CONNECTICUT LAW REVIEW

VOLUME 41 | MAY 2009 | NUMBER 4

Article

Financial Crisis Containment

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This Article maps financial crisis containment—extraordinary measures to stop the spread of financial distress—as a category of legal and policy choice. I make three claims.

First, containment is distinct from financial regulation, crisis prevention and resolution. Containment is brief; it targets the immediate term. It involves claims of emergency, rule-breaking, time inconsistency and moral hazard. In contrast, regulation, prevention and resolution seek to establish sound incentives for the long term. Second, containment decisions deviate from non-crisis norms in predictable ways, and are consistent across diverse countries and crises. Containment invariably entails three kinds of choices: choices between wholesale and case-by-case response to financial distress, choices about whether to enforce private contracts and government regulations, and choices about distributing losses from crisis. I illustrate these with case studies from Indonesia in 1997–1998, Japan in 1994–1998, the United States in 1933, Argentina in 2001–2002, and Mexico in 1982. Third, containment measures are costly, but so is failure to distinguish containment from other tasks. Governments use prevention and regulation rhetoric to delay crisis response and to obscure distribution. Once they admit to a crisis, officials may leverage the urgency of containment to secure far-reaching economic reform.

Isolating and mapping containment can help recast well-worn crisis policy debates, and make crisis response more transparent and accountable.

ARTICLE CONTENTS

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ANNA GELPERN[*]

I. INTRODUCTION: BEAR STEARNS, NORTHERN ROCK AND MEMORIES OF SEOUL

On the evening of March 13, 2008, U.S. Treasury officials got on the phone with their colleagues at the Federal Reserve and the Securities and Exchange Commission.[1] A big investment bank was on the verge of bankruptcy in deeply stressed credit markets. Bear Stearns had a network of large, complex positions that linked it with many parts of the U.S. and global financial system. Faced with the risk of widespread collapse, the regulators arranged a shotgun marriage between Bear and its banker, J.P. Morgan, complete with a $30 billion dowry from the Federal Reserve Bank of New York.[2]

The episode is an example of financial crisis containment,[3] a category of extraordinary policy measures to stop the spread of untold economic damage, akin to containing a fire or infectious disease. Despite the rhetoric of exception that surrounds every instance of containment, even a casual inquiry reveals it to be a fixture of global finance.

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[*] Rutgers School of Law—Newark. I am grateful to Robert Ahdieh, Joshua Blank, William Bratton, Lee Buchheit, Giselle Datz, Kevin Davis, Onnig Dombalagian, Adam Feibelman, Michael Froomkin, Mitu Gulati, Eric Helleiner, Howell Jackson, Melissa Jacoby, Sky Julian, Chris Kushlis, Thomas Laryea, Adam Levitin, Anthony Marcus, Leonardo Martinez-Diaz, Patricia McCoy, Ralf Michaels, Russell Munk, Louis Pauly, Adam Posen, Heidi Schooner, Steven Schwarcz, Brad Setser, David Skeel, David Snyder, Edwin M. Truman, Matthew Tubin, Alan White, Arthur Wilmarth, David Zaring and the participants in conferences and workshops of Seton Hall University School of Law, University of Connecticut School of Law, CIGI/University of Waterloo, the Canadian Law and Economics Association, Duke University School of Law, American University Washington College of Law, George Washington University School of Law, the American Association of Law Schools and the International Studies Association for helpful insights, to Sarah Jaramillo, A.J. LaRosa and Kelly Targett for excellent research assistance, to the editors of this volume for valuable input and patience, and to the Dean's Fund at Rutgers—Newark for financial support.

[1] *See, e.g.*, *Turmoil in U.S. Credit Markets: Examining the Recent Actions of Federal Financial Regulators*: *Hearing Before the S. Comm. on Banking, Housing and Urban Affairs* 1 (Apr. 3, 2008) (statement of Timothy F. Geithner, President and CEO, Federal Reserve Bank of New York), *available at* http://banking.senate.gov/public/_files/OpgStmtGeithner4308Testimony.pdf.

[2] JPMorgan Chase & Co. and the Bear Stearns Companies, Inc., *Summary of Terms and Conditions* (Mar. 28, 2008), *available at* http://www.ny.frb.org/newsevents/speeches/2008/Contract.pdf. The loan was later reduced to $29 billion. Federal Reserve Bank of New York, Summary of Terms and Conditions Regarding the JPMorgan Chase Facility (Mar. 24, 2008), *available at* http://www.newyorkfed.org/newsevents/news/markets/2008/rp080324b.html.

[3] I use the term with apologies to George Kennan, who in 1947 famously advocated "long-term, patient but firm and vigilant containment of Russian expansive tendencies," framing U.S. foreign policy under the rubric of containment for decades after. X, *The Sources of Soviet Conduct*, 25 FOREIGN AFFAIRS 566 (1947). My use differs somewhat from Kennan's, especially with respect to time horizons, though the element of damage control remains.

In November 1997, the fourth largest securities house in Japan fell after disclosing massive hidden debts. The image of Yamaichi Securities' president crying at the press conference[4] became an icon of Japan's "lost decade." The government had tried to persuade Yamaichi's bank to take over the business. The bank refused, itself under water. The firm folded, but not before drawing billions in public funds to pay its creditors—an effort to avoid further disruption to fragile domestic and global markets.[5]

In August 1997, foreigners stopped lending to Korean banks.[6] To shore up confidence, the Korean government announced a blanket guarantee of bank liabilities.[7] U.S. and U.K. officials were indignant: the guarantee would bail out the reckless, and encourage more recklessness.[8] In any event, the guarantee failed to stop the slide. Finance ministers from the world's richest economies spent the next Christmas pleading with the world's top bankers to renew loans to Korean banks.[9]

In September 2007, a British bank called Northern Rock had trouble refinancing its debt in the increasingly wobbly global markets. To halt a run on deposits, the U.K. authorities reprised Korea's blanket guarantee of the banking system, and soon nationalized Northern Rock.[10]

In December 2001, Argentina devalued its currency and defaulted on $100 billion in foreign bonds, capping off a year of political turmoil, bank runs and deepening economic depression. The government then converted all dollar-denominated domestic debt contracts and bank deposits into

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[4] GILLIAN TETT, SAVING THE SUN: HOW WALL STREET MAVERICKS SHOOK UP JAPAN'S FINANCIAL WORLD AND MADE BILLIONS 105 (2004).

[5] HIROSHI NAKASO, BANK FOR INT'L SETTLEMENTS, THE FINANCIAL CRISIS IN JAPAN DURING THE 1990S: HOW THE BANK OF JAPAN RESPONDED AND THE LESSONS LEARNT 9–11 (2001), *available at* http://www.bis.org/publ/bppdf/bispap06.pdf?noframes=1; TETT, *supra* note 4, at xxiii, 106.

[6] PAUL BLUSTEIN, THE CHASTENING: INSIDE THE CRISIS THAT ROCKED THE FINANCIAL SYSTEM AND HUMBLED THE IMF 125 (2001).

[7] MORRIS GOLDSTEIN, THE ASIAN FINANCIAL CRISIS: CAUSES, CURES, AND SYSTEMIC IMPLICATIONS 39 (1998); Carl-Johan Lindgren et al., *Financial Sector Crisis and Restructuring: Lessons from Asia*, 16 n. 17 (Int'l Monetary Fund, Occasional Paper No. 188, 1999), *available at* http://www.imf.org/external/pubs/ft/op/opFinsec/op188.pdf. The initial guarantee was limited to a vaguely defined category of external liabilities. *Id.* It was expanded to all liabilities in November. *Id.* at 18–19.

[8] *See* GROUP OF TWENTY-TWO (G-22) WORKING GROUP ON INTERNATIONAL FINANCIAL CRISES, REPORT OF THE WORKING GROUP ON INTERNATIONAL FINANCIAL CRISES 7–9 (1998), *available at* http://www.imf.org/external/np/g22/ifcrep.pdf; G-22 WORKING GROUP ON STRENGTHENING FINANCIAL SYSTEMS vi-vii, 20–21, 25, 27, 33, REPORT OF THE WORKING GROUP ON STRENGTHENING FINANCIAL SYSTEMS (1998), *available at* http://www.imf.org/external/np/g22/sfsrep.pdf (criticizing blanket guarantees extended in financial crisis and reflecting the policy sentiment of the day).

[9] BLUSTEIN, *supra* note 6, at 198–202..

[10] *See e.g.,* HOUSE OF COMMONS TREASURY COMMITTEE, THE RUN ON THE ROCK, FIFTH REPORT OF SESSION 2007–08, 36–37, 140–41 (2008), *available at* http://www.publications.parliament.uk/pa/cm200708/cmselect/cmtreasy/56/56i.pdf; David Stringer, *Britain to Nationalize Northern Rock Bank,* WASH. POST, Feb. 18, 2008, at A-11. For one of many criticisms of the nationalization of Northern Rock, see William Buiter's *Maverecon* blog for FT.com. Immoral Hazard and Northern Rock, *available at* http://blogs.ft.com/maverecon/2008/02/immoral-hazard-and-northern-rock/ (Feb. 19, 2008, 18:58 EST).

devalued pesos. Argentine courts upheld the measure to rewrite private contracts, citing Argentine precedent that relied on U.S. Supreme Court jurisprudence from the 1930s.[11]

In these cases and many others like them, rules were suspended as policymakers tried to hang on to the precipice. A different set of regularities replaced them. This Article is an effort to describe the new regularities, which comprise containment, and to show why it is important to conceive of them as a distinct category of legal and policy choice.

Containment is often conflated with financial regulation, crisis prevention and resolution. These are all long-term projects that share the goal of entrenching sound economic incentives, often embodied in positive rules. In contrast, containment is urgent and brief, defined by rule-breaking, claims of exception and the dearth of positive law. The paramount goal is "to stop the bleeding";[12] the long view falls by the wayside. As they practice containment, formerly stern and stingy officials dole out bailouts and sow the seeds of future gambling—time inconsistency and moral hazard problems loom large.

The persistent specter of such problems helps explain why containment inhabits a negative space in law and policy, unacknowledged in the run-up to crisis and renounced in its aftermath. Judging financial crisis containment by the standards of regulation, prevention and resolution is doomed to yield a failing grade and a feckless promise to hold firm the next time. Acknowledging and defining containment opens it to critical analysis. On the one hand, isolating containment helps explain why some well-worn paradigms—sanctity of contracts, moral hazard, and the liquidity-solvency distinction—fall so flat so consistently in crisis after crisis. On the other hand, it reveals the importance of other ideas, such as distribution, accountability, and path dependence, which receive less attention than they should.

This Article maps containment using examples from Asia, Latin America and the United States. Although each episode involves a departure from non-crisis norms for resolving financial distress, such departures follow a consistent pattern across radically different crises in rich and poor, democratic and authoritarian states. First, faced with the

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[11] *See* Horacio Spector, *Constitutional Transplants and the Mutation Effect*, 83 CHI.-KENT L. REV. 129, 142–44 (2008) (pointing to the reliance of the Argentine courts on *Home Building & Loan Ass'n v. Blaisdell* in the *Avico v. de la Pesa*, *Bustos v. Estadio Nationale* and *Massa v. Poder Ejecutivo National* cases, which applied the doctrine of economic emergency).

[12] *See, e.g.*, Paul R. LaMonica, Commentary: *The Fed Tries to Stop the Bleeding*, CNNMONEY, Sep. 18, 2008, http://money.cnn.com/2008/09/18/markets/thebuzz/index.htm?postversion=2008091814; Robert Gavin, *A Plan to Stop the Bleeding: Federal Authorities Would Buy Troubled Mortgages, Securities; Support in Congress Likely*, BOSTON GLOBE, Sept. 19, 2008, at A1, *available at* LEXIS, News Library, BGLOBE file (referring, respectively, to a plan by central banks to inject liquidity into the markets, and a proposal by the U.S. Treasury to buy troubled mortgage assets from financial institutions).

prospect of mass default, policy makers choose between case-by-case and wholesale response. Second, they decide whether to enforce private contracts and their own regulations. Third, they begin to allocate losses from the crisis among their constituents.

Financial distress in ordinary times is resolved case-by-case, through renegotiation, default, or bankruptcy.[13] These tools rely on market valuation and an administrative infrastructure designed for a relatively low rate of failure in the economy. In crisis, they may be inadequate: markets vanish, and with them, market valuation; panic, contagion and widespread distress overwhelm the resolution infrastructure. Yet the alternative—wholesale subsidies or across-the-board restructuring—is unappealing. By definition, it is over- and under-inclusive: it may fail the prudent, save the profligate, and spawn moral hazard.

Governments generally enforce private contracts, except in bankruptcy, where contracts yield to a public debt adjustment proceeding. Enforcing contracts in crisis can exacerbate distress. For example, where a large portion of all debtors cannot pay, enforcement may trigger spillover effects throughout the economy. Separately, otherwise unobjectionable contract terms—such as those indexing debts to gold or foreign currency—if widespread, may bring on financial instability.[14] In either case, individual creditors have no incentive to compromise for the sake of the economy.[15] In response, governments may assume private debts or rewrite private contracts.[16] Assuming debts costs public money; failure to enforce contracts is costly in a different way: it can disrupt commercial expectations, undermine incentives to perform, and faith in the rule of law.[17]

Similarly, in ordinary times, governments enforce their own

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[13] Bankruptcy is a collective proceeding for creditors; however, each debtor's case is resolved individually.

[14] Debt contracts indexed to foreign currency or commodity prices are designed to offset the effects of devaluation. Where the domestic currency declines in value, indexation increases the debt burden and eliminates the policy benefits of devaluation. This aggregate effect does not depend on any particular borrower's capacity to perform any given contract. Anne-Marie Gulde et al., *Dealing with Banking Crises in Dollarized Economies*, *in* MANAGING FINANCIAL CRISES: RECENT EXPERIENCE AND LESSONS FOR LATIN AMERICA 54 (Charles Collyns & G. Russell Kincaid eds., 2003).

[15] This is distinct from creditor collective action problems with respect to a single debtor, which are addressed in a single collective bankruptcy proceeding.

[16] NOURIEL ROUBINI & BRAD SETSER, BAILOUTS OR BAIL-INS 87–93 (2004) (summarizing the choices and related economic literature). For legal perspectives on enforcing contracts in crisis, see, for example, *Home Bldg. & Loan Ass'n. v. Blaisdell*, 290 U.S. 398 (1934) (establishing the constitutionality of state foreclosure moratoria), and Michael W. McConnell & Randal C. Picker, *When Cities Go Broke: A Conceptual Introduction to Municipal Bankruptcy*, 60 U. CHI. L. REV. 425, 449–50 (1993) (discussing the effects of enforcing municipal debts during the Great Depression).

[17] *Blaisdell*, 290 U.S. at 449. (Sutherland, J., dissenting) ("He simply closes his eyes to the necessary implication of [this] decision who fails to see in it the potentiality of future gradual but ever-advancing encroachments upon the sanctity of private and public contracts."); *see also* Spector, *supra* note 11, at 145.

regulations. Doing so in crisis may backfire. For example, where a large portion of the financial system becomes undercapitalized because its borrowers are broke, strictly enforcing capital and accounting rules may mean shutting down most banks and cutting off the credit essential to recovery.

Each containment episode also entails loss distribution, which is distinct from and in addition to loss limitation. Losses from financial distress initially fall on debtors and creditors: a debtor may pay and fail, or default, shifting loss onto creditors. Such losses may have spillover effects, or may be politically unacceptable in their own right. In response, government restructuring mandates can allocate losses between debtors and creditors. An infusion of public money can shift losses onto taxpayers. New private capital can absorb some of the losses. Public or private money from abroad can spread the burden to foreigners.

Unlike loss limitation, distribution is politically costly. It requires governments to choose among constituents, such as homeowners in Ohio, investment banks in New York that repackaged their mortgages, and municipalities in Florida or Norway that bought them.

In sum, containment may call for measures—wholesale treatment, rewriting contracts, suspending regulations, and distributing losses—that are legally and politically fraught. Governments delay and obscure such measures as long as possible. Once forced to admit a crisis, officials may leverage the sunk political cost of containment to transform the economic landscape, for example, by enacting comprehensive regulation or creating vast new power centers in the form of merged financial institutions. Conflating containment with other kinds of financial policy can mask large wealth transfers and major institutional change; it can make political choices look technical and inevitable, reduce accountability and increase the social cost of a crisis.

Starting with a description of containment as a category, this Article seeks to shift the terms of the debate about crisis response. I argue that much of what appears as rule-breaking in containment is neither good nor bad, but unavoidable. Legal and institutional design for crisis response should reflect this reality, with channels of accountability appropriate to the tasks of containment. Part II sets out the context in which containment decisions arise. Part III examines the relationship between containment and prevention, regulation, and resolution, and the literature on economic emergency. Part IV describes the recurring elements of containment: the choice between wholesale and case-by-case response, the decision to enforce, suspend or rewrite private contracts and regulations, and judgments about distribution in crisis. Part V presents five crisis case studies. Part VI concludes with policy implications.

II. THE OBJECT OF CONTAINMENT

Containment choices as described in this Article arise in a particular subset of financial crises. Such crises are usually called systemic, either in the sense that they threaten the financial system as a whole, or, less frequently, in the sense that they threaten large parts of the economy through finance channels.[18] Because the meaning of "systemic" is the subject of a debate not directly relevant to my project,[19] I use this Part to highlight specific crisis attributes that would prompt policy makers to consider a containment response. In sum, if it is big enough, bad enough, and moving fast and far enough, financial distress will as a matter of fact prompt containment.

A. *Scope*

A crisis that brings on containment usually imperils large parts of the domestic, and occasionally global, financial system. This in turn threatens the macroeconomy: economic growth, employment, prices, and government finances. The ultimate concern is economic harm to a great number of people. The number of financial firms at risk can be telling but is not dispositive: mass failures usually merit containment, but so does the

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[18] This is the sense in which the word "systemic" is used in the phrase "systemic corporate crisis". *See, e.g.*, Jay Lawrence Westbrook, *Systemic Corporate Distress: A Legal Perspective, in* RESOLUTION OF FINANCIAL DISTRESS: AN INTERNATIONAL PERSPECTIVE ON THE DESIGN OF BANKRUPTCY LAWS 57 (Stijn Claessens et al., eds., 2001).

[19] *See generally* SYSTEMIC FINANCIAL CRISES: CONTAINMENT AND RESOLUTION 76, 101 (Patrick Honohan & Luc Laeven eds., 2005) (linking containment and systemic risk). Debates over the definition of systemic risk usually take place in the context of systemic risk regulation. COMMITTEE ON THE GLOBAL FINANCIAL SYSTEM, RISK MANAGEMENT AND SYSTEMIC RISK: PROCEEDINGS OF THE THIRD JOINT CENTRAL BANK RESEARCH CONFERENCE 1–13 (2002) *available at* http://www.bis.org/cgfs/conf/mar02.pdf (illustrating the evolution of official concern with systemic risk); Timothy F. Geithner, President and C.E.O. of the Fed. Reserve Bank of N.Y., Remarks to the Fed. Reserve Bank of Chicago Conference: Systemic Financial Crises-Resolving Large Bank Insolvencies (Oct. 1, 2004), *available at* http://www.bis.org/review/r041011a.pdf; Steven L. Schwarcz, *Systemic Risk*, 97 GEO. L.J. 193, 196 (2008) [hereinafter Schwarcz, *Systemic Risk*] (citing uncertainty surrounding the definition and proposing to expand the concept of systemic risk beyond banks to financial markets).

