Credit Markets and the Visible Hand

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Abstract

This Article joins a growing conversation about the appropriate role for government in the credit markets. Although the government, through the US Federal Reserve, has edged in this direction, the Fed continues to cling to its traditional roles in conducting conventional monetary policy and, in the face of crisis, sprinting toward the politically costly provision of lender-of-last resort interventions. We argue that the Fed should take on a new role that would moderate its need to break the glass on its emergency powers, even as it extends its reach in the face of economic disruption. That new role is to channel credit policy in the event of disruption in the proper functioning of the credit markets, through the Fed's discount window authority.

To show how the credit channeling function might work, we focus on a market that currently is highly dysfunctional: the market for credit in bankruptcy. For the largest corporate debtors, bankruptcy financing is available but extremely costly, due to the monopoly held by debtors' inside lenders. Smaller debtors, by contrast, are almost completely locked out of these markets. We propose that the Fed create a DIP Discount Window facility tailored to fit the two segments of the market. With large corporate debtors, the facility would only be available to outside lenders, so that the facility could inject more competition into the market to ensure more value preservation in bankruptcy. With small debtors, the debtor's current lender would be eligible; indeed, the program would seek to draw these lenders into the DIP financing market, a place they have been unwilling to venture because of the cyclicality and risks that inhere to it. In each context, the facility would be limited to banks.

In addition to improving bankruptcy financing, the DIP Discount Window facility would bring other benefits as well. It would shift more lending from the shadow banking to the formal banking sector, for instance, and would enhance the Fed's visibility into the participating banks. It would also provide

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an intermediate option in the event that more extreme fiscal, monetary, and emergency options are taken off the table because they are so politically disruptive. Finally, the novel and modest credit channeling role we advocate in this Article could also be used in other contexts where structural flaws impede the smooth functioning of a credit market.

INTRODUCTION

This Article proposes a new approach for the US government to respond to economic crises that would pull the Federal Reserve back from its status as the preferred instrument of crisis response. The tool, ironically through the Federal Reserve itself, is a new discount window facility that would permit banks to gain access to liquidity to stave off the bankruptcies of small- and medium-sized businesses throughout the economy. In pushing the Fed to respond to such crises through its more conventional lending tools, rather than through its growing use of emergency lending, it can better preserve its status as a core monetary policymaker and as a lender of last resort in financial panics. While this proposal—what we can the Debtor-in-Possession Discount Window Facility, for reasons explained below—might appear to institutionalize the Fed's support of an economy in crisis, it would do the opposite: a regularized facility would normalize banking relationships for bankruptcies in a way that would put market actors in the front lines to manage their own risks, rather than pushing those risks more squarely into the hands (and balance sheets) of the public.

Our proposal comes at an important moment of transition in the way that scholars, policymakers, and the general public conceptualize the government's relationship to markets. Until recently, prevailing norms among most technocrats held that the financial markets should be left to their own devices rather than steered or channeled by regulators in any way. Questions about capital allocation—in capital markets or through the banking system—were seen through the lens of market efficiency. Other than requiring disclosure and policing fraud—and even these were contested by some—regulators, it was thought, should defer to the wizardry of market actors operating in their own self interest. Hands off—or "light touch," as it was called in the United Kingdom—was the best mode of regulation and market support.

Thus it was when Brooksley Born, the head of the Commodity Futures Trading Commission, suggested at the end of the last century that at least minimal regulation of derivatives—financial contracts whose value is linked to another price (such as stock or currency prices) or event—was needed to ensure transparency and reduce the risk of destabilizing defaults. The three most powerful financial regulators in the nation—the Federal Reserve Chairman, the Treasury Secretary and the Chairman of the Securities and Exchange Commission—promptly issued a joint statement insisting that regulation was unnecessary and would interfere with the proper functioning of the derivatives market.[1] In the short-run, the hands off perspective

[1] *See* Joint Statement by Treasury Secretary Rubin, Federal Reserve Board Chairman Greenspan, and Securities and Exchange Commission Levitt (May 7, 1998).

prevailed, as reflected in 2000 legislation that explicitly protected the over-the-counter ("OTC") derivatives market from regulatory oversight.[2]

What a difference two massive financial crises in a decade can make.

