized in the wake of the Great Depression—regulating institutions in the maturity transformation business, forbidding risky investments, imposing strict capital requirements, and insuring money-claims in exchange.[224] Nor does recent financial reform take steps sufficient to reduce the activity of shadow banks: the trading activities of *banks* are restricted (e.g., swaps activity must take place in a non-bank subsidiary), but maturity transformation activities of non-banks are not precluded.[225]

In addition, Dodd-Frank attempts to *strip* the federal government of much of its ability to address monetary consequences in a future financial crisis.[226] Institutions are, nonetheless, still able to issue money-claims, and MMMFs still remain uninsured.[227] Crucially, after Dodd-Frank insurance of money market funds is now impermissible absent congressional approval.[228] The OLA only allows the FDIC to serve a role as *receiver* of a shadow bank: "it is

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[222] Ricks, *supra* note 1, at 132–33.

[223] *Id.* at 96.

[224] *Id.* at 122–33.

[225] POZSAR ET AL., *supra* note 2, at 46.

[226] *See supra* note 11; *Shapiro Testimony supra* note 162.

[227] Ricks, *supra* note 1, at 85–88.

[228] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 1105(c)(1), 124 Stat. 1376, 2121 (2010) (to be codified at 12 U.S.C. § 5612(c)(1)).

designed to maximize enterprise value, not to address the problem of money-claim defaults."[229] If it is correct that the Great Depression was largely attributable to the lack of insurance of money-claims, we ought to be gravely concerned that shadow banks are not regulated like banks, and that the government—in the event of a run on these institutions —apparently now lacks the power to act immediately to stem such a run.[230]

While bankruptcy is not capable of providing a complete solution to these problems, it is not sensible to ignore the increased risk posed by defaults on money market obligations as compared to investments or loans not subject to money demand. If policymakers are serious about addressing systemic risk, every regime that addresses financial institutions in distress must take into account the unique nature of money-claims. We would find it deeply troubling if FDIC receivership did not provide for priority payments to depositors; yet shadow banks' "depositors"—in particular, MMMF investors—are not currently given any special treatment or assurance of prompt payment in the varying regimes that might apply when a financial institution to which they are exposed faces financial distress. This Article has attempted to explore how one such regime—bankruptcy—may be modified to mitigate, if not all, at least some of, the risks associated with defaults on money-claims.

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[229] Ricks, *supra* note 1, at 136.

[230] *Id.* at 132–33.