Because containment seeks to limit damage now spreading through known channels, it does not raise the same information, incentive, or administrative resource concerns as ex-ante systemic risk regulation. Regulation targets multiple risks at once without necessarily knowing the precise source, magnitude or even nature of the harm that might come. Labeling risk from a future hypothetical event as "systemic" is significant in the regulatory context because it may bring on broader, stricter oversight, more overseers, and more generous insurance, perhaps with durable behavior changes among market actors. In contrast, containment happens ex-post, when the harm has either materialized, or has become much more certain. At this stage, calling the crisis "systemic" means that "the system" is in present danger, which justifies an exceptional, perhaps wholesale, public response. Thus when the term "systemic crisis" is used as a predicate for containment policies, it is almost invariably ex-post, instrumental, and political. This is contrary to the regulatory aspiration in Steven Schwarcz's recent proposal: "[S]ystemic risk is an economic, not a political, definition. It should not be used uncritically as an ex post political label for any large financial failure or downturn." Schwarcz, *Systemic Risk*, *supra*, at 204. As I note in Part III, Schwarcz's goal is to establish a regulatory regime. I argue that containment is different, not least in its political content.

failure of one large government savings bank that holds a significant portion of the people's deposits, or one large hedge fund with contractual links to many others. An entity's nodal position is important because it can transmit distress far and wide. In addition, the failure of a financial institution that supports important sectors of the real economy, such as housing, can be critical even if it does not immediately affect the broader markets. Disruption of market infrastructure, such as payments and clearing systems, is important on its own and in conjunction with firm failure.[20]

To some extent, the authorties' response determines whether a crisis is perceived as one of mass individual insolvency or large institutional failure. For example, where rescue measures focus on institutions that are too big or too interconnected to fail,[21] they come to define a crisis. In the same crisis, individual insolvency may be pervasive, but it recedes from public view when the policy response to it is indirect, channeled through institutions.

B. *Path and Pace*

Crises spread through two kinds of transmission mechanisms, which are not mutually exclusive. First, in a chain reaction, failure travels from one or several entities to others throughout the financial system.[22] For example, a run on one badly-managed bank can cause runs on banks with contractual or ownership links to it, as well as copy-cat runs on good banks unconnected with the original culprit.[23] Second, a common shock (for

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[20] Howell E. Jackson, Systemic Risk after Glass-Steagall Reform (July 12, 2001) (unpublished manuscript) (on file with the *Connecticut Law Review*).

[21] On the role of contractual and institutional "interconnectedness" in transmitting risk throughout the financial system, see, for example , Arthur E. Wilmarth, Jr., *Controlling Systemic Risk in an Era of Financial Consolidation*, *in* INTERNATIONAL MONETARY FUND, CURRENT DEVELOPMENTS IN INTERNATIONAL MONETARY AND FINANCIAL LAW (2002, 2005); Cynthia C. Lichtenstein, *International Standards for Consolidated Supervision of Financial Conglomerates: Controlling Systemic Risk*, 19 BROOK. J.INT'L 137, 138–42 (1993), Onnig H. Dombalagian, *Requiem for the Bulge Bracket?: Revisiting Investment Bank Regulation*, 20 (Working Paper, 2009) *available at* http://papers.ssrn.com/sol3/Delivery.cfm/SSRN_ID1339628_code349188.pdf?abstractid=1249441&mirid=1; Gillian Tett & Krishna Guha, *The Cost of a Lifeline*, FT.COM, April 24, 2008, http://www.ft.com/cms/s/0/9812cd96-1197-11dd-a93b-0000779fd2ac.html?nclick_check=1.

[22] Douglas W. Diamond & Philip H. Dybvig, *Bank Runs, Deposit Insurance, and Liquidity*, 91 J. POL. ECON. 401 (1983); *see also* Schwarcz, *Systemic Risk*, *supra* note 19, at 196–97 (2008).

[23] The two transmission mechanisms within the chain reaction category may be seen as distinct: distress may spread through real links among dissimilar institutions (banks, hedge funds, manufacturers), or through imitation among those perceived to share similar vulnerabilities (banks). Yehning Chen, *Banking Panics: The Role of the First-Come, First-Served Rule and Information Externalities*, *in* FINANCIAL CRISES, CONTAGION, AND THE LENDER OF LAST RESORT: A READER 359 (Charles Goodhart & Gerhard Illing eds., 2002); Franklin Allen & Douglas Gale, *Optimal Currency Crises*, *in* FINANCIAL CRISES, CONTAGION, AND THE LENDER OF LAST RESORT: A READER, *supra*, at 379.

example, a currency collapse) can affect everyone simultaneously.[24] Some regulatory measures, such as a sudden change in provisioning rules, can have the effect of a common shock, especially when the financial sector as a whole is undercapitalized. International transmission mechanisms are essentially similar.[25]

The pace at which a crisis unfolds is important in its own right. A sudden loss of confidence in institutions, such as banks, or in a country's currency, can trigger a run. Depositors or investors demand safe assets (cash, hard currency, precious metals) and may rush to sell all at once, depressing asset values. Certain kinds of contractual arrangements, such as lending on margin, can mechanically replicate this effect: as the value of collateral declines, "margin calls" for additional collateral can cause market participants to liquidate assets *en masse*, setting off a spiral of further losses.[26] Run-style crises can develop in a matter of hours, though many have underlying causes that go back years. Other crises unfold in slow motion, in tandem with a deepening economic slump, which might cause the supply of capital to dry up as non-performing loans mount. It may take years of loosely connected failures and ad-hoc responses before the authorities recognize a system-wide pattern that prompts a change of course, including broader, more muscular containment measures.

C. *Timing: You Know You Are in Crisis When*

Deciding when financial distress justifies resort to extraordinary tools is one of the most daunting policy challenges in crisis. In his classic case for public intervention, Charles P. Kindleberger addressed timing with cheeky understatement:

> Timing presents a special problem. After a crash has occurred, it is important to wait long enough for the insolvent firms to fail, but not so long as to let the crisis spread to the solvent firms that need liquidity . . . Whether too soon and too much is worse than too little and too late is difficult to specify.[27]

The economics and politics of timing are equally intractable.

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[24] COUNTERPARTY RISK MANAGEMENT POLICY GROUP II, TOWARD GREATER FINANCIAL STABILITY: A PRIVATE SECTOR PERSPECTIVE 5–7 (2005), *available at* http://www.crmpolicygroup.org /crmpg2/docs /CRMPG-II.pdf; Claudio Borio, *Towards a Macroprudential Framework for Financial Supervision and Regulation?*, 49 CESIFO ECONOMIC STUDIES, 181, 189–90 (2003) *available at* http://cesifo.oxfordjournals.org/cgi/reprint/49/2/181.

[25] ROUBINI & SETSER, *supra* note 16, at 43–44.

[26] *Compare* MAURY KLEIN, RAINBOW'S END: THE CRASH OF 1929, 237–38 (2001) (effect of margin calls in 1929), *with* Posting of Yves Smith to nakedcapitalism blog, http://www.nakedcapitalism.com/2008/10/are-hedge-fund-margin-calls-leading-to.html (Oct. 10, 2008, 15:00 EST) (effect of margin calls in 2008).

[27] CHARLES P. KINDLEBERGER, MANIAS, PANICS & CRASHES 13, 209 (5th ed. 2005).

Recognizing that a financial crisis threatens the economy can amount to admitting policy failure. Announcing that mass bankruptcy is nigh may undermine confidence further.[28] In many cases, including those discussed later in this Article, it may bring on a political crisis. Deploying extraordinary measures too early may damage incentives to perform contracts and monitor risk among debtors and creditors. On the other hand, the risk of delay is particularly acute in a big, fast-moving financial crisis. Waiting until everyone agrees on the magnitude of the threat may mean flying off the cliff.

In practice, the timing of containment does not depend on real or perceived economic necessity alone, but also on political and legal possibility. Containment is not one seamless, externally determined phase of a crisis, but rather a series of political decisions that may come in concentrated spurts, or over time, alongside decisions on prevention, regulation and restructuring. Their focus on the immediate term distinguishes containment decisions from the others; incidents such as the Bear Stearns sale, which began this Article, acquire their singular status through a combination of perceived threat, government response and perfect hindsight. In all cases discussed in Part V, containment could have come earlier or later, depending on one's view of the underlying economics.[29] Political acceptance of extraordinary measures was critical to their economic and legal viability, and helped set their timing.

As a matter of fact, in every big financial crisis, there comes a time when the authorities recognize that measures used to handle non-crisis distress may not be enough—which is when they ask their staff to prepare memos with "Plan B" in the title.

A government might consider containment when the country's firms must pay foreign debt twenty times the size of its hard currency reserves, as happened in Korea in 1997.[30] Extraordinary response may be in order when more than half of all firms in the economy are technically insolvent, as happened in Indonesia in 1998,[31] or when the local currency has lost

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[28] *Id.;* ROUBINI & SETSER, *supra* note 16, at 42 (describing shock from "disclosure of bad news"); TETT, *supra* note 4, at 69 (2004) (contrasting Japanese regulatory forbearance with Swedish enforcement: "We didn't want to create panic in the financial markets or among consumers. We wanted to deal with the problems slowly and calmly." (quoting Ministry of Finance official)). *But see* Kenneth Ayotte & David A. Skeel, Jr., *Bankruptcy or Bailouts?* (U. Penn. Inst. for L. and Econ. Research Paper, No. 09-11), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1362639 (arguing that bankruptcy of a major financial firm in an advanced institutional setting need not trigger panic).

[29] In the overwhelming majority of cases, the consensus is earlier.

[30] *See, e.g.*, BLUSTEIN, *supra* note 6, at 182.

[31] *See, e.g.*, Timothy Lane, et al., *IMF Supported Programs in Indonesia, Korea, and Thailand: A Preliminary Assessment* 4–5 (IMF Occasional Paper No. 178, 1999), *available at* http://www.imf.org/external/pubs/ft/op/op178/OP178.pdf.

three-quarters of its value, as happened in Argentina in early 2002.[32] Time may be ripe for containment when private banks no longer heed the government's pleas to rescue ailing comrades, as happened in Japan in 1997[33]—or when the authorities shut down three hundred savings institutions, and over six hundred line up the resolution pike, as happened in the United States in the late 1980s.[34] So too it might be as officials get on the phone at night to decide the fate of a big Wall Street investment bank.

Yet in all these cases, policy makers may lack political capacity to consider the full range of responses until things get worse and the public's perception of the crisis has caught up with theirs.

III. CONTAINMENT IN CONTEXT

Containment rarely gets special mention in the vast economic[35] and still-limited legal[36] literature on financial crises. As used in this Article—

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[32] *See generally* PAUL BLUSTEIN, AND THE MONEY KEPT ROLLING IN (AND OUT): WALL STREET, THE IMF, AND THE BANKRUPTING OF ARGENTINA (2005); FEDERICO STURZENEGGER & JEROMIN ZETTELMEYER, DEBT DEFAULTS AND LESSONS FROM A DECADE OF CRISES 182–86 (2006), Brad Setser & Anna Gelpern, *Pathways Through Financial Crisis: Argentina*, 12 GLOBAL GOVERNANCE 465 (2006).

[33] TETT, *supra* note 4, at 74; NAKASO, *supra* note 5, at 4-5.

[34] Timothy Curry & Lynn Shibut, *The Cost of the Savings and Loan Crisis: Truth and Consequences*, 13 FDIC BANKING REV. (No. 2) 26, 27 (2000), *available at* http://www.fdic.gov/bank/analytical/banking/.

[35] Examples from the economic literature on international financial crises alone are innumerable. These range from big-picture overviews using vastly different methodologies, such as CHARLES P. KINDLEBERGER, *supra* note 27 and Kenneth Rogoff & Carmen M. Reinhart, *This Time is Different: A Panoramic View of Centuries of Financial Crises* (Nat'l Bureau of Econ. Research, Working Paper No. 13882) (2008), to works driven by specific crisis episodes, such as NOURIEL ROUBINI & BRAD SETSER, BAILOUTS OR BAIL-INS (2004), SYSTEMIC FINANCIAL CRISES: CONTAINMENT AND RESOLUTION (Patrick Honohan & Luc Laeven eds., 2005), and STURZENEGGER & ZETTELMEYER, *supra* note 32. Other influential contributions include, for example, BARRY EICHENGREEN, ET AL., CRISIS? WHAT CRISIS? ORDERLY WORKOUTS FOR SOVEREIGN DEBTORS (1995), Paul Krugman, *Financing vs. Forgiving a Debt Overhang*, 29 J. DEV. ECON. 253 (1988). Jeffrey D. Sachs, *Do We Need an International Lender of the Last Resort* (Apr. 20, 1995), *available at* http://www.earthinstitute.columbia.edu/about/director/pubs/intllr.pdf. The economic literature on domestic financial crises is even bigger. There is also a large political economy literature on crisis and response. *See e.g.*, ECONOMIC CRISIS AND POLICY CHOICE: THE POLITICS OF ADJUSTMENT IN THE THIRD WORLD (Joan M. Nelson, ed., 1990).

[36] Apart from the growing literature on sovereign debt (*see, e.g.*, Symposium, *Odious Debt: Exploring the Outer Limits of Sovereign Debt*, N.C. J. INT'L L & COM. REG. 605 (2007); Symposium, *Conference on Sovereign Debt Restructuring: The View from the Legal Academy*, 53 EMORY L.J. 657 (2004); Symposium, *Sovereign Debt Restructuring*, 6 CHI. J. INT'L L. 177 (2005); Symposium, *Sovereign Debt*, 35 GEO. J. INT'L L. 637 (2004) for recent examples), which unlike its economist counterpart rarely ventures into broader crisis matters, U.S. law scholars have had relatively little to say about economic crises, less about financial crises, and less yet about international financial crises. *See* Daniel W. Levy, *A Legal History of Irrational Exuberance*, 48 CASE W. RES. 799, 803–04 (1998) (observing the dearth of legal literature on economic distress); *see also* Eric A. Posner & Adrian Vermuele, *Crisis Governance in the Administrative State: 9/11 and the Financial Meltdown of 2008* 6 (Univ. Chicago Law and Econ., Olin Working Paper No. 442), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1301164 ("Financial crises are less familiar than security crises."). Exceptions from before the current crisis include, for example, Levy, *supra* (history of judicial

to describe resort to extraordinary legal and policy measures to limit damage from financial distress—the concept usually appears unnamed in the writing on crisis management and regulatory reform.[37] When used, the term containment usually describes early-phase response to domestic banking crises,[38] or efforts to stop crises from spreading internationally.[39] Both uses highlight the goal of stemming losses, but stop short of elaborating the decision category. Containment choices in this literature are often tinged with mistake and compromise, regrettable exceptions to be avoided next time.

Like the economic and regulatory writing, U.S. law scholarship on economic emergency deals with the use of extraordinary measures to respond to economic stress, but it does so quite differently. Emergency is not itself a policy category like regulation, but rather the predicate for a broad range of responses to different crises. Authors who write about economic emergency tend to concern themselves broadly with crisis decision-making rather than economic and financial policy; they often operate by analogy to security emergency.[40]

This Part examines the relationship between containment and financial regulation, and crisis prevention and crisis resolution. It concludes with a brief discussion of containment as emergency response.

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response to financial panics); Daniel K. Tarullo, *Rules, Discretion, and Authority in International Financial Reform*, 4 J. INT'L ECON. L. 613 (2001) (international financial crisis response). The related but distinct category of writing on economic emergency includes CLINTON ROSSITER, CONSTITUTIONAL DICTATORSHIP: CRISIS GOVERNMENT IN THE MODERN DEMOCRACIES 255–64 (1948, 2002) (on the rise of executive power during the Great Depression), Michael Belknap, *The New Deal and the Emergency Powers Doctrine*, 62 TEX. L. REV. 67 (1983) (discussing the use of wartime powers in economic emergency); William E. Scheuerman, *Exception and Emergency Powers: The Economic State of Emergency*, 21 CARDOZO L. REV. 1869 (May 2000) (discussing Carl Schmitt's theories of executive power in economic emergency), Rebecca M. Kahan, *Constitutional Stretch, Snap-Back, Sag* 99 NW. U.L. REV. 1279 (2005) (comparing doctrinal stickiness of judicial responses to security and economic emergencies), and OREN GROSS & FIONNUALA NI AIOLAN, LAW IN TIMES OF CRISIS: EMERGENCY POWERS IN THEORY AND PRACTICE 76–79 (2006) (on the expansion of wartime powers to economic exigency). Contributions inspired by the ongoing crisis include Posner & Vermuele, *supra*, Schwarcz, *Systemic Risk*, *supra* note 19, Steven M. Davidoff & David Zaring, *Big Deal: The Government's Response to the Financial Crisis*, 61 ADMIN. L. REV. (2009) (forthcoming), *working paper available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1306342.

[37] *See, e.g.*, Morris Goldstein, *Making the G-20 Summit Work: The "Ten-Plus-Ten" Plan*, PETERSON INSTITUTE FOR INTERNATIONAL ECONOMICS, *available at* http://www.petersoninstitute.org/realtime/?p=146 (Oct. 27, 2008) (recommendations for economic recovery/crisis management and financial regulatory reform/crisis prevention).

[38] *See, e.g.*, Carl-Johan Lindgren, *Pitfalls in Managing Closures of Financial Institutions*, *in* SYSTEMIC FINANCIAL CRISES: CONTAINMENT AND RESOLUTION 76 (Patrick Honohan & Luc Laeven eds., 2005).

[39] ROUBINI & SETSER, *supra* note 16, at 5, 43–44.

[40] For criticisms of the security analogy, see generally, Levy, *supra* note 36. Politicians have used it strategically beginning in the 20th century; scholars have adopted it as the dominant paradigm of emergency decision-making. *See* Franklin Delano Roosevelt, First Inaugural Address, March 4, 1933; *see also* Belknap, *supra* note 36; Posner & Vermuele, *supra* note 36.

A. *Containment and Regulation*

Regulation looks to the future; containment to the present. The core operational difference between the two is in the sequence of priorities. Regulation first seeks to change incentives to reduce the risk of failure and crisis; mitigating damage from crisis is contingent on the occurrence of a crisis despite the regulatory effort. For containment, the priorities are reversed: changing long-term incentives is relevant only if the financial system survives the present calamity.[41]

Public management of private risk-taking is at the core of financial regulation.[42] Regulation tries to shape the behavior of firms and individuals, for example, to reduce the likelihood of bank failure or financial ruin of unsophisticated consumers.[43] Another aspect of regulation goes to limiting the fallout from risks once they materialize. For example, risk-based capital adequacy requirements work in two ways. Ex-ante, they try to discourage excessive risk-taking by making it more costly for the regulated firms. Ex-post, they seek to ensure that each firm has the capital cushion to withstand economic shocks. Containment choices arise strictly ex-post and seek immediate results.

In another example, a regulatory system fraught with moral hazard, one that prompts excessive risk-taking, has failed in a central mission. Containment policy that arrests financial collapse has met its goal; its adverse effects in the long run are for resolution and regulation to mitigate.

The growing popularity of "macro-prudential" regulation[44] adds a twist to the relationship between regulation and containment, but does not change it. Macro-prudential regulation is preoccupied with overall financial stability, as distinct from the protection of any particular

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[41] *See, e.g.*, Mervyn King, Draft Opening Statement for Appearance before the Treasury Committee, Turmoil in Financial Markets: What Can Central Banks Do? 7 (Sept. 12, 2007), *available at* http://media.ft.com/cms/a7ed52c2-6111-11dc-bf25-0000779fd2ac.pdf ("[T]here must be strong grounds for believing that the absence of ex post insurance would lead to economic costs on a scale sufficient to ignore the moral hazard in the future.").

[42] Howell E. Jackson, *Regulation in a Multi-Sectored Financial Services Industry: An Exploratory Essay*, 77 WASH U. L.Q. 319, 332–36 (1999) [hereinafter Jackson, *Regulation*]; *see also* HOWELL E. JACKSON & EDWARD L. SYMONS, THE REGULATION OF FINANCIAL INSTITUTIONS: CASES AND MATERIALS 6–7 (1999). Risk management is a central, but not the only driver of regulation. Considerations of equity and political economy, as well as historical accident, help shape regulatory design, for example, to prevent concentration of political power, or give historically disadvantaged groups access to credit. Jackson, *Regulation*, *supra* at 336–39.

[43] Jackson, *Regulation*, *supra* note 42, at 332–36.

[44] *See generally* GROUP OF THIRTY, FINANCIAL REFORM: A FRAMEWORK FOR FINANCIAL STABILITY (2009), *available at* http://www.group30.org/pubs/reformreport.pdf [hereafter G-30 REPORT]; U.S. DEPT. OF THE TREASURY, BLUEPRINT FOR A MODERNIZED FINANCIAL REGULATORY STRUCTURE (2008) *available at* http://www.treas.gov/press/releases/reports/Blueprint.pdf [hereafter TREASURY BLUEPRINT]; Ben S. Bernanke, *Financial Reform to Address Systemic Risk*, Speech at the Council on Foreign Relations (Mar. 10, 2009), *available at* http://www.federalreserve.gov/newsevents/speech/bernanke20090310a.htm; Borio, *supra* note 24.

institution or consumer.[45] It is regulation geared to minimizing the risk of and damage from systemic financial crises. Unlike conventional (micro-prudential) regulation, macro-prudential regulation is countercyclical: stricter in good times, looser in bad.[46] Like containment, it is concerned with the scope and transmission of financial shocks. Unlike containment, it seeks to preempt transmission through ex-ante system design.