The first of these crises—the Global Financial Crisis of 2008-2009 and the associated Great Recession and Eurozone Crises that followed—unfortunately proved Born to be prescient.[3] Rather than preventing the crisis, as its enthusiasts claimed, the unregulated derivatives market proved to be a "financial crisis accelerator," as one commentator later put it.[4] Due to the absence of meaningful regulation, regulators had very little visibility into the derivatives and other financial contract exposure of the investment bank Bear Stearns as it collapsed; and they feared that market participants' exercise of their contractual rights would trigger a system-wide crisis. And because most of that activity occurred outside the banking system, the entities themselves weren't subject to any meaningful supervision. The implosion of credit markets took these regulators and supervisors largely by surprise.[5]

With Bear, regulators and supervisors quickly abandoned their hands-off approach and organized a bailout for the troubled bank.[6] The era of government non-intervention, such as it was, was over.[7] Congress responded by institutionalizing the collaborative, corporatist approach to regulation and

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[2] For discussion of the insulation of OTC derivatives from regulation under the Commodity Futures Modernization Act of 2000, Pub. L. No. 106-554, 114 Stat. 2763 (2000), see, e.g., Noah L. Wynkoop, Note, *The Unregulables? The Perilous Confluence of Hedge Funds and Credit Derivatives*, 76 FORDHAM L. REV. 3095, 3099 (2008).

[3] The Great Recession actually was the second major crisis of the new century. The first—the corporate scandals in 2001-2002—did not cause a major economic crisis, but it too revealed the inadequacies of existing regulation. *See, e.g.,* JOHN C. COFFEE, GATEKEEPERS: THE PROFESSIONS AND CORPORATE GOVERNANCE (2006)(analyzing the failures of accountants and other gatekeepers to curb the misbehavior).

[4] Mark J. Roe, *The Derivatives Market's Payment Priorities as Financial Crisis Accelerator*, 63 STAN. L. REV. (2011).

[5] See, e.g., Tami Luhby, *Bank Regulators 'Asleep at the Switch': Senate Banking Committee Chair Blasts Regulators for not Sounding Warning About Risky Lending Practices*, CNNMONEY.COM, March 4, 2008, available at https://money.cnn.com/2008/03/04/news/companies/senatebank/index.htm (accessed January 24, 2022).

[6] For an excellent treatment of Bear Stearns and the Fed's other 2008 interventions, written for a popular audience, see DAVID WESSEL, IN FED WE TRUST: BEN BERNANKE'S WAR ON THE GREAT PANIC (2009).

[7] Footnote on how flimsy and temporary that ethos actually was.

supervision.[8] The new regulation sought to create a new system of financial architecture, which included a requirement that most derivatives be presented to clearing houses for clearing, created extensive new oversight of systemically important financial institutions, institutionalized the "stress tests" initiated by the Fed and Treasury in 2009, and otherwise increased oversight. The legislation also created a new regulator—the Consumer Financial Protection Bureau (CFPB)—devoted entirely to protecting the interests of consumers. Congress had long paid attention to consumers' interests, but had placed those various legal authorities in the hands of the Federal Reserve and other financial regulators, each of which had other responsibilities that stood in tension with protecting consumers.[9] As with the derivatives and financial institution reforms, Congress also expanded the powers of the CFPB well beyond disclosure and policing fraud.[10]

This trend of increasing the government's interaction with markets continued into the next major crisis of the 21st century, the Covid-19 pandemic and its associated financial crisis of March 2020. Although the pandemic was not caused or accelerated by inadequate regulation of market transactions, the public role in addressing the limitations of markets was even more pronounced. Both federal and state lawmakers imposed moratoria on mortgage payments and evictions that might otherwise have caused massive numbers of foreclosures and evictions after the economy was shut down in response to COVID-19.[11] Congress also stepped in to support businesses with

[8] For an overview of the reforms, see, e.g., DAVID SKEEL, THE NEW FINANCIAL DEAL: UNDERSTANDING THE DODD-FRANK ACT AND ITS (UNINTENDED) CONSEQUENCES (2010). The clearinghouse requirements are summarized at pp. 61-62 and the regulation of systemically important financial institutions at pp. 78-79.