The macro-prudential approach shares the essential priorities of regulation, namely, the emphasis on changing the incentives and structures of the financial system to reduce its vulnerability far into the future. Capacity for damage control comes second. In contrast, the essence of containment is ex-post short-term damage control; it operates on existing system architecture without aspiring to refashion it.

B. *Containment and Prevention*

Crisis prevention straddles regulation and containment. The term is widely used in popular, policy, and academic writing to include all regulation to bolster financial stability. In this sense, most regulation—and certainly all macro-prudential regulation—is also crisis prevention. In the narrowest sense, prevention is government action at Kindleberger's mystical sweet spot after a shock has killed off the bad firms, but before it has dragged down the good ones.[47] In his argument, this is the time to deploy the Lender of Last Resort (LOLR). The preceding Section distinguished containment and regulation, including prevention in the broad regulatory sense; this Section distinguishes containment and prevention in the narrow sense.

One way to tease out the difference is by reference to the relationship between insolvency and illiquidity. The classic function of LOLR—

[45] This distinction is explicit in Borio, *supra* note 24; also it is implied in the TREASURY BLUEPRINT, *supra* note 44, and the G-30 REPORT, *supra* note 44.

[46] Borio, *supra* note 24, at 197. Forbearance—suspension of prudential strictures in crisis—is commonplace in conventional regulation. *See* Arthur E. Wilmarth, Jr., *Controlling Systemic Risk in an Era of Financial Consolidation* in INTERNATIONAL MONETARY FUND, CURRENT DEVELOPMENTS IN INTERNATIONAL MONETARY AND FINANCIAL LAW 61 (2002, 2005). The recurrent demand for safety valves in conventional regulation illustrates the dilemma. One well-known example is the systemic risk exception for bank resolution, created under the Federal Deposit Insurance Corporation Improvement Act of 1991, PL 102-242, 105 Stat. 2236 (1991) (codified as amended in scattered sections of 12 U.S.C.). Prior to the enactment of FDICIA, FDIC was bound to use the least cost method of bank resolution; the systemic risk exception allows the FDIC to bypass it if using the least cost method "would have serious adverse effects on economic conditions or financial stability" and if bypassing the least cost method would "avoid or mitigate such adverse effects." *Id.* For a discussion of the exception, see Martin J. Gruenberg, Vice Chairman, FDIC, Remarks at the international Association of Deposit Insurers Symposium on Deposit insurance Cross Border Issues (May 3, 2007), *available at* http://www.fdic.gov/news/news/speeches/archives/2007/chairman/spmay0307.html. For a more recent example, see, for example, Floyd Norris, *Banks Get New Leeway in Valuing Their Assets*, N.Y. TIMES, Apr. 2, 2009, at B1 (detailing the Financial Accounting Standards Board's move to relax "mark-to-market" accounting requirements for banks in financial crisis).

[47] *See supra* note 27 and the accompanying text.

unlimited short-term lending to banks at high interest on good collateral to overcome temporary illiquidity[48]—seeks to prevent a liquidity shock from becoming a solvency crisis. Illiquidity presumes no fundamental economic problem, only a loss of confidence. Economic losses—along with their distribution, and the associated politics—are completely avoidable by confidence-boosting liquidity support. The LOLR also has an explicit role ex-ante: confidence in the availability of public liquidity support, even without any lending, should deter runs on solvent institutions. So that healthy confidence does not become moral hazard (for example, encouraging investment in insolvent firms effectively backed by the public), the availability of LOLR support may be restricted subject to official discretion,[49] and in exchange, may require regulatory oversight.[50]

In contrast, containment starts from the presumption of economic loss. The deployment of extraordinary measures in containment may "stop the bleeding", but it will not undo the injury.

A variation on the traditional view of the LOLR emerges from Steven Schwarcz's recent work on systemic risk. He proposes a market liquidity provider of last resort (LPOLR) "to purchase securities in panicked markets."[51] Schwarcz frames it as a regulatory proposal for ex-ante risk reduction.[52] Like the macro-prudentialists, he seeks to reduce risk to the financial system broadly defined.[53] His proposal would preempt market panics and limit damage from them[54] through a mix of traditional tools such as circuit-breakers, disclosure, leverage caps and activity restrictions, along with the LPOLR.[55] Like the traditional LOLR, it would help calm

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[48] WALTER BAGEHOT, LOMBARD STREET: A DESCRIPTION OF THE MONEY MARKET 57–64 (1906).

[49] This is commonly referred to as "constructive ambiguity."

[50] Fred Hirsch, *The Bagehot Problem*, *in* Goodhart & Illing, *supra* note 23, at 187, 193.

[51] Steven L. Schwarcz, *Markets, Systemic Risk, and the Subprime Mortgage Crisis* 8 (Working Paper, 2008), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1102326 [hereinafter, Schwarcz, *Markets*].

[52] *Id.* at 8; Schwarcz, *Systemic Risk*, *supra* note 19, at 193, 205 *et seq*. Schwarcz notes the possibility of ad hoc ex post approaches to systemic risk management; these stand in contrast to most of the proposal. *Id.* at 230–31.

[53] *See supra* note 45 (works on macro-prudential regulation). Schwarcz's perspective has antecedents in the legal literature. For example, Cynthia Lichtenstein described systemic risk as encompassing risks presented by securities firms in 1993. *Cf.* Lichtenstein, *supra* note 21, at 141; Schwarcz, *Systemic Risk*, *supra* note 19, at 207, 210–14.

[54] Schwarcz, *Systemic Risk*, *supra* note 19, at 214; "Prevent" is used later in the text. *Id.* at 216.

[55] *Id.* at 225–30. The distinction between Schwarcz's proposal and the existing powers of the Federal Reserve is relatively fine. *Id.* at 213 (distinguishing proposal by characterizing Fed lending as limited to banks). In the Bear Stearns incident, the Federal Reserve Bank of New York used its authority under Section 13(3) of the Federal Reserve Act to buy assets, including securities, from a nonbank using a special purpose vehicle; the same technique was used to support the insurance company AIG several months later. MARKETS GROUP OF THE FEDERAL RESERVE BANK OF NEW YORK, DOMESTIC OPEN MARKET OPERATIONS DURING 2008 25–26 (2009) http://www.newyorkfed.org/markets/omo/omo2008.pdf. Using the same authority, the Federal Reserve expanded its facilities to lend to all manner of nonbank institutions against a wide range of illiquid assets; the stated goal, as in Schwarcz, is to boost market liquidity. Fed. Reserve Bank of N.Y.,

markets simply by standing ready to lend or buy assets when panic strikes. Like the traditional LOLR, Schwarcz's proposal addresses illiquidity, not insolvency. The paradigmatic scenario involves no losses at all, since the provision of liquidity restores normal market functioning. This in turn makes it possible to frame both LPOLR and LOLR as apolitical: both save the system (everyone), neither distributes within it.[56]

Containment comes after prevention and preemption have failed to bring the markets about; it presumptively entails losses; and it is inherently political, if only because it must distribute such losses.

C. *Containment and Resolution*

Policy, political science and economics writing often combine discussion of crisis containment and resolution. Resolution refers broadly to the restructuring and reregulation that happen in the aftermath of financial collapse—after panic has abated, but before the economy has returned to normal.[57] By then, the political system has come to terms with the crisis, at least some losses have become apparent, and the actors have

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Understanding the Recent Changes to Federal Reserve Liquidity Provision, http://www.newyorkfed.org/markets/Understanding_Fed_Lending.html (last visited Feb. 27, 2009) Fed. Reserve Bank of New York, Commercial Paper Funding Facility: Frequently Asked Questions, http://www.newyorkfed.org/markets/cpff_faq_081105.html (last visited Feb. 27, 2009). The distinction between Schwarcz's proposal and the general (though not the institution-specific) facilities is that the Fed only lends against illiquid assets; technically, it does not buy them except through special-purpose vehicles. However, lending and repurchase operations that put the assets on the Fed's balance sheet for a long time can be hard to distinguish from outright purchases. Section 13(3) allows Federal Reserve banks to lend to nonbanks "in unusual and exigent circumstances" with the approval of a supermajority of its governors and where credit is unavailable elsewhere. It was enacted in 1932 as part of a road construction bill. Emergency Relief and Construction Act of 1932, ch 520, § 210, 47 Stat. 715, (codified at 12 U.S.C. § 13(3) (2006)). President Hoover vetoed that bill's predecessor, which put expansive authority to lend to firms in the Reconstruction Finance Corporation, citing recent corruption scandals involving former RFC officials. *Text of President's Message Vetoing the Relief Bill*, N.Y. TIMES, Jul. 12, 1932, at 2. Two weeks later, the Fed got expanded authority as a compromise; it appears not to have used it between the Great Depression and the current crisis, although it came close several times. *See* David Fettig, *The History of a Powerful Paragraph,* The Region, The Federal Reserve Bank of Minneapolis (Jun. 2008) at http://www.minneapolisfed.org/publications_papers/pub_display.cfm?id=3485.

[56] Schwarcz, *Systemic Risk*, *supra* note 19, at 204, 226.

[57] Honohan & Laeven, *Introduction and Overview*, in SYSTEMIC FINANCIAL CRISES, *supra* note 19, at 11; *cf.* Joan M. Nelson, *Introduction: The Politics of Economic Adjustment in Developing Nations*, *in* ECONOMIC CRISIS AND POLICY CHOICE: THE POLITICS OF ADJUSTMENT IN THE THIRD WORLD 3–4 (Joan M. Nelson ed., 1990):

> The adjustment of individual nations usually comprises two distinct though intertwined tasks. The first is *stabilization;* that is, reducing balance of payments deficits and inflation to levels compatible with resumed and sustainable growth . . . . The second aspect of adjustment is *structural change* designed to encourage foreign exchange earning or saving activities, and more generally, to improve incentives and efficiency for sustainable growth.

Containment in this Article is distinct from macroeconomic stabilization. Governments use macroeconomic policy tools much more aggressively in crisis, but the difference from ordinary times is one of degree. In contrast, wholesale restructuring and rewriting contracts is a qualitative departure from non-crisis policymaking.

begun to look to the future. The imperative is not to stop the bleeding, but to rebuild:

> The goal of resolution policy is to achieve the necessary rebuilding of banks' and borrowers' balance sheets at the lowest cost, where costs include costs from taxpayers' transfers of wealth and the worsening of incentives in the financial system.[58]

Rebuilding must take account of past mistakes and design a new system to avoid them.[59] This view of resolution shares a long-term focus with regulation. But because resolution usually operates on a landscape of economic and institutional wreckage, it can be both more backward-looking (for example, compensating crisis victims and mitigating collateral damage from containment) and more ambitious (for example, creating new institutions and changing regulatory paradigms).

Containment relates to resolution in two ways: timing and causation. Economists usually describe containment and resolution as successive stages in managing a banking crisis. Containment seeks to stop the outflow of money, whether in the form of deposit runs or capital flight; where applicable, to stabilize the currency; to arrest asset stripping; and to limit the collapse of asset prices.[60] Containment is a prerequisite to resolution, and resolution is its necessary sequel.[61] But containment is also a source of path dependence: policies adopted "in the heat of the crisis," such as regulatory forbearance, can prove sticky in the resolution phase[62] and can have "potentially irreversible" distribution consequences.[63]

Because the writing on crisis resolution tends to be geared to policy adoption, and because it is usually embedded in medium and long-term policy reform agendas, it produces a particular view of containment. On the one hand, containment is a source of costly, if necessary, departures from non-crisis rules,[64] where cost is measured both in fiscal terms and in terms of compromised incentives.[65] On the other hand, it is a window of

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[58] Charles W. Calomiris et al., *Financial Crisis Policies and Resolution Mechanisms: A Taxonomy from Cross-Country Experience* in SYSTEMIC FINANCIAL CRISES, *supra* note 19, at 72.

[59] *See, e.g.*, Goldstein, *supra* note 37.

[60] Honohan & Laeven, *supra* note 19, at 6–11; Lindgren et al., *supra* note 7, at 16–23.

[61] *See, e.g.*, ROUBINI & SETSER, *supra* note 16, at 17 ("No mater what the precise cause of the crisis is, getting out of it almost always requires a combination of policy adjustment and emergency financing, whether from an official loan or a restructuring of private debts. Policy adjustment . . . [involves] steps to make the country a better long-term credit.")

[62] Calomiris et al., *supra* note 58, at 31.

[63] Honohan & Laeven, *supra* note 19, at 11; *see also* Lindgren, *supra* note 38, at 89 ("All [bank closure] triggers must be designed to hold up legally, because interventions and closures will destroy and redistribute private property and wealth and therefore have a high likelihood of being challenged in courts.").

[64] *See generally* Lindgren, *supra* note 38.

[65] Calomiris et al., *supra* note 58; Honohan & Laeven, *supra* note 19, at 17; Lindgren et al., *supra* note 7, at 29–45.

opportunity to secure far-reaching changes in areas such as corporate governance, bankruptcy, and foreign investment:

> It is during the height of the crisis when the pain is felt most that there is an opportunity to break established malpractices and governance structures, to implement new laws and regulations, and to find support for economic and financial reforms.[66]

In some cases, containment measures might simultaneously promote resolution: for example, arresting a market panic may require an indication of a near- or even medium-term policy path. But in the quotation above, containment and resolution are joined strategically to achieve a policy outcome that is politically impossible when nerves are calmer. Where the outcome is good policy, this may be for the better, but it is not always good policy, and the fog of crisis makes it hard to tell.

D. *Containment and Emergency*

As already noted, contemporary U.S. law scholarship on financial crises has been sparse until now, especially when compared with the economics, political science, and economic history writing.[67] In search of a legal perspective on financial crisis containment, I look also to the scholarship on economic emergency.

Emergency response is a qualitatively different category from financial regulation, prevention, and resolution. The last three comprise relatively specific objectives and tasks to achieve them—for example, investor protection may require suitability rules; preventing a bank run may require deposit insurance and a LOLR; managing impaired assets on a large scale may require an asset management company. In contrast, economic emergency is a set of conditions, a state of the world claimed as a predicate for extraordinary government action. Each instance of emergency response is unique; neither the predicate nor the response may be specified ex-ante. One way of looking at the discussion of containment in this Article is as an effort to carve out that part of emergency response whose operational content can be described in advance.

Lawyers have considered financial and economic emergency response

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[66] Honohan & Laeven, *supra* note 19, at 17. This is a variant of the ubiquitous sentiment against "wasting" a crisis, military or economic. *See, e.g.*, Jonah Goldberg, *Obama's Fear-Mongering*, L.A. TIMES, Mar. 10, 2009, *available at* http://www.latimes.com/news/opinion/sunday/la-oe-goldberg10-2009mar10,1,7171121.column. *Compare* JOEL SELIGMAN, THE TRANSFORMATION OF WALL STREET 52 (2003) (describing FDR's use of popular support for fighting the banking crisis to reshape securities regulation).

[67] See *supra* notes 36, 37 and the accompanying text, and Levy, *supra* note 36, at 803–04 for a similar complaint.

occasionally from constitutional theory,[68] legal history,[69] and comparative[70] perspectives. Its economic policy content remains largely unexplored in the law literature. Where economists detail a sequence of bank closures, capital controls, payment standstills, emergency funding and regulatory forbearance—noting all the while that "a clear and transparent legal framework" for extraordinary measures is "essential"[71]—lawyers delegate.

Part of the reason may be that the literature on economic emergency is properly seen as a relatively small part of a much larger literature on emergency response, most of which focuses on security. The central question in legal writing is one of authority: who decides whether an emergency exists, who decides the content of emergency measures, and who or what might shape and cabin such emergency authority.[72] Concerns about separation of powers and checks and balances loom large. Financial crisis and economic policy specifics serve as background texture for much more encompassing discussions about allocation of power.[73]

The question of authority is crucial; I will return to it at the end of this Article. For now, I suggest that it is difficult to answer the question "who decides" how to respond to a financial crisis without a more granular and systematic understanding of what they do[74]—the subject of the next two

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[68] *See, e.g.*, ROSSITER, *supra* note 36, 255–64 (2002) (on the rise of executive power during the Great Depression), Scheuerman, *supra* note 36, at 1882–92 (discussing Carl Schmitt's theories of executive power in economic emergency).

[69] *See, e.g.*, Belknap, *supra* note 36 (arguing for a legal regime for economic emergencies); Levy, *supra* note 36 (examining judicial attitudes to finance through the prism of financial crises).

[70] *See, e.g.*, GROSS & NI AIOLAN, *supra* note 36, 76–79 (on the expansion of wartime powers to economic exigency. The authors do not purport to address economic emergency comprehensively).

[71] Lindgren, *supra* note 38, at 101.

[72] This framing is clearest in Schmitt. *See also* Scheuerman, *supra* note 36, at 1871–91 (discussing economic crisis as a catalyst for reevaluation of authority as a means of governance).

[73] *See e.g.*, Posner & Vermuele, *supra* note 36, 15–16. The authors describe the Federal Reserve's effective purchase of AIG stock, which they suggest pushed the limits of the Fed's authority under Section 13(3) of the Federal Reserve Act (*see supra* note 55) in a singular fashion. They draw parallels to Carl Schmitt's ideas about emergency and the power of the Executive. AIG was one of a species of heavily-lawyered transactions with precedents in the ongoing crisis (Bear Stearns used the same special purpose vehicle structure under the same legal authority six months earlier), the crisis response of the 1980s (*see infra* Part V.E, description of the Brady Plan) and the 1990s, to name a few. *Compare* ROBERT E. RUBIN, IN AN UNCERTAIN WORLD: TOUGH CHOICES FROM WALL STREET TO WASHINGTON 21-36, 219-223 (2004) (describing the unorthodox use of the U.S. Treasury's Exchange Stabilization Fund to support Mexico in 1995, and the subsequent Congressional restrictions on its use during the Asian Financial Crisis in 1997–1998). The supermajority and exigency requirements in Section 13(3) may have provided more ex-ante procedural protections than the other authorities. FDICIA's systemic risk exception (*supra* note 46) has a similarly elevated ex-ante threshold.

[74] In a rare law article to integrate a substantive treatment of financial crisis economics with theoretical perspectives on authority in a specific institutional setting, Daniel Tarullo suggests that some tasks of international financial crisis management may present an intractable challenge for allocating authority. Tarullo, *supra* note 36, at 613. Tarullo's work responding to the financial crises of the late 1990s also comes closer than most to addressing the substantive problem of containment. He revisits the tradeoff between applying rules-systems and granting discretion to policy makers in an international financial crisis, using IMF lending and sovereign bankruptcy as case studies, and

Parts of this Article.

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In sum, academic and policy approaches to financial crisis management present a sporadic view of containment. For some, it is a time-limited stage comprising a sequence of known technical tasks designed to stop financial panics—a sequence that requires a firm and transparent legal foundation.[75] For others, it is the response to a unique, unpredictable cataclysm that entails suspending laws and delegating power. In practice, until both officials and their constituents have owned up to a crisis, containment measures are conflated with crisis prevention. Once the crisis is acknowledged, policy prescriptions mix containment, resolution, and regulatory reform.[76] Once normalcy returns, containment policy often looks like a regrettable aberration. None of these treatments generalize or explain the pattern of containment in recent crises. The next Part is an effort to distil a core set of recurring decisions that comprise containment. It is more general than most policy studies of crisis management, but less so than most legal writing on economic emergency. The goal is to help situate debates about authority and accountability in a financial crisis setting.

IV. WHEN RULES DO NOT APPLY: THE CONTENT OF CONTAINMENT

In his iconic history of financial crises, Kindleberger twice quotes this passage from nineteenth-century banker and economist Thomas Joplin: "There are times when rules and precedents cannot be broken; others when they cannot be adhered to with safety."[77] But as Kindleberger and those who followed him have observed, emergency does not unleash chaos. Instead, non-crisis rules give way to new habits.

The following sections explore three kinds of choices that policymakers must make once they have determined they are facing a financial crisis: whether to invoke wholesale solutions, whether to enforce private contracts and government regulations, and how to distribute losses. Although they often overlap, these choices address distinct containment challenges.

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highlighting the implications of the authority deficit in the international realm. He argues that some of the rules proposals he critiques, if adopted, "may hinder efforts to contain a developing systemic crisis," *id.* at 630. Although Tarullo is clearly concerned about containment, his focus is not on systematically defining the decision category and its implications. As his article's title suggests, the policy proposals and his critique go more to crisis prevention and reform of the international financial system.

[75] Lindgren, *supra* note 38, at 101.

[76] *See, e.g.*, Goldstein, *supra* note 37 (recommendations for economic recovery/crisis management and financial regulatory reform/crisis prevention).

[77] KINDLEBERGER, *supra* note 27, at 13, 197.

A. *Blanket or Bespoke*

A severe financial crisis necessarily raises the prospect of a wholesale response. This is most obvious with traditional macroeconomic policy: a shock may cause the authorities to raise or lower interest rates, adjust the value of the currency (e.g., devaluation), or change the currency regime altogether (e.g., dollarization)—measures that by definition target the economy as a whole. It also holds for financial policy: bank holidays, exchange controls, deposit freezes and comprehensive guarantees, are containment staples. These have surfaced in economies ranging from Sweden, the United Kingdom and the United States to Argentina, Russia and South Korea. Less common across-the-board responses include redenominating debt contracts, legislating debt relief, general exchange rate subsidies, and injecting capital in the financial sector. In all cases, wholesale financial measures are a departure from non-crisis norms.

Absent crisis, failure is resolved case-by-case. Outside bankruptcy, contracts are enforced or renegotiated one-by-one. But even bankruptcy, a collective proceeding, coordinates multiple creditors of a single debtor. With a judge for every case, a plan for every firm, and a price for every asset, bankruptcy overcomes collective action problems among creditors that might otherwise race to the courthouse or dismember a viable enterprise.

A large-scale financial crisis adds new constraints: collective action problems appear across the economy, affecting both creditors and debtors.[78] Asset prices collapse; courts and regulators are overwhelmed. Such constraints may militate in favor of applying wholesale measures, despite their bluntness, to broad categories of debtors and creditors. Four factors drive the choice between wholesale and case-by-case measures in containment.

First, speed is a key objective of containment policy: the goal is to jolt the system into reversing course. A fast-moving crisis, such as a run, does not allow time to design and implement solutions tailored to individual persons' or firms' needs. Wholesale measures instantly signal that the authorities see a system-wide problem, but also their intention to address it forcefully and comprehensively.

Second, a crisis strains administrative capacity. The capacity challenge goes to scale as much as speed. In a run—or in the case of a simultaneous shock such as a currency collapse—the non-crisis resolution infrastructure cannot process an avalanche of failures. This constraint is

[78] *See, e.g.*, Aaron Tornell et al., *NAFTA and Mexico's Less-Than-Stellar Performance* 22–23 (Nat'l Bureau for Econ. Research, Working Paper 10289, 2004) (discussing Mexico's "cultura de no pago" or "culture of non-payment" which followed its recent financial crisis. With little enforcement from Mexican authorities, there was little incentive even for solvent debtors to make good on their debts).

relative: states with no resources and fragile institutions, such as Haiti, can handle fewer cases at once than wealthy ones with established bankruptcy and bank resolution systems, such as Sweden. But no ordinary system can handle a 65% insolvency rate. Wholesale measures can relieve capacity constraints through standardization, such as a limited menu of subsidies and restructuring formulas, through new institutional arrangements such as special courts or asset management companies to take over bad debts, or a combination. In addition, while generalized regulatory forbearance is rarely driven by the desire to lighten the load for bureaucrats, it can have the side benefit of letting them focus scant resources on containment priorities.

Third, a crisis can make valuation difficult to impossible. In normal times, it makes sense to let the markets value individual contracts and to let bankruptcy laws distinguish successful firms from ones that should fail. Bankruptcy relies on both a credible threat of liquidation and the existence of a plausible liquidation value. But the threat is not credible, and the value meaningless, where over half of all firms are technically insolvent.[79] Extreme currency fluctuation may make it impossible for businesses to plan and for markets to value: firms that look viable at Monday's exchange rate may look insolvent on Wednesday, then good again on Friday. Complexity—in the form of financial engineering or opaque, convoluted ownership structures—can compound the valuation problem. Replacing a large number of individually negotiated contracts with fewer, simpler, standardized ones can help the market value them, put a floor under falling asset prices, improve liquidity and restore market mechanisms for later restructuring.

Equitable and political considerations supply a fourth reason to choose wholesale over case-by-case containment policy. For example, identical treatment for different groups – such as foreign and domestic creditors—can buy peace with important constituencies. Alternatively, securing political support for crisis response may require wholesale measures that discriminate among groups (taxing all CEOs, subsidizing all farmers). Wholesale policies often look simple and transparent, but their economic effect can diverge from the political signal: identical measures may affect different groups differently. Compensation measures in the resolution phase may redistribute containment subsidies. Defining target groups for wholesale measures can have the effect of structuring crisis politics:

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[79] Marcus Miller and Joseph Stiglitz put it in terms of bankruptcy's capacity to convey information about the firm's management and prospects. Where failure is system-wide, bankruptcy is uninformative because failing to plan for an 80% devaluation and 100% interest rates is not normally a sign of bad management. Marcus Miller & Joseph Stiglitz, *Bankruptcy Protection Against Macroeconomic Shocks: The Case for a 'Super Chapter 11'* 2 (Centre for the Study of Globalisation and Regionalisation, 1999), *available at* http://www2.warwick.ac.uk/fac/soc/csgr/research/keytopic/global/milrstig.pdf.

picking winners and losers, reshaping old coalitions.

Wholesale measures can be mandatory and punitive (for example, capital controls) or voluntary and generous (capital infusions). All share a defect: they are by definition over- and under-inclusive. Wholesale measures will always leave worthy victims unhelped and will send scarce resources to the undeserving, potentially encouraging others to gamble. Such defects only recede against the imperatives outlined earlier—speed, administrability, valuation, politics and equity.

B. *Enforce, Suspend, Rewrite*

Debtors who run out of money typically have three choices: they may negotiate with their creditors, default, or file for bankruptcy. Ordinarily, governments enforce private contracts and punish default. Bankruptcy is a standing mechanism for rewriting contracts outside crisis.

Suspending or rewriting private contracts in crisis addresses different problems. The first reflects a difference of degree, discussed in the preceding section: in a general downturn, there may simply be too many defaults and insolvencies for the administrative apparatus to handle. The second is a difference in kind. Even in a crisis, any given debtor and any given creditor may be willing and able to carry on in their unamended relationship. However, the performance of some contracts may have spillover effects that exacerbate a crisis.[80] The presence of externalities from performance may prompt government intervention.

Externalities are particularly apparent where a category of contracts—or a contract clause that is boilerplate in a given market—poses a macroeconomic threat. For example, an agreement to pay debts in scarce hard currency, if it is widespread, can drain reserves. Pervasive indexation of private contracts to foreign currency similarly can put pressure on monetary and financial authorities.[81] Economists cite other sources of contract rigidity, notably pervasive barriers to renegotiation, as a source of vulnerability in crisis.[82]

To address the first category of threats from private contract language, governments may subsidize performance, amend the contracts by law or decree, or refuse to enforce them. For the second category, subsidies are not normally an option. But rewriting contracts is costly: it may make future breach too easy (moral hazard), undermine commercial certainty,[83]

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[80] Anna Gelpern & Adam Levitin, *Rewriting Frankenstein Contracts*, 82 U.S.C. L. REV. (forthcoming 2009).

[81] *See* Guide et al., *supra* note 14, at 54. (Discussing hard currency indexation.) Indexation more broadly is a means of risk-allocation; depending on the index, it may favor debtors or creditors.

[82] EICHENGREEN ET AL., *supra* note 35, at 15-16, 34-36 (on the barriers to renegotiating sovereign debt contracts).

[83] *See, e.g.*, Sun Printing & Publishing Ass'n. v. Remington Paper & PowerCo., 139 N.E. 470, 471–72 (N.Y. 1923) (invoking the central importance of commercial certainty in contract law).

and diminish faith in the rule of law. The possibility of government intervention to rewrite contracts that had been unobjectionable when made also introduces an element of sovereign risk. As one Argentine commentator noted, rewriting contracts often not only undermines the institution of contract, but also the credibility of the national legal system.[84]

A different but related set of concerns attends regulatory forbearance. In normal times, governments enforce their laws and regulations. In crisis, doing so may mean shutting down large portions of the economy and the financial system. One central bank official told this author that enforcing capital adequacy and loan provisioning requirements in crisis would have meant taking over the private bankings system.[85] Although his description may over-dramatize, regulatory forbearance in crisis is ubiquitous.[86] It is most common with respect to capital adequacy, provisioning, and regulatory accounting, which reflects respectively the pervasive capital scarcity, bad loans and valuation difficulties that characterize a financial crisis. Recognition that strict enforcement of micro-prudential rules can severely exacerbate the effects of a crisis animates the design of macro-prudential regulation.

Some of the established criticisms of regulatory forbearance echo the concerns with rewriting private contracts. Suspending rules in crisis, especially doing so often, makes rules less credible going forward. It penalizes those who comply despite distress, and rewards those who break the rules even when they could have complied. Like other containment measures, regulatory forbearance may encourage risky behavior on the assumption that rules prohibiting such behavior would not be enforced when bets go bad.

Regulatory forbearance also raises distinct concerns from suspending contract enforcement. First, it is hard to stop. Regulated entities develop a vested interest in forbearance, and lobby hard to keep it going: it becomes part of the business model. Perhaps more importantly, early forbearance makes it possible for public and private actors to delay recognition of the crisis, while prolonged forbearance makes it possible to delay restructuring. Put differently, forbearance can work both as a crisis response measure and as a means of denial. In the first instance, it creates a breathing space for other response measures. In the second, it serves as cover for channeling scarce resources to the regulated entities and their creditors. The difference between the two uses of forbearance is often hard to tell and politically determined.

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[84] Spector, *supra* note 11, at 129.

[85] Anna Gelpern & Brad Setser, Trip Report: Argentina, August 4–9, 2003 at 7 (Council on Foreign Relations) (unpublished paper on file with author, Nov. 3, 2003).

[86] Lindgren, *supra* note 38, at 89–92.

C. *Distribution*

In September 2007, days before he had to rescue Northern Rock and guarantee the liabilities of the British banking system, Bank of England Governor Mervyn King criticized other central banks for injecting money into the market. He framed his criticism in terms of creditor moral hazard, and warned that central bank actions could encourage creditors to gamble in the expectation of being bailed out.[87] Shortly thereafter, the Shadow Financial Regulatory Committee argued that the U.S. Treasury's limited and voluntary mortgage modification initiative was sowing moral hazard among irresponsible debtors.[88] This illustrates another containment perennial: when doing nothing is not an option, policy makers trying to contain a crisis must effectively decide whose moral hazard is worse—from the start, they engage in distribution.

Debt restructuring and "bailouts" both distribute. Losses from financial distress first fall on debtors and creditors. Debt reduction mandates take away from creditors and give to debtors. Government-funded rescue operations shift loss from both debtors and creditors to the taxpayers. Creditors can be some combination of bank depositors, bank owners, and government-backed deposit insurance agencies. Where debt takes the form of a marketable security (whether it started out that way or was repackaged through securitization), creditors can be local pension funds with long time horizons, foreign municipalities that count on the income to maintain vital services, Italian retirees, Connecticut hedge funds, or Wall Street investment banks. Similarly, debtors can be poor homeowners or wealthy corporations. Each crisis will have its own

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[87] *See, e.g.*, Carol Douherty, *British Central Bank Critical of Cash Infusions*, N.Y. TIMES, Sept. 13, 2007; Mervyn King, *Turmoil in Financial Markets: What Can Central Banks Do?* 7 (Draft Opening Statement for Appearance before the Treasury Comm., Sept. 12, 2007), *available at* http://media.ft.com/cms/a7ed52c2-6111-11dc-bf25-0000779fd2ac.pdf:

> But, on the other hand, the provision of such liquidity support undermines the efficient pricing of risk by providing ex post insurance for risky behaviour. That encourages excessive risk-taking, and sows the seeds of a future financial crisis. So central banks cannot sensibly entertain such operations merely to restore the status quo ante. Rather, there must be strong grounds for believing that the absence of ex post insurance would lead to economic costs on a scale sufficient to ignore the moral hazard in the future. In this event, such operations would seek to ensure that the financial system continues to function effectively.

Id.

[88] Statement of the Shadow Financial Regulatory Committee on Treasury Department's Mortgage Foreclosure Program 2 (Dec. 10, 2007), *available at* http://www.aei.org/docLib/20071210_ShadowStatement250.pdf:

> The interest-rate freeze appears to reward borrowers who made bad decisions . . . Additional problems of fairness and moral hazard are raised by wholesale adjustment of investor and lender claims to interest-rate income under pre-existing mortgage contracts. Rewriting mortgage contracts without open negotiations between servicers and investors promises to discourage future investors from participating in markets for securitized loans.

Id.

constellation of constituents.

Distribution is politically, and often legally, fraught. It requires officials to choose among constituents, many of whom wear multiple hats at once: homeowners, depositors, retirees, shareholders, and investment bankers, to name a few. It may require imposing new taxes, breaking contracts and taking property.

In contrast, framing crisis response decisions in terms of loss limitation puts decision makers above the political fray. This can be done in two ways. First, if the crisis is one of temporary illiquidity, there should be no losses and no need to spread the pain. As noted earlier, the LOLR advances funds to solvent institutions and expects to be repaid forthwith.[89] Second, even in a solvency crisis that entails losses, supporting some constituents over others may help limit overall social cost. In this view, banks and households are vehicles, not objects of intervention.[90] A bank looks like a better vehicle than a household, because a bank failure can bring down many firms and households. Helping banks helps everyone at once and no one in particular.

Where the problem is insolvency, masking distribution in these ways can be costly. First, it may delay recognition of a crisis and crisis response, which can magnify aggregate losses. Second, it may reduce accountability. The liquidity-solvency paradigm reinforces the view that financial crisis containment decisions, while urgent and complex, are essentially technical: it creates the illusion of a hard boundary accessible with scientific precision. But judgments about liquidity and solvency are often wrong or fudged, and virtually always contested and political.[91] If a crisis is mislabeled, the public may be stuck with losses from failed liquidity support where other distribution options might have been chosen up front.

Third, once the decision is made to shift some losses to the public, choices about who gets scarce rescue resources and who is left to fail require legitimacy in their own right. This is so even when such choices–like triage in battlefield medicine–are easy to justify as limiting aggregate

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[89] BAGEHOT, *supra* note 48, at 57–64.

[90] RUBIN, *supra* note 73, at 19:

> I tried to explain that I wouldn't spend a nickel of taxpayer money for the sake of rescuing investors. Again and again, I returned to my arguments that our proposal to help Mexico was driven by our national interest. These numbers are always hard to calculate, but we made a rough judgment about the potential costs of a prolonged Mexican crisis to the United States—700,000 jobs affected, a 30 percent increase in illegal immigration, and so on.

Id.

[91] *See* Goodhart & Illing, *supra* note 23, at 13, 16 (summarizing contributions on the subject), and *infra* Part II.B.

losses.[92] They are not always easy to justify; and measures that are perceived as illegitimate may ultimately fail for lack of political support.

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The description of containment so far raises a number of questions for crisis response. I collect these here before proceeding to the case studies in Part V. First, if the decisions about wholesale measures, enforcing contracts and regulations, and loss distribution are inevitable, how should policy makers go about making them? What factors should they consider in each case? What legal and institutional features might make for better, or at least for easier, containment decisions? Second, how should the law allocate authority over containment policy? What should be the respective roles of the Executive, Legislative and Judicial Branches—but also of independent agencies, most importantly central banks, and foreign actors, public and private? Third, does isolating containment as a category help determine the timing of emergency response? The accounts below suggest some partial answers.

V. CONTAINMENT IN PRACTICE

This Part examines how the three kinds of crisis containment decisions have played out in very different economic and political settings: Indonesia in 1997–1998, Japan in 1994–1998, the United States in 1933, Argentina in 2001–2002, and Mexico in 1982. All five examples involved bad loans and widespread distress in the banking sector. But the five crises had different causes and developed in different ways. In Mexico and Argentina, government debt was a key source of distress. In the United States, government debt was involved, but it was not central to the crisis. In Japan and Indonesia, financial stress was most severe in the corporate and banking sectors. Mexico offered an odd twist: its government debt problems also threatened the banking sector in the United States. A period of falling real estate prices was key to Japan's collapse; fast-moving currency crises defined Argentina's and Indonesia's. For all the differences, governments in each case faced the containment decisions described in Part IV, even though not all were acknowledged as such. Yet each government's choices reflected a specific institutional and political context.

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[92] Medical triage involves dividing the injured into three groups to conserve scarce rescue resources: priority goes to the borderline cases that might survive with treatment, but would perish without it. The lightly and terminally injured alike must wait.

A. *Indonesia 1997-1998*

Between July 1997 and January 1998, Indonesia's currency, the rupiah, fell by over 75% as international investors fled Asia.[93] In less than a year, the financial crisis would end President Suharto's thirty-two year dictatorship. At the height of the crisis, 80% of all Indonesian firms were illiquid and 65% were technically insolvent, unable to repay foreign-currency debts.[94] At least three-quarters of all bank loans were nonperforming.[95]

Still reeling from having to rescue Korean banks,[96] some international officials had a radical idea: why not swap all corporate debt in Indonesia into equity overnight? This would achieve a conventional bankruptcy result—handing insolvent firms over to their creditors—without getting bogged down in Indonesia's notoriously ineffectual bankruptcy system, and might just work fast enough to arrest the downward slide. Even by crisis standards, the blanket swap was an extreme idea; it was promptly rejected after a few policy brainstorms.

Under another proposal, later described in a theoretical paper by Marcus Miller and Joseph Stiglitz, Indonesia's currency collapse would have triggered across-the-board corporate debt reduction.[97] In Miller and Stiglitz's "Super Chapter 11," general debt relief is appropriate in response to macroeconomic shock because individual managers are not to blame for pervasive insolvency, and because the skills of the existing managerial cadre are essential to rehabilitate the corporate sector.

The instant swap and Super Chapter 11 came from very different diagnoses of the crisis, and, if implemented, would have led to polar opposite outcomes: a swap would expropriate, while debt relief would entrench, the existing owners. But both proposals contemplated the

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[93] INT'L MONETARY FUND, INDONESIA: STATISTICAL APPENDIX 42 tbl.39 (May 1999), *available at* http://www.imf.org/external/pubs/ft/scr/1999/cr9939.pdf. *See generally* Barry Eichengreen, The Asian Crisis After Ten Years, Keynote Address at Singapore Centre for Applied and Policy Economics at Singapore National University 5 (July 31, 2008), *available at* http://www.econ.berkeley.edu/~eichengr/sing_keynote.pdf; Steven Radelet & Jeffrey D. Sachs, *The East Asian Financial Crisis: Diagnosis, Remedies, Prospects*, BROOKINGS PAPERS ON ECON. ACTIVITY 1–2 (1998) (attributing the crisis in part to investor behavior).

[94] The exchange rate plunge quadrupled the rupiah value of their dollar debt. Conservative estimates of private sector debt topped $72 billion, over 70% of Indonesia's GDP. LEONARDO MARTINEZ-DIAZ, BARBARIANS AT THE GATE 226 n.42 (forthcoming 2009) (on file with author); RICHARD ROBISON & VEDI R. HADIZ, REORGANIZING POWER IN INDONESIA: THE POLITICS OF OLIGARCHY IN AN AGE OF MARKETS 153 (2004); Int'l Monetary Fund, *IMF Concludes Article IV Consultation with Indonesia*, 1999 PUB. INFO. NOTICE NO. 99/33.

[95] ROBISON & HADIZ, *supra* note 94 at 154.

[96] *See supra* notes 6–9 and accompanying text (discussing the Korean government's guarantee of Korean bank liabilities).

[97] Miller & Stiglitz, *supra* note 79. *See also* JOSEPH STIGLITZ, GLOBALIZATION AND ITS DISCONTENTS 57–64 (2002); Joseph Stiglitz, *The Insider*, NEW REPUBLIC, Apr. 17, 2000, at 56, *available at* LEXIS, News Library, NEWRPB File. At the time of the proposal, Stiglitz was Chief Economist of the World Bank.

restructuring of private contracts on an economy-wide scale. In 1997–1998, such blanket measures seemed sensible considering the rapid spread of Indonesia's crisis and the wild currency fluctuations, which made valuation nearly impossible. Institutional factors, such as the complex web of corporate conglomerates, corrupt courts and an unused bankruptcy law from Dutch colonial days compounded the containment challenge.