[9] *See, e.g., id.* at 100-101. The Consumer Financial Protection Bureau was inspired by Elizabeth Warren, who pointed out the conflicts faced by existing regulators—including the fact that banking regulators' responsibility for assuring the health of financial institutions conflicted with their responsibility to protect consumers—in a now famous article that advocated for the new consumer regulator. Elizabeth Warren, *Unsafe at Any Rate*, DEMOCRACY, Summer 2007, at 8.

[10] The Consumer Bureau also is authorized to remedy "abusive" practices, for instance. This language was inspired by findings in behavioral economics that suggest consumers may be vulnerable even if they are provided with extensive disclosure and creditors do not engage in fraud. Many consumers drastically underestimate future costs, a tendency that often will not be cured by disclosure alone. The Consumer Bureau's power to curb "abusive" practices enables it to regulate credit arrangements that take advantage of this behavioral bias.

[11] For a helpful overview of the vast array of federal and state responses to the pandemic, see Sarah Hammer, *Economic and Financial Policy Responses to the COVID-19 Pandemic: Review and Analysis* (unpublished manuscript, Jan. 20, 2021)(on file with authors); *see also* Lev Menand, *Unappropriated Dollars: The Fed's Ad Hoc Lending Facilities and the Rules that Govern Them* (ECGI Law, Working Paper No. 518/2020, 2020), https://ecgi.global/sites/default/files/working_papers/documents/menandfinal_0.pdf.

loans (forgivable in many instances) under the CARES Act and its other pandemic interventions.[12] And once again, Congress turned to the Fed as the instrument of its policies: the Federal Reserve, in collaboration with the United States Treasury, would provide much of the liquidity support in the initial response to the pandemic.[13]

The recent crises, together with recent scholarship, have revealed that even robust markets may be undermined by serious structural flaws due to, among other things, participants' cognitive biases or hidden constraints on competition.[14] Public actors are often the best—and sometimes the only realistic—corrective for these problems.

For the first time in decades, then, the central question in business law and regulation has become, how can the public sector best assure the smooth functioning of the markets and intervene where needed? Others have offered answers to this question for corporate law, consumer regulation and antitrust enforcement (some of which are compelling in our view, others less so). Our focus in this Article is gaps and structural flaws in the credit markets—in particular, corporate loans and other forms of corporate debt.

Our basic argument is quite simple (though the details are a bit more subtle): the Federal is uniquely well-positioned to address a variety of structural flaws in the credit markets by resuming its former role of using its conventional lending authority to allocate a specific kind of credit through the banking system. In particular, we argue that the Fed should add to its three existing discount window facilities a fourth: the DIP Discount Window, to be used to facilitate more orderly bankruptcies in the event of a major economic, but not financial, crisis.

We recognize that our suggestion that the Fed should add yet another set of responsibilities to its portfolio may be met with skepticism. No regulator has played as sweeping a role in the past two decades as the Fed, and none has expanded its footprint so aggressively. During the 2008 crisis, the Fed used its emergency lending powers under the Federal Reserve Act to make rescue loans to systemically important financial institutions such as Bear Stearns and AIG, an exercise of creativity that former Fed Chair Paul Volcker criticized as

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[12] *Id.* For an overview of the CARES Act's Paycheck Protection Program, which provided for often forgivable loans, see David Autor, *An Evaluation of the Paycheck Protection Program Using Administrative Payroll Microdata*, MIT Files at https://ecnomics.mit.edu/files/20094.

[13] *See, e.g.,* Hammer, *supra* note 9.