These elements, which argued in favor of an expansive wholesale response, weighed against powerful countervailing considerations. When the crisis hit, fifteen families, all but one of Chinese descent, controlled over 60% of the stock market capitalization. Suharto's family controlled nearly 17%.[98] These were the principal debtors whose unhedged foreign borrowing made the country so vulnerable. With such extreme concentrations of ownership and debt, a wholesale debt-equity swap would have expropriated the ethnic Chinese elite on a revolutionary scale, most likely in favor of foreign investors. On the other hand, across-the-board debt forgiveness under "Super Chapter 11" would have visibly rescued the same ethnic elites facing a backlash from the native Indonesian majority.[99]

Similar distribution concerns were present, albeit less stark, in more conventional containment policy options mooted in Indonesia. For example, some had suggested imposing general restrictions on capital outflows. These were unacceptable to the International Monetary Fund (IMF), whose views came with billions of dollars in emergency lending, but also to the elites rushing to get money out of Indonesia.[100] Blanket deposit guarantees similarly faced resistance as bank runs spread in the fall of 1997. Indonesian technocrats and IMF officials opposed such guarantees for fear of moral hazard, but also because they did not want to appear to reward the elites whose banks had been funneling dubious loans to connected firms.[101]

Absent good distribution options, officials lapsed into policy paralysis and incrementalism. In October of 1997, the government agreed with the IMF to shut down sixteen out of over 200 banks, and to extend a partial guarantee to small deposits. Designed to include banks owned by Suharto's family and associates, the narrowly targeted closing was meant

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[98] STIJN CLAESSENS ET AL. EAST ASIAN CORPORATIONS: HEROES OR VILLAINS? 13–14, tbl.8 (1999); Hugh Patrick, Corporate Governance, Ownership Structure and Financial Crisis: Experience of East Asian Countries 16 (Dec. 11, 2001) (unpublished manuscript on file with Columbia Business School), www.kdic.or.kr/english/down/2001_I_2(Session1).doc.

[99] Similar concerns surfaced in connection with a proposal to establish a currency board, fixing the value of the rupiah: international officials suspected among other things that Suharto and his cronies would set the value artificially low and spirit the remaining dollars out of the country. BLUSTEIN, *supra* note 6, at 225.

[100] BLUSTEIN, *supra* note 6, at 85–115

[101] This also reflected residual hope that the crisis was not entirely systemic, and that confidence could return with closing the right subset of bad banks. *Id.* at 111. For further information regarding connected lending, see MARTINEZ-DIAZ, *supra* note 94, at 190.

to signal both the government's seriousness and the discreet nature of the crisis.[102] It backfired badly: Suharto's son got his bank back within days of closing; confusing announcements suggested (correctly) that more banks were at risk; and the partial guarantee did nothing for large depositors who made up most of the deposit base by value.[103]

In the interim, central bank lending continued in force. Like the rejected options, this ostensible liquidity support had the effect of bailing out the best-connected. For the government it may have had the added virtues of being discretionary and less obvious to the public eye than blanket guarantees or moratoria. Better yet, the authorities' heavy reliance on central bank lending allowed everyone to avoid admitting that Indonesia was in the middle of a nasty solvency crisis. A few months later, when the grim reality settled in, the state issued a full guarantee of all bank liabilities. By then, the capital had decamped for Singapore.[104]

The next round of measures, launched in January 1998 along with the guarantee, tried to straddle containment and resolution. Coming at the lowest point in rupiah's slide, it aimed to arrest it—but not at the cost of bailing out the undeserving. The centerpiece of the emergency package was an asset management company, the Indonesian Bank Restructuring Agency (IBRA). The agency's mission was all-encompassing: taking over bad banks, restructuring and selling their assets, and recovering as much as possible of the central bank liquidity support dispensed in the preceding months. Meant to boost market confidence, IBRA took months to sort out its mandate, management, and authority, all in the public eye. It then embarked on a multi-step process of taking over and culling banks, assuming portfolios, and negotiating individual restructuring arrangements. Initially, it had no authority to reduce debt or foreclose on collateral. IBRA eventually came to control assets worth over one-third the size of Indonesia's economy. In its capacity as "the chief arbiter of . . . a massive redistribution of corporate assets," IBRA became a major political force in its own right.[105]

A year into the crisis, bank resolution costs stood at 51% of Indonesia's GDP[106] and much of the economy was in state hands. With

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[102] *See* Lindgren et al., *supra* note 7, at 2.

[103] BLUSTEIN, *supra* note 6, at 112; *see also* ROBISON & HADIZ, *supra* note 94, at 156 (noting that Suharto expected the announcement of the IMF to restore confidence in the financial system, which it ultimately did not).

[104] INDEP. EVALUATION OFFICE, INT'L MONETARY FUND, EVALUATION REPORT: THE IMF AND RECENT CAPITAL ACCOUNT CRISES 13–15 (2003) *available at* http://www.imf-ieo.org/eval/complete/pdf/07282003/all.pdf [hereinafter EVALUATION REPORT].

[105] *See* ROBISON & HADIZ, *supra* note 94 at 197 (noting that by mid-1999, the IBRA controlled assets amounting to 546 trillion rupiah); Wayne Arnold, *Indonesian Bank Agency Fading Out*, N.Y. TIMES, Oct. 2, 2003, at W3, *available at* LEXIS, News Library, NYT File (noting that the IBRA recouped 146 trillion rupiah of the 650 trillion spent on rebuilding the Indonesian banking system).

[106] *See* Lindgren et al., *supra* note 7, at 165.

Suharto out of power and many of his associates out of sight, asset sales remained mired in political controversy.[107] The new government rejected demands to hand over IBRA's holdings to native Indonesians, but also barred sales to the old, mostly Chinese, owners. Western investors remained unpopular; however, the state's dire fiscal predicament prompted further opening to foreign capital, notably in the banking sector. It took years and much maneuvering to bring a mix of old and new capital back to Indonesia,[108] with the state absorbing losses many times the size of the original corporate liabilities.

It is customary to blame Indonesia's crisis response on the dysfunction of a dying dictatorship and the dogmatism of international officials.[109] Both are likely at fault. But Indonesia's choices, while extreme, are not unique. Politicians and technocrats everywhere recoil at drastic wholesale response to crisis, then come to embrace it after costly bespoke measures fail to stop the collapse. Politicians hate to admit to large-scale failure; technocrats resent the moral hazard and inequity inherent in across-the-board response. And few policy makers have the stomach to preside over revolutionary redistribution.

Indonesia's case was notable in yet another respect. From the start, even before the government had acknowledged the full depth and breadth of the crisis, domestic and international policy makers saw distress as an opportunity to secure far-reaching structural reforms of the Indonesian economy. While the dynamic itself is quite common, the depth of Indonesia's crisis and the breadth of the reform ambition were impressive. IMF and World Bank lending conditions, many developed with the quiet support of technocrats within the Indonesian government,[110] among other things sought to break up industrial and trading monopolies, privatize state enterprises, open the financial sector to foreign participation, revamp the bankruptcy regime and clean up the courts. Although the reform agenda might have been reasonable as a matter of economic policy, in retrospect, it is harder to justify as crisis management. Foreign and domestic actors were quite open about their desire to use the crisis as a window of policy opportunity, and they were right—perhaps to a greater degree than anyone had expected.[111] Yet the muscular push for reforms, some of which had

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[107] Arnold, *supra* note 105 (noting that the IBRA was viewed as an agency that would reform the banking system following Suharto's exit from power).

[108] *See* ROBISON & HADIZ, *supra* note 94, at 191–92 (noting that while IBRA was established in 1997 to work toward recapitalizing Indonesian banks, by 2001 Indonesian banks were still struggling); *see also* Patrick, *supra* note 98, at 16 (noting that violence in Indonesia in 1998 contributed to the flight of Indonesian capital).

[109] BLUSTEIN, *supra* note 6, at 110–11; EVALUATION REPORT, *supra* note 104, at 13–15; Radelet & Sachs, *supra* note 93, at 1; Stiglitz, *supra* note 97, at 56.

[110] MARTINEZ-DIAZ, *supra* note 94, at 195.

[111] *Id.* at 218 (describing President Habibie's reluctant embrace of IMF program conditionality, including trade openness, as a way out of the crisis even as it was contrary to his own nationalist

less-than-obvious payoff in arresting the crisis, cost domestic and international policy makers enormous political capital.

Indonesia offers one of the starkest illustrations of containment decision-making and its extreme distributional consequences. Perhaps because the distribution stakes were so high, the default option—avoiding wholesale restructuring for as long as possible, quietly supporting entrenched interests with forbearance and central bank lending, all the while shifting losses onto the general public—carried the day.

B. *Japan 1994–1998*

Japanese banks were among the largest creditors to bankrupt Indonesian companies. Apart from that, the two crises had little in common. Indonesia was poor; Japan was rich. Indonesia had deep ethnic divisions compounded by extreme inequality; Japan had some of the lowest levels of wealth and income inequality in the industrial world.[112] Indonesia was an oligarchic dictatorship; Japan a democracy, albeit one where a single party had dominated the political scene for decades. Indonesia suffered a sudden currency collapse; Japan's economy unraveled over a decade. Unlike Indonesia, Japan had ample financial, technical and institutional capacity. Yet the two governments made some similar decisions about crisis containment. Through most of Japan's "lost decade," its authorities approached institutional failure case-by-case, practiced regulatory forbearance, and insisted on scrupulous performance of private contracts. Perversely, this approach resulted in a wholesale rescue of the financial system, and at least in the first instance, a large-scale loss transfer from banks and their borrowers to the public.

Japan entered the 1990s with a burst real estate bubble and a stock market that had dropped over half its value. The height of the bubble in the late 1980s coincided with capital markets deregulation, which made it easier for the largest Japanese manufacturing firms to issue securities, and sent Japanese banks to scramble for new borrowers. Loans to small and medium-size firms, to real estate and finance companies, and to individuals, grew rapidly.[113] A large portion of these loans was directly and indirectly secured by real estate. Historically, real estate had been the dominant form of collateral for bank lending in Japan. As a result, many

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preferences). The most extreme "reform" was political—the end of Suharto's dictatorship. Although many saw the crisis and the ensuing reform conditionality as part of a Western plot to overthrow the President, such charges remain the province of conspiracy theories.

[112] *See, e.g.*, Thomas Piketty & Emmanuel Saez, *The Evolution of Top Incomes: A Historical and International Perspective*, 96 AM. ECON. REV. 200, 204 (2006) (describing the far lower levels of wealth and income inequality in post-war Japan than in the United States).

[113] Yoshinori Shimizu, *Convoy Regulation, Bank Management, and the Financial Crisis in Japan*, *in* JAPAN'S FINANCIAL CRISIS AND ITS PARALLELS TO U.S. EXPERIENCE 57, 61–71 (Ryoichi Mikitani & Adam S. Posen eds., 2000).

loans went bad when land prices fell by more than two-thirds at the turn of the decade.[114] But the damage was hidden, as the government encouraged banks to recycle the loans and paper over losses while waiting for a recovery that did not come.[115]

Commentators often date the start of the financial crisis to 1994 and the near-failure of two urban credit cooperatives. Contrary to crisis stereotype of falling giants, Tokyo Kyowa and Anzen were small deposit-taking institutions of the sort that lent locally to families and small businesses.[116] Bad real estate loans put the two in such bad shape that even their notoriously lax municipal regulators recommended shutting them down. Instead, they were rescued with financial support from other banks and contributions from the local and national governments. This was the first time since World War II that Japan used public funds to bail out a financial institution, and the first in a series of ad-hoc rescues that soon covered the entire financial system.

Over the next four years, failures spread to housing lenders, banks big and small, and global securities houses. In November 1997, nearly every week brought news of financial collapse—including the bankruptcy of Yamaichi Securities that began this article.[117] The inflection point came in 1998 with the failure of Long Term Credit Bank ("LTCB,") once the ninth largest in the world by asset size,[118] followed by a spate of more comprehensive legislation, including an asset management scheme in 1999.

The government's response between 1994 and 1998—continued regulatory forbearance, central bank liquidity support and "voluntary" contributions from solvent banks to meet the contractual obligations of the failing—signaled that the troubles were limited and temporary, even as many policy makers knew they were not. Each failure exposed new gaps in the resolution infrastructure and each rescue package appeared to be jimmy-rigged to make up for these gaps. After a while some of the features, such as the private bank contributions—or *hougachou* (a term also used to describe village collections for religious feasts)[119]—became fixtures of Japan's crisis response. Fiscal contributions remained immensely controversial. As a result, last-resort lending during that period turned conventional central banking principles upside down: one finance

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[114] *Id.* at 60, 64, 70–71, 74. Banks also indirectly backed long-term capital market financing. Most bank and capital market financing was effectively secured. *Id.*

[115] *Id.* at 77.

[116] NAKASO, *supra* note 5, at 4; TETT, *supra* note 4, at 72; Basel Committee on Banking Supervision, *Bank Failures in Mature Economies*, 13 BANK FOR INT'L SETTLEMENTS 7 (2004), *available at* http://www.bis.org/publ/bcbs_wp13.pdf?noframes=1.

[117] NAKASO, *supra* note 5, at 8.

[118] TETT, *supra* note 4, at xxiii. When it failed, LTCB had $240 billion in assets. NAKASO, *supra* note 5, at 12.

[119] NAKASO, *supra* note 5, at 5.

ministry official observed in retrospect that most Bank of Japan ("BOJ") support went to failed institutions, not temporarily illiquid ones.[120]

Just before the rescue of the credit cooperatives in 1994, the Central Bank Governor had assured the public that BOJ funds would not be used to bail out failed firms, but only to maintain financial stability.[121] In practice, the government appears to have seen the latter as a function of the former: *any* failure was a threat to stability. Often-cited institutional factors provide only part of the explanation.

Japanese banks and their customers had been linked for decades, some longer, in an elaborate pattern of cross-shareholding.[122] By some counts, over half of all public companies' shares could be found in the hands of their banks, their customers, and related firms; a relatively small percentage of all shares traded publicly in practice.[123] Although ownership links were common in the corporate sector and not limited to public companies, they were especially strong among financial firms: in the early 1990s, banks' largest equity holdings were overwhelmingly in other financial institutions.[124]

The avowed purpose of cross-shareholding was to foster stability. Stability in turn had several dimensions. First, it could be a vehicle for promoting financial stability through access to credit, a form of mutual assistance. Second, it was justified as a way of warding off hostile takeovers. Third, cross-shareholding was a means of commitment: it fostered long-term business dealings and reinforced existing contractual links, for example, between suppliers and their customers, or banks and their borrowers.[125]

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[120] *Id.* at 22.

[121] *Id.* at 5.

[122] For a more in-depth discussion of Japanese cross-shareholding, see generally J. Mark Ramseyer, *Cross Shareholding in the Japanese* Keiretsu (Harvard Law School John M. Olin Center for Law, Econ. and Bus. Discussion Paper Series, Paper No. 244, 1998), *available at* http://lsr.nellco.org/cgi/viewcontent.cgi?article=1032&context=harvard/olin (explaining the functions and purpose of the Japanese keiretsu); U.N. Dep't of Econ. & Soc. Affairs [DESA], *Bank-firm Cross-shareholding in Japan: What Is It, Why Does It Matter, Is It Winding Down?*, U.N. Doc. ST/ESA/1999/DP.15 (Feb. 2001) [hereinafter DESA Discussion Paper] (*prepared by* Mark Scher), *available at* http://www.un.org/esa/desa/papers/2001/esa01dp15.pdf (examining the development of cross-shareholding involving Japan's commercial banks, and the problems accompanying the practice). Cross-shareholding has roots in the history of Japanese corporate organization; however, it evolved and adapted in response to legal reform and foreign investment after World War II. *See, e.g.*, Scher, *supra*, at 4–5 (explaining the evolution of cross-shareholding from World War II through the 1990s).

[123] *See* DESA Discussion Paper, *supra* note 122, at 1–2 (citing 65–70% as the level of "quiescent stable shareholding" in publicly traded firms). Hugh Patrick cites a lower percentage than Scher, but still above 50% for financial firms in the 1980s and 1990s. Patrick, *supra* note 98, at 10–12.

[124] Patrick, *supra* note 98, at 11; DESA Discussion Paper, *supra* note 122, at 15 ("Fifteen out of the top sixteen companies in which city, regional and long-term credit banks held shares were in fact other financial institutions . . . .").

[125] *See* ENCYCLOPEDIA OF JAPANESE BUSINESS AND MANAGEMENT 96–99, 318–319 (Alan Bird, ed., 2001) (defining and explaining "cross-shareholdings" and "mochiai"); Japan Economic Planning Agency, *White Paper: Economic Survey of Japan, (1991–1992)* 180–181 (1992); *see also* Ramseyer, *supra* note 122, at 16–17, 19–20 (discussing cross-shareholding in supplier relationships).

The functions and efficacy of cross-shareholding and other linkages among Japanese firms are debated in a large literature.[126] For purposes of this case study, cross-shareholding is interesting as a variant of interconnectedness that affects crisis management in many countries. In Japan, the practice of cross-shareholding, along with the financial and other business relationships it sought to bolster, appeared to make it more difficult for the system to countenance individual failure, to encourage continued lending to weak firms,[127] and to make financial institutions generally more prone to peer and government pressure to maintain confidence.[128] Cross-shareholding was far from the only means of interconnectedness or the most important barrier to individual failure in Japan, yet it offers an especially stark illustration of the predicament.

The commitment device seemed to work as designed. Quite apart from any "soft" rescue norm, the "hard" contractual and ownership links helped transmit individual failure far and wide.[129] Private sector executives described themselves as bound by a public duty to maintain confidence in the face of cascading bad news. Thus the head of LTCB explained his decision to pay dividends while the bank was insolvent as a matter of protecting the system. If he failed to pay, he would be responsible for bringing down other banks, firms and perhaps the economy as a whole.[130] But even where failure could not be avoided—as in the Yamaichi bankruptcy and the ultimate nationalization and sale of LTCB—the government scrupulously paid up on the firms' contracts, for fear that interconnectedness would bring down others and further disrupt the

[126] *See, e.g.*, Masahiro Aoki et al., *The Japanese Main Bank System: An Introductory Overview*, *in* THE JAPANESE MAIN BANK SYSTEM: ITS RELEVANCE FOR DEVELOPING AND TRANSFORMING ECONOMIES (Masahiro Aoki & Hugh Patrick, eds., 1994); Ronald J. Gilson & Mark J. Roe, *Understanding the Japanese* Keiretsu*: Overlaps Between Corporate Governance and Industrial Organization*, 102 YALE L.J. 871, 872, 874–75 (1993) (discussing the purpose and functions of the Japanese keiretsu); Yoshiro Miwa & J. Mark Ramseyer, *The Myth of the Main Bank: Japan and Comparative Corporate Governance*, 27 LAW & SOC. INQUIRY 401, 403–04 (2002) [hereinafter *The Myth of the Main Bank*] (discussing the role of the "main bank" in Japanese keiretsu groups); Yoshiro Miwa & J. Mark Ramseyer, *Does Relationship Banking Matter? The Myth of the Japanese Main Bank*, 2 J. EMPIRICAL LEGAL STUD. 261, 285–97 (2005) [hereinafter *Does Relationship Banking Matter?*] (arguing that the main bank "insurance" function is a fiction); *see also* DESA Discussion Paper, *supra* note 122, at 10(citing to interviews with Japanese bankers).

[127] Joe Peek & Eric Rosengren, *Crisis Resolution and Credit Allocation: The Case of Japan*, *in* SYSTEMIC FINANCIAL CRISES 305 (Patrick Honohan & Luc Laeven eds., 2005).

[128] Patrick writes more broadly about the challenge of overcoming "embedded relationships" in crisis. Patrick, *supra* note 98, at 22–24; *see also generally* NAKASO, *supra* note 5; TETT, *supra* note 4 (citing examples of contractual and ownership links between LTCB and real estate clients as crisis transmission mechanisms and policy constraints).