[14] *See, e.g.,* OREN BAR-GILL, SEDUCTION BY CONTRACT: LAW, ECONOMICS AND PSYCHOLOGY IN CONSUMER MARKETS (Oxford University Press, 2012)(role of consumer biases in credit card markets).

"neither natural nor comfortable for a central bank."[15] The Fed also used its emergency lending powers to create an array of other crisis programs, and it bought trillions of dollars of bonds in an effort to stabilize the markets, an exercise it dubbed "quantitative easing."[16]

In the recent pandemic, the Fed once again took center stage. At the outset, the Fed dropped interest rates 1.75 percent, the largest such drop in the Fed's history.[17] It announced a significant interjection of liquidity into short-term funding markets, expanding a similar intervention it had engineered in September 2019.[18] The Fed also launched a large-scale asset purchasing program, and it reintroduced many of the lending policies first engineered in response to the 2008 financial crisis, including a commercial paper funding facility, a primary dealer lending facility, a money-market fund liquidity facility, and international swap lines for a select number of foreign central banks.[19]

As wide-ranging as they've been, these interventions all ostensibly fit, albeit sometimes awkwardly, within the two roles that the Fed has long seen as defining its mandate.[20] The first is "conventional monetary policy." In good times, the Fed sits above the financial system, using regulatory and supervisory tools to manage the government's role in the economy and monetary tools to intervene in the secondary markets of federal governmental

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15 Paul A. Volcker, Former Chairman, Fed. Reserve Sys., Address at the 395th Meeting of the Economic Club of New York 5 (Apr. 8, 2008), https://www.econclubny.org/documents/10184/109144/2008VolckerTranscript.pdf [https://perma.cc/5UND-XDJ8].

16 For a good overview and analysis of this interventions, see Menand, *supra* note 11.

17 *See* Press Release, Board of Governors of the Fed. Reserve Sys., Federal Reserve issues FOMC statement (Mar. 15, 2020), https://www.federalreserve.gov/newsevents/pressreleases/monetary20200315a.htm.

18 Press Release, Board of Governors of the Fed. Reserve Sys., Federal Reserve Announces Extensive New Measures to Support the Economy, (Mar. 23, 2020), https://www.federalreserve.gov/newsevents/pressreleases/monetary20200323b.htm.

19 Press Release, Board of Governors of the Fed. Reserve Sys., Federal Reserve Actions to Support the Flow of Credit to Households and Businesses, (Mar. 15, 2020), https://www.federalreserve.gov/newsevents/pressreleases/monetary20200315b.htm.

20 We say "ostensibly" because the Fed's discount window has been used at times in ways that are best described as channeling credit. We discuss the discount window and how it has been deployed at length in Part II(A), *infra.*

debt with an eye to influencing the rates at which banks lend to each other on a short-term basis.[21]

The second is serving as the lender of last resort. If the nation's largest banks or other systemically important institutions face a liquidity crisis, and their default threatens to jeopardize the financial markets, the Fed is authorized to provide emergency loans.[22] Under traditional lender of last resort principles, the loans should simply be used to address the immediate liquidity crisis and each should be secured by enough collateral to ensure that the lender will be fully repaid. It is this authority that the Fed has used especially creatively in the past two crises, continuing to do so despite new constraints put in place by the Dodd-Frank Act in 2010.[23]

But the (over)use of the Fed's emergency powers comes at a cost of politicization, a cost that the Fed is now navigating at the time of this writing. The basic problem with emergency lending in an economic crisis is that the public (and the politicians that represent them) will be divided about who should receive what kind of assistance, on what terms, from the Fed. This problem was the central problem the Fed faced in 2020-2021. It will not go away and is likely to get worse before it gets better.[24]

The role we advocate for the Fed-- intervening through the financial system in credit markets that are not functioning properly—occupies an intermediate ground between ordinary monetary policy and emergency lending as a lender of last resort. We take our cue, in a sense, from a recent call by Professor Kathryn Judge for the Fed and commentators to "acknowledge that the Fed is currently involved in credit policy, acknowledge the contours of who it has helped and who its efforts have failed to reach, and figure out

[21] *See* Glenn D. Rudebusch, *A Review of the Fed's Unconventional Monetary Policy*, FED. RESERVE BANK OF S.F. ECON. LETTER (Dec. 3, 2018), https://www.frbsf.org/economic-research/publications/economic-letter/2018/december/review-of-unconventional-monetary-policy/.