[129] TETT, *supra* note 4, at 59, 87, 105; Patrick, *supra* note 98, at 22–24 (discussing "embedded relationships). It seems fitting that the bookends of Japan's slow-motion financial collapse—the failure of two credit cooperatives in 1994 and of LTCB in 1998—were connected. LTCB had an undisclosed equity stake in Tokyo Kyowa; all three also shared a big client, a real estate company that ultimately destroyed them all. TETT, *supra* note 4, at 72–73.

[130] TETT, *supra* note 4, at 112.

markets.[131]

In the background, forbearance permeated the regulatory fabric. Senior officials expected to assume high posts with commercial banks upon retiring from public service.[132] Leading up to the crisis, financial sector and official actors understood the prevailing "convoy regulation" system as a way for the government to ensure the survival of even the weakest banks; the banks in turn accommodated government lending priorities.[133] In crisis, the government supported "flexible" accounting and coordinated "voluntary" rescues among regulated institutions.

In sum, Japan was in a peculiar position of resisting comprehensive crisis response where single-firm failure was seen as a threat to the system in financial and political terms. This resulted in ad-hoc, case-by-case rescues that added up to a wholesale bailout of the financial sector. Those that borrowed from Japanese banks at the height of the real estate bubble—small and midsize firms that did not have access to the capital markets, real estate and financial firms, and some individual borrowers[134]—appeared to benefit disproportionately from the infusion of government money.

In Japan, as in many other crisis countries, banks were poorly capitalized and underprovisioned; the deposit insurance and investor protection funds were small and broke; and until 1998, the government had limited power to take over and restructure failed institutions. Interconnectedness and mutual assurance were presented, for a time, as an effective substitute for capital cushions and public insurance. But just as the most generous capital cushions and insurance schemes prove inadequate in a severe crisis, mutual assurance—if it ever worked[135]—fails when everyone is under water. It can also constrain crisis response: when offered public recapitalization funds in early 1998, "all major banks . . . applied for capital injection in order to avoid the risk of being singled out as a weak bank,"[136] spreading thin the already limited support. What might have been narrowly targeted measures became wholesale.

Japanese authorities are routinely accused of dawdling for a decade; the social and political context gets blamed for slowing and muting the crisis response. But viewed from another angle, Japan had a predictable reaction to an ordinary predicament. For as long as officials believed that

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[131] NAKASO, *supra* note 5, at 12–13.

[132] The practice was called "descent from heaven." Int'l Monetary Fund [IMF], Monetary & Exchange Affairs Dep't, *Working Paper: The Japanese Banking Crisis of the 1990s: Sources and Lessons*, 26 n.47 (IMF Doc. WP/00/7 Jan. 2000) (*prepared by* Akihiro Kanaya & David Woo), *available at* http://www.imf.org/external/pubs/ft/wp/2000/wp0007.pdf.

[133] NAKASO, *supra* note 5, at 2, 17.

[134] Shimizu, *supra* note 113, at 61–71.

[135] Miwa & Ramseyer argue strongly that it never existed, at least in the "main bank" institution. *See generally The Myth of the Main Bank*, *supra* note 126 (commenting that Masahiko Aoki's "main bank" theory does not accurately describe Japan).

[136] NAKASO, *supra* note 5, at 12

there was nothing they could do about the crisis, they had no reason to acknowledge its true magnitude.[137] They resorted to regulatory forbearance and measures meant to avoid losses, such as central bank liquidity support and mutual assistance among banks. As more firms teetered on the brink, the government adopted by default a policy of rescuing everyone, and paid failed institutions to perform under financial contracts that would have been breached without government help. This increased the total magnitude of financial sector losses and progressively shifted them onto the general public. More radical measures had to wait for the political system to adjust to the magnitude of the crisis, which took more and bigger failures and failed rescues.

C. *United States 1933*

Franklin Delano Roosevelt took office more than three years after the stock market crash, when the economy had shrunken by half, five thousand banks had failed, states and companies printed scrip, and Mexican money circulated in the United States.[138] In some industrial cities, over 70% of all workers were unemployed. Farmers with pitchforks stormed courthouses to block foreclosures. Lloyd's of London sold riot insurance in America.[139] Crisis denial was not an option.

Despite popular perception to the contrary, the Hoover Administration had not stood idle since 1929. Towards the end of his term, Hoover boosted federal construction, tried to raise agricultural prices, and sought new funding for the mortgage market under the Federal Home Loan Bank Act. He also preceded FDR in using military metaphor to fight economic malaise. In December 1931, Hoover proposed to establish the Reconstruction Finance Corporation, modeled after the War Finance Corporation of World War I, to channel money to banks, municipalities and railroads.[140] Yet the government response was generally limited to voluntary programs, exhortations, and subsidies for intermediaries. Hoover opposed outright mandates for banks and government relief

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[137] *See* Adam S. Posen, *Introduction: Financial Similarities and Monetary Differences*, *in* JAPAN'S FINANCIAL CRISIS AND ITS PARALLELS TO U.S. EXPERIENCE, *supra* note 113, at 1, 7–10 (setting aside monetary policy and discussing how a policy of regulatory forbearance failed to contain Japan's financial crisis).

[138] WILLIAM E. LEUCHTENBURG, FRANKLIN ROOSEVELT AND THE NEW DEAL 18, 42 (1963) [hereinafter LEUCHTENBURG, ROOSEVELT].

[139] WILLIAM E. LEUCHTENBURG, THE PERILS OF PROSPERITY 1914–1932, at 247, 261–62 (1958) [hereinafter LEUCHTENBURG, PROSPERITY].

[140] The idea to revive the War Finance Corporation originally came from Federal Reserve Chairman Eugene Meyer. James L. Butkiewicz, *The Impact of a Lender of Last Resort During the Great Depression: The Case of the Reconstruction Finance Corporation*, 32 EXPLORATIONS IN ECON. HIST. 197, 199 (1995). LEUCHTENBURG, PROSPERITY, *supra* note 139, at 257–58. Although RFC support may have slowed the rate of failure among recipients, it did not spur net new lending, since the banks had become risk-averse. *Id*.

payments to individuals.[141] Instead, he tried to jawbone financial industry captains over dinner and to shame them with Congressional probes.[142] Hoover also set up a vehicle for the strong banks to help the weak (they did not).[143]

States filled the void with mandates of their own. By the time of Roosevelt's inauguration, many had imposed foreclosure moratoria; nearly all had some form of banking restrictions.[144]

FDR's inaugural address on March 4 was laced with war imagery and broadsides against "money changers."[145] On March 5, he used wartime emergency powers to declare a national bank holiday.[146] In the words of one historian, "[t]he very totality of the bank holiday helped snap the tension the country had been under all winter."[147] The same measure banned transactions in gold as a first step to dollar devaluation.[148] News

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[141] LEUCHTENBURG, PROSPERITY, *supra* note 139, at 252, 257–58; BARRIE A. WIGMORE, THE CRASH AND ITS AFTERMATH: A HISTORY OF SECURITEIS MARKETS IN THE UNITED STATES, 1929–1933, 209–12 (1985).

[142] LEUCHTENBERG, PROSPERITY, *supra* note 139, at 251–59; SELIGMAN, *supra* note 66, at 8–9, 11–13 (describing Hoover's dinners with bankers and stock exchange officials and his role in launching Senate Banking Committee hearings into Wall Street misdeeds).

[143] LEUCHTENBURG, PROSPERITY, *supra* note 139, 257–58; Butkiewicz, *supra* note 140, at 199 (describing, among other things, the establishment of the National Credit Corporation); *cf.* Robert F. Bruner & Sean D. Carr, *Lessons from the Financial Crisis of 1907*, 19 J. OF APPLIED CORP. FIN. 115, 122 (2007) (describing the efforts of J.P. Morgan and other New York bankers to stop market panic in 1907 by backing weaker institutions); NAKASO, *supra* note 5, at 1, 10–11 (describing Japanese government policies encouraging strong banks to rescue weak ones); Grace Wong, *Wall Street Superfund: Not So Super*, CNNMONEY, Oct. 22, 2007, http://money.cnn.com/2007/10/22/markets/super_fund/index.htm (describing a U.S. Treasury Department effort to get banks to pool resources to buy distressed financial assets, announced on October 15, 2007).

[144] BARRY EICHENGREEN, GOLDEN FETTERS: THE GOLD STANDARD AND THE GREAT DEPRESSION 1919–1939, 329 (1996); LEUCHTENBURG, ROOSEVELT, *supra* note 138, 38–39, 42–43 (1963).

[145] Franklin Delano Roosevelt, President of the United States, First Inaugural Address (Mar. 4, 1933), *available at* http://www.archives.gov/education/lessons/fdr-inaugural/ [hereinafter Franklin Delano Roosevelt's First Inaugural Address]; *see* Belknap, *supra* note 36, at 67–68 (describing the war analogy).

[146] Bank Holiday, March 6–9, 1933, Inclusive, Proclamation No. 2039, 48 Stat. 1689–91 (1933); Trading with the Enemy Act, ch. 106, 40 Stat. 411 (1917) (codified as amended at 12 U.S.C. § 95 et seq. (2000)); Belknap, *supra* note 36, at 73. Roosevelt approved the issuance of the proclamation on the afternoon of Sunday, March 5. LEUCHTENBURG, ROOSEVELT, *supra* note 138, at 42 (1963).

[147] LEUCHTENBURG, ROOSEVELT, *supra* note 138, 42 (1963).

[148] Bank Holiday, March 6–9, 1933, Inclusive, Proclamation No. 2039, 48 Stat. 1689–91 (1933); Trading with the Enemy Act, ch. 106, 40 Stat. 411 (1917) (codified as amended at 12 U.S.C. § 95 (2000)); Belknap, *supra* note 36, at 73. Roosevelt did not formally devalue until January 30, 1934, after a series of interim legislative and executive measures. *See* Agricultural Adjustment Act, 73 Pub. L. No. 10, 48 Stat 31 (1933) (giving the Executive discretion to inflate); Gold Reserve Act, 48 Stat. 337 (1934) (mandating a 40% minimum reduction in the gold value of the dollar). For a discussion of the Administration's gold buying program and other initiatives to promote commodity price inflation, see, for example, ARTHUR M. SCHLESINGER, JR., THE COMING OF THE NEW DEAL 1933–1935, 197–252 (1959); LEUCHTENBURG, ROOSEVELT, *supra* note 138, at 78–84 (1963); *see also* Kenneth W. Dam, *From the Gold Clause Cases to the Gold Commission: Half Century of American Monetary Law*, 50 U. CHI. L. REV. 504, 512–15 (1983).

headlines warned of "Prison for Gold Hoarder."[149] Legislation validating the President's actions and expanding his authority passed the Congress "sight unseen" on March 9 in an atmosphere that evoked "great war measures."[150] Sticks joined words and carrots in the containment toolkit.

Roosevelt's primary objective in delinking the dollar from gold was to inflate agricultural commodity prices.[151] The move was also part of a national recovery policy that sought to redistribute power away from New York bankers to Western farmers and entrepreneurs;[152] it was moreover a nationalist bid for policy autonomy amid the crumbling international gold standard.[153] In the Administration's way lay over $100 billion in face value of government and private debt contracts that gave creditors the option of payment in gold at the rates prevailing when the contract was made.[154] Such "gold clauses" had become boilerplate after the last bout of dollar devaluation following the Civil War;[155] by 1933, they were in over half of all debt, totaling more than 130% of GDP.[156] The U.S. government was the largest debtor affected, with $22 billion in gold clause debt in June 1933, followed by state and municipal governments at $14 billion, railroads at $11 billion, $34 billion for other domestic corporations, and $10 billion issued by foreign entities.[157]

The clauses were designed as a hedge against precisely the sort of move contemplated by FDR.[158] They were a policy problem because they had become ubiquitous:[159] if they were enforced, public and private debt

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[149] *Use of Scrip Authorized: President Takes Steps Under Sweeping Law of War Time*, N.Y. TIMES, Mar. 6, 1933, at 1.

[150] LEUCHTENBURG, ROOSEVELT, *supra* note 138, at 43–44 (1963).

[151] *Id.* at 48; *see also* Dam, *supra* note 148, at 511–13 (1983). For a contemporary perspective, see Charles S. Collier, *Gold Contracts and Currency Regulation*, 23 CORNELL L. Q. 520, 528, 532 (1937–1938) (describing the Joint Resolution's objective as "*reflation of prices*").

[152] SCHLESINGER, *supra* note 148, at 233.

[153] *See generally* EICHENGREEN, *supra* note 35; SCHLESINGER, *supra* note 148, at 199–200, 221.

[154] *Gold Obligations Are $100,000,000,000; Federal Bonds Total $22,000,000,000*, N.Y. TIMES, May 27, 1933, at 2; Randall S. Kroszner, Is it Better to Forgive than to Receive? An Empirical Analysis of the Impact of Debt Repudiation 2, 6 (Nov. 2003) (unpublished manuscript, on file with the University of Chicago Graduate School of Business), *available at* http://faculty.chicagogsb.edu/randall.kroszner/research/repudiation4.pdf. Some of the clauses were drafted to require payment in gold; others permitted payment of the specified gold value in paper dollars. The second category presented a more difficult problem for the government in later litigation.

[155] *Ignore Indenture Payable in Gold: Agents for Bonds with Coupons Due Fail to Give Coin When Demand Is Made; Court Action Possible; Issues of French Municipalities Soar in Price on Offer to Settle in Metal*, N.Y. TIMES, May 2, 1933, at 2 (describing "the familiar clause"); Knox v. Lee and Parker v. Davis (*Legal Tender Cases*), 79 U.S. 457 (1871); *see also* Juilliard v. Greenman (*Legal Tender Case*), 110 U.S. 421, 436, 449 (1884) (describing the post-Civil War acts passed by Congress to address dollar devaluation); *see* Levy, *supra* note 36 (discussing the *Legal Tender Cases*).

[156] Dam, *supra* note 148, at 523 (citing 55% of all debt); Kroszner, *supra* note 155 (citing two-thirds).

[157] *Gold Obligations Are $100,000,000,000; Federal Bonds Total $22,000,000,000*, N.Y. TIMES, May 27, 1933, at 2; Kroszner, *supra* note 154, at 2.

[158] Norman v. Balt. & Ohio R.R. Co., 294 U.S. 240, 302 (1935); John P. Dawson, *The Gold Clause Decisions*, 33 MICH. L. REV. 647, 662–63 (1934–1935); Dam, *supra* note 148, at 522–23.

[159] *Text of the Two Reports on the Gold Resolution*, N.Y. TIMES, May 30, 1933, at 2:

stock would rise by as much as 69% when the dollar fell against gold, triggering mass bankruptcy.[160] On June 5, Congress passed and Roosevelt signed a Joint Resolution that made gold clauses in public and private debt unenforceable as against public policy.[161] It was rushed through to allow the Treasury to issue new debt without the clauses on June 15.[162] Commodities rallied briefly;[163] creditors sued.

The first federal ruling came a year later when a district court in St. Louis held that a railroad's promise to pay in gold was no more enforceable in the aftermath of the Joint Resolution than a promise to pay "100 piculs of Chinese opium."[164] Within months, four appeals were joined before the Supreme Court: two suits on railroad bonds (including the consolidated Missouri appeal), and two on U.S. government obligations.[165]

In all four cases, the creditors claimed due process and takings violations; on the editorial pages, they pressed the image of a bank depositor arbitrarily denied access to his money.[166] To the President and his allies, they were "no better than racketeers" trying to finagle $1.69 for their dollar.[167]

For the Court, the private obligations presented the simplest problem.[168] They plainly had to give way to Congress, since all those

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> If the gold clause applied to a very limited number of contracts and security issues, it would be a matter of no particular consequence, but in this country virtually all obligations, almost as a matter of routine, contain the gold clause. In light of … [pervasive gold hoarding and capital flight], … no currency system … can meet the requirements of a situation in which many billions of dollars of securities are expressed in a particular form of the circulating medium, particularly when it is the medium upon which the entire credit and currency structure rests.

160 *See, e.g.*, Kroszner, *supra* note 154, at 2.

161 H.J. Res. 192, 73d Cong., ch. 48, 48 Stat. 112 (1933). The operative portion read:

> Resolved . . . That (a) every provision contained in or made with respect to any obligation which purports to give the obligee a right to require payment in gold or a particular kind of coin or currency, or in an amount in money of the United States measured thereby, is declared to be against public policy; and no such provision shall be contained in or made with respect to any obligation hereafter incurred. Every obligation, heretofore or heareafter incurred, whether or not any such provision is contained therein or made with respect thereto, shall be discharged upon payment, dollar for dollar, in any coin or currency which at the time of payment is legal tender for public and private debts. Any such provision contained in any law authorizing obligations to be issued by or under authority of the United States, is hereby repealed . . . .

162 *Roosevelt Signs Gold Clause Ban: Resolution, Rushed to Cover June 15 Federal Issue, Put Into Effect Quickly; 'Repudiation' Is Denied*, N.Y. TIMES, June 6, 1933, at 35.

163 SCHLESINGER, *supra* note 148, at 236.

164 *In re* Missouri Pacific R. Co., 7 F. Supp. 1, 9 (E.D. Mo. 1934); *Court Knocks Out Bond Gold Clause*, N.Y. TIMES, June 20, 1934, at 1.

165 Norman v. Balt. & Ohio R.R. Co. and United States v. Bankers Trust Co., 294 U.S. 240 (1935); Nortz v. United States, 294 U.S. 317 (1935); Perry v. United States, 294 U.S. 330 (1935).

166 Norman C. Norman, *Our Gold Certificates*, Letter to the Editor, N.Y. TIMES, June 1, 1933.

167 ARTHUR MEIER SCHLESINGER, JR., THE POLITICS OF UPHEAVAL 256 (1960).

168 Seth P. Waxman, *The Physics of Persuasion: Arguing the New Deal*, 88 GEO. L.J. 2399, 2416 (2000) (arguing that the private contracts cases were the easiest of the Gold Clause lot). For a similar

subject to "national power"—including private parties, states and municipalities—contracted subject to the Congress's powers to regulate commerce, and certainly to establish the value of money. Chief Justice Hughes wrote for the majority:

> There is no constitutional ground for denying to the Congress the power expressly to prohibit and invalidate contracts although previously made, and valid when made, when they interfere with the carrying out of the policy it is free to adopt.[169]

Two aspects of the opinion stand out for purposes of this discussion. First, despite explicit reference to emergency in the preamble to the Joint Resolution, the Court refused to carve out a temporary emergency regime for contract abrogation.[170] This followed from the court's reliance on the last of the Legal Tender Cases, *Juilliard v. Greenman*, which upheld the government's power after the Civil War to issue paper money and make it legal tender in peacetime.[171] Second, also flowing from *Juilliard*, the Court would not limit the ruling strictly to the Congress's power to coin money. Instead, it affirmed Congressional capacity to strike contracts that interfered with its macroeconomic powers, broadly defined.[172]

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view from a contemporary, see, for example, John Dickinson, *The Gold Decisions*, 83 U. PA. L. REV. 715, 720 (1935) and Dawson, *supra* note 158, at 664.

[169] *Norman*, 294 U.S. at 309–10, (1935).

[170] *Cf.* Summary of the brief of Bankers Trust in Norman v. Balt. & Ohio R.R. Co. and United States v. Bankers Trust Co., 294 U.S. 240:

> This Resolution is not, and does not purport to be, an emergency measure. Besides, if this were an emergency measure, it would end with the emergency and then the Railway Company would have to pay these bondholders what it agreed to pay. But it purports to be legislation for all time.

[171] Juilliard v. Greenman, 110 U.S. 421, 450 (1884).

[172] Norman v. Baltimore & Ohio R.R. Co., 294 U.S. 240, 303 (1935). Congress clearly had the power to invalidate private contracts retroactively where they interfered with legitimate exercise of government power. One contemporary commentator stressed that in all four cases, the majority and the dissent broke over whether the clauses did in fact interfere with any government power, and what that power was. *See generally*, Collier, *supra* note 151. Most agreed that the powers to coin currency and establish its value were central to the decision; however, under *Juilliard*, these were derived not just from the coinage power, but also from the taxing and borrowing powers of the government, among others. *Norman* after *Juilliard* essentially cited the entire macroeconomic remit as the source of Congressional power at issue. As noted earlier, most elite legal observers at the time considered *Norman* an easy case and were not surprised by the outcome. *See, e.g.*, Dawson, *supra* note 158, at 664, 676 n.57 ("That the gold-clause resolution would be sustained by the Supreme Court was predicted in all the published discussions of the subject"); *see also* Dickinson, *supra* note 168, at 716; Richard Friedman, *Switching Time and Other Thought Experiments: The Hughes Court and Constitutional Transformation*, 142 U. PA. L. REV. 1891, 1924 (1994) ("For the Justices that had constituted the majority in *Blaisdell*, this was an easy case."). The same view would likely prevail today. *See, e.g.*, Alan R. Burch, *Purchasing the Right to Govern: Winstar and the Need to Reconceptualize the Law of Regulatory Agreements*, 88 KY. L.J. 245, 285 & n.153 ("The Supreme Court has consistently applied rational basis review and upheld federal laws that trample quite blatantly on private contractual obligations," citing among others Pension Benefit Guaranty Corp. v. R. A Gray & Co., 467 U.S. 717 (1984)).

The clear and muscular tone of *Norman* was in contrast to the Chief Justice's argument in *Perry v. U.S.*, a suit to enforce gold clauses in the government's World War I Liberty Bonds.[173] Hughes first held on due process grounds that stripping the gold clauses from government debt was repudiation, exceeding any Congressional power over currency.[174] Yet he also wrote that the Congress's action caused the creditors no compensable damage, since government restrictions on gold made it impossible for creditors to obtain gold coin or sell it for paper dollars above the government-established value. Moreover, deflation had increased the purchasing power of the dollar: in the minds of many (apparently including the Court), this would create a double windfall for the gold clause creditor.[175]

Justice Stone's concurrence barely disguised contempt for all the casuistry. He would rather have ruled simply that the government's power to issue enforceable debt could not trump its monetary power. Most prominent critics agreed with Stone.[176] In an emotional dissent and still more emotional remarks from the bench, Justice McReynolds compared FDR to Nero and declared the Joint Resolution an exercise in lawlessness, rights-trampling and repudiation.[177] His opinion for the four dissenters

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[173] Another case involving gold certificates issued by the government was disposed of quickly on the theory that the certificates required payment in gold, whose value was determined solely by the U.S. government, and which were tendered before the devaluation of 1934. Unable to sell gold on the world markets, the creditor sustained no meaningful loss and was therefore not entitled to sue in the Court of Claims. Norz v. United States, 294 U.S. 317 (1935). *Perry* potentially involved payment of gold value in paper dollars in connection with an obligation tendered after devaluation.

Between the passage of the Joint Resolution and the time the cases were heard, the government's gold clause debt had gone down to $12 billion, and was less than half the total debt stock as a result of refinancing with new, clause-free debt. Perry v. United States, 294 U.S. 330, 349 (1935).

[174] *Perry*, 294 U.S. at 350, 354. Hughes wrote that removing the gold clauses violated "a fundamental principle" guaranteeing "the integrity of the public obligations," which he derived from the government's power to incur debt and the statement that such debt was inviolable. The due process clause of the Fourteenth Amendment was "confirmatory" of the fundamental principle. *Id.*; *see also* David P. Currie, *The Constitution in the Supreme Court: The New Deal, 1931–1940*, 54 U. CHI. L. REV 504, 539 (1987) (a summary of reactions to *Perry* among legal scholars in the 1930s).

[175] Dam, *supra* note 148, at 517, 525.

[176] Perry, 294 U.S. at 359–61 (Stone, J., concurring). SCHLESINGER, *supra* note 167, at 259. Stone privately disapproved of the gold measure. BARRY CUSHMAN, RETHINKING THE NEW DEAL COURT 35 (1998). Hughes' opinion attracted scathing criticism for incoherence, and for leaving the door open to future lawsuits should the paper dollar decline in purchasing power terms. *See generally* Dawson, *supra* note 158; Dickinson, *supra* note 168; Henry M. Hart, Jr., *Gold Clause in United States Bonds*, 48 HARV. L. REV. 1057 (1934–1935). Judge Learned Hand complemented Stone and scoffed at Hughes' attempt to "trick up" government debt: "'Everybody dealing with a sovereign knows he is dealing with a creature who can welch if he wants to welch. To trick up a lot of international stuff as though it were law frankly makes me puke, as dear old Holmes used to say.'" SCHLESINGER, *supra* note 167, at 259–60; *see also* Friedman, *supra* note 172, at 1926, n.173; Currie, *supra* note 174, at 539.

[177] McReynolds' passionate extemporaneous remarks were originally reported in the Wall Street Journal; a toned-down version appeared as the official dissent in the cases. Perry, 294 U.S. at 361 (McReynolds, J., dissenting); LEUCHTENBURG, ROOSEVELT, *supra* note 138, at 144; ; SCHLESINGER, *supra* note 168, at 260; *Justice McReynolds' Remarks on Gold Case Decision*, WALL ST. J., Feb. 23, 1935, at 1.

covered all four cases; he found none more sympathetic than the other.

The contrast between the majority's construction of the gold clause episode, especially in *Norman*, as an exercise in regulation, and the dissent's view of the same episode as a suspension of legality, is instructive. It is essentially the difference between ordinary regulation and emergency discussed earlier in this article. Yet the incident was neither ordinary nor lawless.

All the Gold Clause Cases, but especially *Norman*, differed from the Court's earlier validation of state foreclosure moratoria. In *Home Building & Loan v. Blaisdell*, decided a year earlier, Hughes writing for the majority upheld Minnesota's 1933 extension of the debtors' right to redeem real property from foreclosure as a valid exercise of state police power in an emergency.[178] To be sure, the Court was construing the Constitution's explicit bar on state interference with private contracts.[179] The Minnesota law also specifically limited itself to the duration of the emergency. In the Gold Clause Cases and *Blaisdell* alike, emergency provided the context for the exercise of existing government power. In *Blaisdell* unlike the others, it also provided the predicate and the time window.[180]

Blaisdell moreover represented a different sort of interference in contracts. Minnesota's suspension of mortgage enforcement was discretionary and case-by-case, in the hands of a judge responding to a specific debtor's application for relief.[181] In contrast, the legislative history of the Joint Resolution, the arguments for the debtors and creditors, and the opinions in the Gold Clause Cases all emphatically divorced the government measure from any given party's capacity to perform. The gold clauses were a problem for the government across the board; all were stricken wholesale.[182]

The immediate distribution effects of the gold measure are hard to discern. On its face, the Joint Resolution was a radical move to transfer wealth from creditors to debtors.[183] But who exactly held the debt and

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[178] Home Bldg. & Loan Ass'n. v. Blaisdell, 290 U.S. 398 (1934).

[179] U.S. CONST. art. I, § 10.

[180] Home Bldg. & Loan Ass'n., 290 U.S. at 420; *see* GROSS & NI AIOLAIN, *supra* note 36, at 76–77 (describing *Blaisdell* as an instance of "interpretive accommodation" of emergency powers by the judiciary).

[181] Home Bldg. & Loan Ass'n., 290 U.S. at 417–19. Later some scholars argued that the judiciary was the more appropriate branch to deal with unsustainable gold clause contracts, and criticized the wholesale approach of the Joint Resolution: "A legislature, by its very nature, can have no knowledge of the intent of parties to individual private contracts, the very kind of factual determination courts are specially suited to decide." GOLD, MONEY AND THE LAW 5 (Manne & Miller eds., 1975).

[182] *Text of the Two Reports on the Gold Resolution*, N.Y. TIMES, May 30, 1933, at 2. For example, Hart argued that the Gold Resolution could have been upheld with respect to government debt because it "was made to apply evenhandedly to all obligations," including government and private bonds alike. Hart, *supra* note 176, at 1092.

[183] Dam, *supra* note 148, at 521. Although he explains the gold measure as primarily distributive, not monetary, Dam acknowledges the ambiguous outcome of distribution in this case. *Id*.

equity at the time? Despite heated populist rhetoric, beneficiaries included some of the country's richest men. This is in part because holding company pyramids that dominated corporate America at the time concentrated stock ownership in the hands of a few industry captains, and leveraged operating companies through massive bond issues and bank borrowing.[184] As the largest debtors, the U.S. government, states, municipalities, and foreign governments, benefited too, and with them their taxpayers.[185] Mortgagors and other individual debtors also had gold clauses in their long-term debt contracts and got relief; however, unlike corporate obligations, these are not documented in detail.

The losers were not all widows and orphans either, despite passionate speeches to the contrary from the Congressional opponents of the Joint Resolution.[186] Even as the Liberty Bond campaign and the 1920s boom brought new investors into the markets,[187] the actual number of retail bondholders at the time of the crash was relatively small, likely fewer than a million.[188] Banks, pension and insurance companies dominated; banks were especially vulnerable in light of their huge "security loan" operations, which effectively underwrote a large portion of the country's retail investing adventures.[189]

Notwithstanding any direct redistribution effected by the Joint Resolution, both stocks and bonds rallied on news of the Supreme Court decisions in the Gold Clause Cases.[190] Randall Kroszner's recent study of the market reaction suggested that the bondholders may have seen debt relief as contributing to their debtors' capacity to pay. Creditors also may have welcomed the certainty of having the abrogation question decided, and may have benefited directly from rising stock prices (according to another study, most corporate debt issues before the crash of 1929 had

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[184] *See, e.g.*, Am. Power & Light Co. v. SEC, 329 U.S. 90, 101–02 (1946) (describing the leverage problem in utility holding companies); EDWIN P. HOYT, JR., THE HOUSE OF MORGAN 375 (1966) (discussing the prevalence of holding companies in the corporate sector generally); SELIGMAN, *supra* note 66, at 129–30 (describing holding company structures). The effect of Roosevelt's gold policy on the debt stock of his companies may have contributed to J.P. Morgan's support for going off the gold standard. SCHLESINGER, *supra* note 148, at 202 (1958). High leverage was not limited to holding company pyramids. Baltimore & Ohio Railroad, one of the defendants in the Gold Clause Cases, was both notably leveraged and operationally vulnerable. WIGMORE, *supra* note 141, at 37.

[185] *Gold Obligations Are $100,000,000,000; Federal Bonds Total $22,000,000,000*, N.Y. TIMES, May 27, 1933, at 2.

[186] *Text of the Two Reports on the Gold Resolution*, N.Y. TIMES, May 30, 1933, at 2 (minority report).

[187] CHARLES CORTEZ ABBOTT, THE NEW YORK BOND MARKET 1920–1930, 52–53, 153 (1937); SELIGMAN, *supra* note 66, at 25.

[188] LEUCHTENBURG, PROSPERITY, *supra* note 139, at 241.

[189] ABBOTT, *supra* note 187, at 37–39, 154, 182–83. "Security loan" refers to bank lending for the purchase of securities, not the lending of securities themselves. *But see* WIGMORE, *supra* note 141, at 287, 552–53 (describing small bank sales of railroad bonds in 1931, and banks' withdrawal from the corporate bond market in favor of U.S. Treasuries).

[190] *See generally* Kroszner, *supra* note 154.

equity "kickers").[191]

The real distributive significance of the gold policies likely went beyond the parties to the gold clause obligations. As noted earlier, it was about the relative power of bankers, farmers and upstart entrepreneurs, and the structure of the economy to come.

D. *Argentina 2001–-2002*

Kroszner's study of market response to the Gold Clause Cases began making the rounds in the late 1990s, with obvious policy relevance in the wake of the Asian financial crisis.[192] However, it was not until Argentina's foreign bond default and mass redenomination of domestic dollar contracts in 2001-2002 that FDR's gold lessons were applied directly in a contemporary context.[193]

To put Argentina's latest crisis response in context, it helps to go back to another crisis a decade earlier. Facing hyperinflation, a mountain of debt and a spate of bank runs, Argentina imposed a bank holiday and mandated the exchange of domestic term bank deposits into government bonds in January 1990.[194] When depositors sued, Argentina's highest court reached for its own 1930s jurisprudence, which upheld a foreclosure moratorium and interest rate caps on economic emergency grounds. The 1934 Argentine ruling relied explicitly on *Blaisdell* and a doctrine of economic emergency.[195]

In an effort to stabilize prices and perhaps prevent future crises, Argentina pegged its currency at par to the U.S. dollar. Initially successful against hyperinflation, this "convertibility" regime framed Argentine politics and economic development in the 1990s. But in the second half of the decade, the dollar gained in value as Argentine exports stagnated. The government was locked into massive fiscal transfers.

After a series of external shocks and four years of recession, Argentina defaulted on $100 billion in debt and abandoned convertibility on Christmas Eve 2001. The legislature also passed a law converting dollar-denominated debts under $100,000 into pesos at 1:1. In February 2002,

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[191] WIGMORE, *supra* note 141, at 27.

[192] The paper was presented at the Federal Reserve Bank of Chicago Annual Conference on Bank Structure and Competition in May 1999, entitled "Global Financial Crises: Implications for Banking and Regulation" (program at http://www.chicagofed.org/news_and_conferences/conferences_and_events/bsc_1999.cfm).

[193] Calomiris et al., *supra* note 58, at 14 (citing Kroszner's study in the Argentina case study); Kroszner, *supra* note 154, at 1, 4–6 (drawing a parallel between the gold clause episode and Argentina's "pesoification").

[194] Int'l Monetary Fund Pol'y Dev. & Rev. Dep't, *Sovereign Debt Restructurings and the Domestic Economy: Experience in Four Recent Cases* 14 (2002), *available at* http://www.imf.org/external/NP/pdr/sdrm/2002/022102.pdf (describing "Plan BONEX").

[195] Spector, *supra* note 11, at 135–38. The Contract Clause and federalism concerns of the U.S. constitution, prominent in *Blaisdell*, did not appear to migrate into Argentine jurisprudence.

the Executive promulgated an emergency decree redenominating all dollar contracts and bank deposits into deeply devalued pesos.[196] However, the "pesification" was asymmetric: debts to banks were converted 1:1, while deposits got a boost at 1:1.4. The reasons for the precise number difference are murky; the result was that at least initially, banks were stuck with subsidizing their debtors and their depositors to the tune of forty cents on the dollar.

During the last year before default, banks had suffered a series of runs and had become deeply undercapitalized. Bank owners complained bitterly about the asymmetric aspect of pesification and threatened to walk away from their banks. The government soon relented and issued domestic law, dollar-denominated compensation bonds to banks. The banks would carry the debt on their books at face value, despite the fact that the government was in default on $100 billion in foreign debt. On the other hand, the government scrupulously serviced over $20 billion in new domestic bonds even as it kept its old foreign bondholders out in the cold. This attempt to subordinate foreign creditors compounded the effects of debt reprofiling operations in late 2001, which allowed Argentina to separate domestic and foreign creditors and engage in selective default.[197]

The "pesification" measures had a profound economic impact because dollar contracts were so prevalent in Argentina before default. Pesification brought as much as 75% debt relief for large companies, but also for scores of small debtors. A recent study suggests that the measure also promoted quick resumption of investment by large firms, and contributed to the recovery of Argentina's banking sector.[198]

The legal fallout was somewhat more complex. Most of the emergency measures were ultimately upheld, though not before politically-charged personnel changes on the Argentine Supreme Court. The court continued to use its *Blaisdell*-inspired jurisprudence to imply broad emergency powers in the Executive to modify contracts.[199]

The Argentine courts' reliance on *Blaisdell* to uphold redenomination

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[196] *Id.* at 139; *The Republic of Arg.*, *Prospectus Supplement*, at 112–14 (Dec. 27, 2004), *available at* http://www.sec.gov/Archives/edgar/data/914021/000095012305000302/y04567e424b5.htm#108. *See* STURZENEGGER & ZETTELMEYER, *supra* note 32, at 182–86 (describing pesification, subsequent lawsuits and compensation awards).

[197] MICHAEL MUSSA, ARGENTINA AND THE FUND: FROM TRIUMPH TO TRAGEDY 42–49, 74–75 (2002); STURZENEGGER & ZETTELMEYER, *supra* note 32, at 177–87.

[198] *See generally* Calomiris et al., *supra* note 58 (comparing Argentina's case favorably with Mexico's in the aftermath of the 1994–1995 crisis; Mexico devalued, but did not redenominate, and suffered a much slower recovery of investment).

[199] Spector, *supra* note 11, at 142–44 (pointing to the reliance of the Argentine courts on Home *Building & Loan Ass'n v. Blaisdell* in the *Bustos v. Estado Nationale / amparo* and *Massa v. Poder Ejecutivo National—DecretoNo. 1.570/01* cases applying the doctrine of economic emergency (citations omitted)). However, in a handful of earlier and lower court cases, the government was mandated to pay compensation. Spector, *supra* note 11, at 140 (discussing *Smith v. P.E.N. / medidas cautelares* (citation omitted)).

is notable, since the U.S. case was decided under the Contract Clause and was heavily influenced by federalism concerns. *Norman* might have made for better precedent, if not a better transplant. The explanation may be as simple as timing: the leading Argentine case transplanting *Blaisdell* was decided in 1934, before the U.S. Supreme Court had spoken on the Gold Clause Cases. Like *Blaisdell*, the 1934 *Avico* case dealt with mortgage foreclosures.[200] Subsequent cases reviewing currency crisis measures cited to the 1934 domestic precedent. But there may be a thicker explanation, such as the Argentine legal system's preference for a distinct legal regime, specified ex-ante, to govern emergencies.[201] The *Norman* model of workaday regulation, which can look strained even at home, would not fit well with a state of siege regime for addressing financial crisis.

In retrospect, Argentina's approach to debt distress in the middle of its last currency crisis was unusual for making the government's distribution policies explicit. An early attempt to limit debt relief to small contracts gave way to general debt reduction, which at first was going to be funded out of bank capital.[202] When banks turned out to be insolvent and protested, the cost of the debtor subsidy shifted to the general public. This may have privileged large domestic firms and the middle class, who could borrow in dollars before the crisis, relative to the poor. Argentina's lengthy default on foreign bonds helped shift some cost onto foreign creditors.

E. *Mexico 1982*

Each of the four case studies so far has had an international dimension. Indonesia's currency collapse made its cross-border corporate debts unsustainable; Japan's failing financial firms were deeply enmeshed in the global and regional markets; the United States' gold policies were part of the demise of the international gold standard; and Argentina delinked its currency from the U.S. dollar and defaulted on its foreign bonds. My last case study offers a twist on cross-border crisis management.

What came to be known as the Third World Debt Crisis took up most of the 1980s and early 1990s.[203] Its origins are commonly traced to oil

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[200] Corte Suprema de Justicia [CSJN], 7/12/1934, "Avico, Don Oscar Agustín v. de la Pesa, don Saúl G. / sobre consignación de intereses," Fallos (1934-172-21) (Arg.), http://www.garridocordobera.com.ar/pagina_ nueva_572.htm.

[201] GROSS & NI AOLAIN, *supra* note 36, at 26–27 (discussing the use of the French "state of siege" model of emergency legality in Latin America, including Argentina); *see also* Spector, *supra* note 11, at 134.

[202] Spector, *supra* note 11, at 139.

[203] The crisis is the subject of an enormous literature, primarily in economics and political science. For an authoritative treatment by a law scholar, see ROSS P. BUCKLEY, EMERGING MARKETS DEBT: AN ANALYSIS OF THE SECONDARY MARKET 5–24 (1999). *See also generally* THE INTERNATIONAL DEBT CRISIS IN HISTORICAL PERSPECTIVE (Barry Eichengreen & Peter H. Lindert, eds., 1989) (providing an economic and political science perspective); DEVELOPING COUNTRY DEBT

price shocks of the 1970s, which filled U.S. and U.K. banks with deposits from oil-exporting economies. The influx of "petrodollars" in turn catalyzed a bank lending spree throughout the developing world, but especially in Latin America, where governments and private firms borrowed hundreds of billions of dollars from foreign banks.[204] A world recession and spiking interest rates in the lending countries brought the boom to a screeching halt in August 1982.