[22] The Fed's emergency lending authority is housed in section 13(3) of the Federal Reserve Act.

[23] The Dodd-Frank of 2010 amended section 13(3) of the Federal Reserve Act to prohibit the Fed from invoking its emergency lending powers for the benefit of a single company and to require Treasury approval of the Fed's use of these powers.

[24] For an overview of the political tensions that the Fed has faced, see Jeanna Smialek, *The Year the Fed Changed Forever*, N.Y. TIMES, December 23, 2021. For critiques of the Fed's responses, see KAREN PETROU, ENGINE OF INEQUALITY: THE FED AND THE FUTURE OF WEALTH IN AMERICA (2021) and CHRISTOPHER LEONARD, THE LORDS OF EASY MONEY: HOW THE FEDERAL RESERVE BROKE THE AMERICAN ECONOMY (2021).

where the Fed can and should go from here."[25] This third role is a step beyond the Fed's routine role in monetary policy but a step well short of its more dramatic emergency interventions. It is also consistent with its historical role of providing liquidity to the banking system in, to use the Fed's own words, to ease "demonstrated liquidity pressures of a seasonal nature."[26] Adding additional credit market support, as we propose, would, tautologically, expand the Fed's footprint into those markets. Such an expansion has the virtue of reducing the temptation for the Fed to stretch its emergency powers to address problems that rightly remain the purview of fiscal authorities.

An important point bears emphasis: the Fed did not create the capacity to channel credit as a consequence of the 2020 pandemic. It has long had that authority. Its "discount window" authority under section 10B of the Federal Reserve Act provides the central bank with the authority to make short-term loans to banks that are members of the Federal Reserve system.[27] The discount window often is viewed as a source of funds for banks that could not qualify for such assistance from their traditional lenders. The discount window sometimes carries a stigma for precisely this reason. But nothing in the statute requires that it be limited in this way, and the discount window has in fact been employed more broadly, even in recent years. Using it to provide greater liquidity in times of economic, but not financial, distress builds on this important historic role without the same risks of overstepping (and politicization) that emergency lending can do.

One reason for this ability both to direct credit while managing the downside risk of political contention is that these efforts would be intermediated—businesses would borrow from private banks, rather than directly from the Federal Reserve.[28] Intermediation provides two core benefits over emergency lending. First, it insulates the Fed from the thorny role of evaluating candidates for credit, a role the Fed did not relish during the 2020 pandemic, since private banks would be the ones deciding which

[25] Kathryn Judge, *Why the Fed Should Issue a Policy Framework for Credit Policy* 7 (Shadow Open Mkt. Committee, Working Paper No. 632, 2020), available at https://papers.ssrn.com/sol3/papers.cfm?abstract id=3716600.

[26] Board of Governors of the Federal Reserve System, Discount Window Lending, available at https://www.federalreserve.gov/regreform/discount-window.htm (accessed on January 12, 2022).

[27] For an overview, see *Discount Window Lending*, BOARD OF GOVERNORS OF THE FED. RESERVE SYS. (Dec. 31, 2020), https://www.federalreserve.gov/regreform/discount-window.htm.

[28] In this sense, it differs from other recent proposals to focus on Fed-directed support that is not so intermediated. *See, e.g.*, Saule T. Omarova, *The People's Ledger: How to Democratize Money and Finance the Economy* (Cornell L. Sch. Res. Paper, Paper No. 20-45, 2020), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3715735; John Crawford, Lev Menand & Morgan Ricks, *FedAccounts: Digital Dollars*, 89 GEO. WASH. L. REV. 113 (2021).

borrowers to lend to. Second, it puts the Fed in a position of learning about key elements of the economy to which it would otherwise lack access, since the banks lending through the discount window are necessarily supervised by the Fed, giving the central bank greater visibility into the lending decisions of the banks that participated in the program.