In the much-repeated account of one U.S. Treasury official, on August 13, 1982, Mexico's Finance Minister Jesus Silva Herzog "showed up on our doorstep and turned his pockets inside out."[205] Having borrowed upwards of $50 billion dollars from foreign banks,[206] Mexico was having trouble refinancing its debt, and was hemorrhaging reserves. After a week of intense talks with U.S. Treasury, Federal Reserve, and international officials, the Finance Minister told a room of 800 bankers in New York that Mexico was out of money, and asked for a 90-day moratorium on principal payments.[207] An advisory committee of large and highly exposed banks was formed to help coordinate the refinancing of private debt in tandem with support from the IMF and other foreign public sources.[208]

The wholesale, yet nominally voluntary, approach was orchestrated by U.S. and international finance officials. It became a model for crises to come. By October 1983, twenty-seven countries had followed in Mexico's footsteps.[209] The approach made sense because the debtors' problems were to an extraordinary degree the problems of the U.S. banking sector. In the words of one Mexican participant:

> We didn't crawl to the international financial community as debtors seeking relief through some minor adjustment that could be made backstage. We walked through the front door. We said we had a major problem with a capital P. We didn't say the problem was a particular debt. We said the problem

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AND ECONOMIC PERFORMANCE (Jeffrey D. Sachs ed., 1989) (economics); BARBARA STALLINGS & ROBERT R. KAUFMAN, DEBT AND DEMOCRACY IN LATIN AMERICA (1989) (political science); Jeremy Bulow & Kenneth Rogoff, *Multilateral Negotiations for Rescheduling Developing Country Debt: A Bargaining-Theoretic Framework*, 35 IMF STAFF PAPERS 644 (1988) (economics); Nelson, *supra* note 57 (political science).

[204] WILLIAM R. CLINE, INTERNATIONAL DEBT REEXAMINED 60 (1995) (listing Brazil, Mexico, Argentina, Venezuela and the Philippines as the five largest debtors, accounting for over 70% of total developing countries' external debt in 1982); *see also* KARIN LISSAKERS, BANKS, BORROWERS AND THE ESTABLISHMENT: A REVISIONIST ACCOUNT OF THE INTERNATIONAL DEBT CRISIS 84 (1991) (noting that most private sector debt was assumed by the governments in the course of the crisis).

[205] LISSAKERS, *supra* note 204, at 84.

[206] CLINE, *supra* note 204, at 61 (citing Bank for International Settlements statistics). This was over 50% of the size of the economy, and over 300% of Mexico's exports. *Id.* at 66. Other sources cite debt stock figures as high as $80 billion. JOSEPH KRAFT, THE MEXICAN RESCUE 4, 35 (1984).

[207] *See* KRAFT, *supra* note 206, at 21–22 (offering a detailed journalistic account of the drama surrounding Mexico's moratorium).

[208] *See id.*

[209] BUCKLEY, *supra* note 203, at 6.

> was the whole international financial structure. We said it was everybody's problem.[210]

This was not a wild exaggeration. In 1982, 17% of Chase bank's assets were in Latin America and the Caribbean; the figures were similar for Citicorp, Manufacturers Hanover, Chemical, and other major U.S. banks. Some of the largest U.S. banks derived a third of their net income in 1982 from operations in Latin America and the Caribbean, which had been growing rapidly over the previous decade.[211] U.S. bank exposure to developing country debt stood at 166% of total bank capital in 1982; Mexico alone accounted for over a third.[212] At a time when the U.S. banking system was undercapitalized, under-provisioned, and already straining from domestic economic pressures, a cascade of developing country defaults presented "the risk of a 1930s-style international financial crisis.[213]

In October 1982, the IMF proposed to lend Mexico more money, but only if the private banks would do the same. Just then, U.S. regulators let it be known that participating banks would not have to make loan-loss provisions on Mexican loans on the theory that concerted action would make Mexico a better credit prospect.[214] The public premise behind the initial concerted lending strategy was that the borrowing countries were illiquid, not insolvent, and capable of recovering without debt reduction.[215] The initial refinancings were thus negotiated case-by-case at market rates, which contributed to a sharp rise in the debt stock of the borrowing countries, which in turn exacerbated their economic decline.[216] Put differently, the new loans in the first instance stuck the Mexican government and its tax paying public with the full burden of unraveling foreign banks' risky loans. With U.S. banks lacking capital and loan-loss cushions, and with U.S. regulators unwilling to see mass bank failure, the initial response to developing country debt difficulties concentrated losses with the borrowing populations.

By 1989, the approach shifted again. The debt crisis showed few signs

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[210] Angel Gurria, quoted in KRAFT, *supra* note 206, at 3.

[211] *See* RAUL L. MADRID, OVEREXPOSED: U.S. BANKS CONFRONT THE THIRD WORLD DEBT CRISIS 48–49, 59 (1990).

[212] CLINE, *supra* 204, at 72–73.

[213] *Id*. at 205.

[214] *See id*. at 205–06.

[215] *See id*. at 92. Over twenty years later, participants acknowledge, at least in private conversations, that the diagnosis of illiquidity was a product of the lenders' inability to absorb the necessary losses at the time.

[216] *See id*. at 206–08; *see also* John Clark, *Debt Reduction and Market Reentry Under the Brady Plan*, 18 FED. RESERVE BANK N.Y. Q. REV. 38, 39–40 (Winter 1993–94), *available at* http://www.nyfrb.org/research/quarterly_review/1993v18/v18n4article3.pdf ("By 1989, this basic case-by-case approach had achieved some measure of success . . . [n]onetheless, important strains had emerged, leading to deeping fatigue and frustration for both debtors and creditors.").

of abating despite successive rescheduling innovations on the part of private and official participants. Private banks grew wary of the endless stream of "voluntary" new lending, and were beginning to balk at official requests.[217] But they also fortified themselves against further losses. Beginning in 1987, U.S. banks raised capital and set aside loan-loss provisions, with the largest banks booking "the worst . . . profits since the Great Depression" in the first year of the new strategy.[218]

In 1989, the Brady Plan (named after the U.S. Treasury Secretary who presided over its launch) offered to exchange banks' loans for tradable bonds, some collateralized with U.S. Treasury securities. The plan was still technically voluntary.[219] Principal reduction was the central plank of the plan, along with a standardized menu of restructuring options for creditors to choose from. By some calculations, Mexico received in excess of 30% principal relief in its first Brady deal in 1990.[220] Yet another round of regulatory forbearance helped boost participation: the U.S. Treasury secured an interpretation of accounting rules from the Securities and Exchange Commission (SEC) that let banks avoid booking losses where the total principal and interest payments on the new bonds over their lifetime would "equal or exceed the book value of the loan."[221] With 30-year bonds, the standard was not hard to meet. The loan-for-bond exchanges of the Brady Plan were a success by all counts, and eventually catalyzed the establishment of today's market for middle-income countries' sovereign debt.[222]

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The case studies in this Part yield somewhat conflicting lessons. On

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[217] *See* Lee C. Buchheit, *Whatever Became of Old New Money?* 9 INT'L FIN. L. REV. 11, 12 (1990) ("The amounts raised have been relatively modest and the coupons relatively high, but these are unquestionably the first steps toward making good on the promise of 'voluntary,' open market operations.").

[218] MADRID, *supra* note 211, at 126–36; *see also* Ross P. Buckley, *The Facilitation of the Brady Plan: Emerging Markets Debt Trading from 1989 to 1993*, 21 FORDHAM INT'L L. J. 1802, 1818 (1998) [hereinafter, Buckley, *Facilitation*] ("[A]fter a major increase in reserves, prices dropped sharply as traders feared the extra supply of debt the banks could now afford to put onto the market."); Clark, *supra* note 216, at 39 (observing that the "case-by-case approach had . . . afforded banks the time to increase their capital, thereby containing systemic threats to the international financial system").

[219] *See, e.g.*, CLINE, *supra* note 204, at 218.

[220] *E.g.*, MADRID, *supra* note 211, at 220–22; *see also* Clark, *supra* note 216, at 46.

[221] Letter form Edmund Coulson & Linda C. Quinn (SEC Officials) to David C. Mulford (Treasury Department), *reprinted in* Jonathan Hay & Narmaljit Paul, Regulation and Taxation of International Commercial Banks During Debt Crisis 126 (World Bank Technical Paper No. 158) *available at* http://www-wds.worldbank.org/external/default/WDSContentServer/WDSP/IB/1999/09/23/000178830_98101904141457/Rendered/PDF/multi_page.pdf; *see also* Buckley, *Facilitation*, *supra* note 218, at 1807–08 ("The prospects of the Brady proposal were greatly enhanced by a letter of July 14, 1989 from the Securities and Exchange Commission ("SEC") to David Mulford, Under Secretary of the Treasury.").

[222] *See* Buckley, *Facilitation*, *supra* note 218, at 1887–89 (discussing the market benefits attributed to implementation of the Brady Plan).

the one hand, each of the very different governments involved, when confronted with a severe financial crisis, had to make the choices I have grouped under the rubric of containment—whether to deploy wholesale measures to manage deep, widespread debt distress, whether to enforce private contracts and government regulations despite the risk of general default, and how to distribute losses. On the other hand, the way in which the governments went about making containment choices reflected their very specific economic, political and institutional settings. Factors such as pre-crisis wealth distribution and business organization, a prior history of financial crises, the cause and location of debt distress, and the legal institutions for handling crises and non-crisis debt problems, all layered on top of the general factors discussed in Part IV, helped determine the policy outcomes.

Yet there were more commonalities. In every case, officials knew the depth and breadth of the crisis before they had the political and legal capacity for adequate response. Governments began with incremental measures premised on no or very limited insolvency, and continued on this path until they secured the political space and legal authority to deploy robust containment policies. Collective action problems on a vast scale stood in the way of crisis response. Non-crisis resolution and debt management tools proved inadequate to contain the crisis and had to be supplemented with some combination of new laws, dedicated institutions, and regulatory adjustment—a process that took months, sometimes years. Also in every case, containment policies began durable economic and political shifts, which continued through resolution and re-regulation. And with the partial exceptions of the United States and Argentina case studies, major loss-distribution proceeded under the guise of loss-prevention, implemented by ostensibly apolitical actors—central banks, international institutions and even foreign bank regulators.

I conclude below with more implications of these and other experiences with containment.

VI. CONCLUSION: CHOICES AT THE PRECIPICE

This Article is an effort to map a category of decisions in financial crisis, decisions made as policy makers stand at the edge of economic catastrophe. Such decisions are often framed as a failure of regulation, and a time for rule-breaking to be regretted when the storm passes. I have argued that these decisions, which I group under the term financial crisis containment, are unavoidable. They are also distinct from financial regulation, crisis prevention, and crisis resolution.

I suggest that three kinds of policy decisions recur in very different financial crises: first, whether the response should be wholesale or case-by-case; second, whether to enforce private contracts and government regulations; and third, how to allocate losses. Importantly, this is not an argument for or against wholesale measures or breaking contracts. Part V confirms that while containment choices are unavoidable, their outcomes are deeply contextual and contingent on a slew of political and institutional factors. Rather, I suggest that the three-part framing in Part IV can help recast some well-worn crisis policy debates, and to make containment decisions more transparent and accountable.

First, the choice between wholesale and case-by-case separates the timing of crisis response from the intractable liquidity-solvency paradigm. In the first instance, decisions about the timing of containment—and hence the timing of the crisis—go to the adequacy of the existing infrastructure for handling financial distress. In every case study in Part V, governments struggled to adapt the existing tools to new circumstances, and found them wanting. They were also pressed to build political support for extraordinary measures, which determined the timing of crisis response perhaps more than any other factor. In most cases, the authorities knew they were dealing with a solvency problem long before they found the legal and political capacity to address it.

What might make for better containment decisions in this context? In many cases, non-crisis bankruptcy and resolution techniques can localize failure and limit the extent to which losses are socialized. Having usable case-by-case restructuring tools and the political capacity to use them can limit the need for wholesale measures without shifting the losses onto the public.[223] Under some circumstances, the fear of bankruptcy and judicial redistribution may beget a much bigger political risk of wholesale restructuring and nationalization. But once the crisis has exceeded the administrative capacity of non-crisis tools, a qualitative shift is in order: simple, transparent, across-the-board measures that can work quickly and can be readily understood by both the public and the markets can be essential for containment. Reform of the existing infrastructure and redress of containment inequities—long-range tasks that require complex balancing of many constituencies—belong with resolution and regulation; they demand more deliberation than containment can afford.

Second, posing the choice between rewriting and enforcing contracts as inevitable puts the contract sanctity meme in a different light. Where contract enforcement may have negative spillover effects, or where performance is possible only with a public subsidy, "sanctity" loses its absolute character and becomse a balancing test. Policy focus shifts to assessing the spillover effects and the magnitude of the subsidy. The question of rewriting contracts, like one of suspending regulation, becomes one of how much, how long, and how often. Who does the rewriting is key: for example, in the Argentina case study, the legislature and the

[223] *Cf.* Ayotte & Skeel, *supra* note 28.

Executive engaged in successive modifications; in the United States, the legislature remained the lead, albeit under heavy influence of a powerful Executive. In both cases, the courts played a complex legitimating role.

Having the power to rewrite contracts rest with the legislature seems appropriate for two reasons: it makes the power harder to exercise, and ensures broad-based accountability in the associated redistribution. On the down side, a controversial decision to override contracts wholesale may take too long to be useful as containment. But since the failure to act is distributive, the legislature remains accountable for the consequences of its inaction. On the other hand, giving the red pen to the Executive may make rewriting contracts too easy, unless this authority is heavily circumscribed to avoid effectively creating a parallel bankruptcy regime.

Third, stipulating distribution as a necessary element of containment recasts the perennial crisis policy debate about moral hazard. Except where the policy is pristine abstention, the risk of moral hazard is unavoidable. The operative question again becomes not whether the imprudent would be rescued, but rather which of the imprudent should be, at what cost, and at whose expense. The debate becomes explicitly about distribution.

To be sure, almost all government policies can distribute,[224] but some—notably those that aim to contain a large-scale, fast-moving financial crisis—can obscure their effect on distribution, even when it is extreme. The case of Indonesia in Part V.A is a stark, but not a unique, example of radically distributive policies that were rarely debated as such.[225] The prevalence of central bank lending, even in well-known solvency crises, and the popularity of large "conduit" institutions as targets of government support, foster the impression that losses are avoidable, and that in any event, limiting total losses makes everyone better off. By the time this strategy runs its course, resource and power shifts may become a source of path dependence. After a crisis, some institutions and communities may be wiped out for good, while others may grow enormous from government-assisted mergers and subsidies. The ethnic and political landscape may shift dramatically.[226]

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[224] Posner & Vermuele, *supra* note 36, at 45 (arguing that post-9/11 policies were distributive, like the U.S. financial crisis response in 2008).

[225] *See, e.g.*, Lindgren, *supra* note 38, at 89 (following general observations about bank closures in crisis: "All triggers must be designed to hold up legally, because interventions and closures will destroy and redistribute private property and wealth and therefore have a high likelihood of being challenged in courts").

[226] *See generally* AMY CHUA, WORLD ON FIRE: HOW EXPORTING FREE MARKET DEMOCRACY BREEDS ETHNIC HATRED AND GLOBAL INSTABILITY 1–17 (2003) (evaluating ethnic and political repercussions of economic crises); *see also* Honohan & Laeven, *Introduction and Overview*, *supra* note 19, at 10, 15 (highlighting the "potentially irreversible impact on the ultimate allocation of losses in the system," rent-seeking opportunities, and durable political changes that stem from containment policies).

The possibility of dramatic and durable distribution should be an important factor in allocating containment authority. Scholars in different disciplines have observed that the Executive tends to gain in crisis; some have suggested it is inevitable and probably sensible.[227] Less prominent but critically important is the rising stock of independent agencies, notably central banks, whose lending authorities can become indispensable to the political branches in the containment project.[228] The courts are often marginal in a fast-moving crisis, though they may gain power in a protracted one: it took over a year for the Gold Clause Cases to reach the U.S. Supreme Court, but their political and economic salience for crisis containment remained high.[229] The legislators' role is harder to gauge: they may be slow and unmotivated[230] but they can also serve important—if disorderly—gatekeeping and legitimating functions when the Executive and independent agencies come to it for new authority. Perhaps more importantly, legislative debates and hearings can condition the politics of crisis response: they can spread public awareness of dire economic circumstances and chart a course for both containment and reform.[231]

The Executive's role in a financial crisis and its relationship with the monetary authorities go to the heart of the containment challenge. The Executive is presumed to be politically accountable; it can act quickly and flexibly, integrating diverse policy areas in its crisis response.[232] However, the Executive's authority to distribute is circumscribed by the legislature, and its actions are more visible than those of the central bank—an attribute of accountability that can make the Executive politically vulnerable. In theory, the central bank is technically competent and better able to guard against time inconsistency, which is a particular problem in crisis containment; however, it is poorly placed to preside over messy, large-

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[227] *See generally* Posner & Vermuele, *supra* note 36, at 16.

[228] *See generally* Davidoff & Zaring, *supra* note 36, at 4 (describing the U.S. Treasury and Federal Reserve engaging in "governance by deal"); *see also* BLUSTEIN, *supra* note 6, at 305–36 (describing the Federal Reserve and its role in the Long Term Capital Management crisis ; KRAFT, *supra* note 206, (describing the role of the U.S. Federal Reserve in the Mexican crisis). Posner & Vermuele appear to view the Federal Reserve as following executive preferences, partly owing to their own political legitimacy deficit. Posner & Vermuele, *supra* note 36, at 34–35 (citing Neal Devins & David E. Lewis, *Not-So Independent Agencies: Party Polarizaiton and the Limits of Institutional Design*, 88 B.U. L. REV. 459 (2008)). It is not clear whether the power balance reversed in crisis, where the central bank in particular has more resources and authority.

[229] *See* Levy, *supra* note 36, at 800–02; *supra* notes 188–224 and accompanying text (discussing the *Gold Clause Cases*). The same may be said about the judiciary's response to Argentina's pesification. *See supra* notes 233–47 and accompanying text (discussing Argentina's pesification).

[230] Posner & Vermuele, *supra* note 36, at 21 (suggesting that legislators have trouble responding to complexity).

[231] *See, e.g.*, Bear Stearns Hearings, *supra* note 1 (discussing the merger of Bear Stearns and JPMorgan Chase); *cf.* SELIGMAN, *supra* note 66, at 21–38 (describing the Pecora Hearings and their role in the subsequent overhaul of financial regulation).

[232] *See generally* Alberto Alesina & Guido Tabellini, *Bureaucrats of Politicians? Part II: Multiple Policy Tasks*, 92 J. PUB. ECON. 426, 427 (2007) (discussing the modeling policy making in general, not during crisis).

scale distribution. The central bank's expansive powers to lend and create money are premised on the idea that it does not distribute.[233]

An Executive that is facing a hostile legislature—or is otherwise politically vulnerable—may come to need the central bank in crisis not just for its traditional monetary policy functions, but for its regulatory and less traditional transactional powers.[234] Collaborating with the central bank may help the Executive to avoid the legislature, but also to diminish accountability at the height of the crisis. If crisis containment were a purely technical project with fixed distributional consequences, this would be a minor concern. But it rarely, if ever, is purely technical. The result can be damaging for both the Executive and the central bank: where their containment collaboration is perceived as illegitimate, it may fail, and result in loss of crisis-management authority going forward. Regulators and foreign actors, such as the IMF, stand in a similar relationship to the Executive: they can be its indispensable partners in containment, but can also help reduce accountability and get caught in the political fallout.

The intricate tradeoffs of allocating authority over crisis containment, and more broadly crisis response, merit more study beyond the scope of this Article. Perhaps the biggest question, explored in proposals such as "Super Chapter 11" and echoing the emergency literature, is whether there should be a standing ex-ante legal regime for crisis containment. The advantage is predictability. The fear is that governments will be tempted to use emergency powers willy-nilly, at best requiring constant recalibration of ex-ante procedural hurdles. This Article suggests that many if not most of the tools of crisis containment are within the existing scope of government authority. The challenge is to use them in a way that is legitimate and accountable.

My goal has been to draw attention to containment policies as a distinct category of policy choice that deserves more analytical scrutiny than it has received to date. The core consistency of crisis policies across very different cultural, institutional, and historical settings is revealing. Crisis response is necessarily fraught with moral hazard and political risk. Containment measures inevitably contravene non-crisis policy wisdom and legal norms. But governments and private actors invoke extraordinary measures routinely. Acknowledging that crises will return, rules will be suspended, and emergency tools will be used, should prompt a critical examination of when, how, by whom, and to whose benefit.

[233] *Id.* The Federal Reserve's "industrial policy" function has been controversial. Its power to lend to nonbanks under Section 13 of the Federal Reserve Act is subject to procedural hurdles, has been criticized throughout its history, and was used sparingly before 2008. *See* Fettig, *supra* note 55.

[234] *See* Davidoff & Zaring, *supra* note 36, at 12, 14 (describing transactions under the authority of Section 13(3) of the Federal Reserve Act). *See also supra* note 55.