To show how the Fed could use the discount window to address structural problems in the credit markets, we identify a market that currently needs the kind of intervention we advocate: the market for "debtor in possession" or "DIP" financing in bankruptcy.[29] These oddly named loans are used by debtors to fund their operations while they try to reorganize in Chapter 11. A debtor that obtains DIP financing is much more likely to reorganize than one that does not.[30] Given that tens of thousands of companies file for bankruptcy every year, the market is extremely important.

In some respects, the market seems to function well. During 2020, the height of the pandemic, businesses obtained an estimated $20.762 billion in bankruptcy loans, which is $5 billion <u>more</u> than business debtors borrowed in 2019, prior to the pandemic.[31] It appears that, in one of the greatest economic crises in a century, markets held up remarkably well without the kind of intervention we advocate.

If we scratch beneath the surface, however, the picture is more worrisome. The first warning sign is that corporate debtors are forced to pay extremely high interest rates for these loans, despite invariably having the highest priority claim to the debtor's assets. One recent study (which predated the pandemic) found that lenders charge several percentage points higher than a competitive interest rate;[32] another concluded that DIP loans are priced

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[29] The term, which is quite non-intuitive to those who are not bankruptcy experts, comes from the fact that bankruptcy law deems the debtor and its managers to be a "debtor in possession"—that is, a debtor that has authority over its assets—when the debtor files for bankruptcy. *See* ll U.S.C. § 1107 (powers of debtor in possession). If the debtor obtains financing for its operations in bankruptcy, the funds are thus Debtor in Possession financing.

[30] *See e.g.,* Maria Carapeto, *Does Debtor-in-Possession Financing Add Value?* (IFA Working Paper No. 294-1999), online at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=161428; Sris Chatterjee, Upinder S. Dhillon, Gabriel G. Ramirez, Debtor-in-possession Financing, 28 J. BANK. FIN. 3097 (2004). [I need to doublecheck this.]

[31] Our thanks to David Smith for these numbers, which he compiled from information in the Deal database. *See* Email from David C. Smith to David Skeel (June 7, 2021, 2:37pm).

[32] B. Espen Eckbo, Kai Li, & Wei Wang, *Rent Extraction by Super-Priority Lenders* (Tuck Sch. of Bus., Working Paper No. 3384389, 2020).

similarly to junk debt, despite being far less risky.[33] This pattern continued during the pandemic: J.C. Penny paid 11.75% above the risk-free rate for bankruptcy financing, Horbeck Offshore paid 12.5% more, and LA Fitness $10%.[34] High credit costs impose an undue burden on debtors seeking to reorganize and undermine the efficiency of the bankruptcy system.

How can the lenders charge so much? The short answer is the debtor's prebankruptcy lenders have a monopoly. Outside lenders that wish to offer alternative financing are at a severe competitive disadvantage to the inside lenders, both because an information asymmetry-- the inside lenders are privy to better information about the debtor's condition—[35] and because the inside lenders invariably have a lien on all of the debtor's assets. Unless the court gives the outsider a lien with priority even over the inside lenders' existing lien, the outsider would be foolish to make the loan, since the loan proceeds might simply subsidize the insiders' earlier loan.[36] Although courts have the power to give "priming liens," they can do so only if the insider's loan is "adequately protected," a standard they rarely find met if the inside lender does not consent.[37] As a result, the vast majority of DIP loans—75% or 80%, according to the most recent evidence—are made by the debtor's current lenders.[38]

The second warning sign is that, while the largest corporate debtors often obtain DIP financing, smaller businesses usually do not. In a unique empirical analysis of nearly all of the corporate bankruptcies filed since 1987

[33] Frederick Tung, *Financing Failure: Bankruptcy Lending, Credit Market Conditions, and the Financial Crisis*, 37 YALE J. REG. 651 (2020).

[34] Email from Wei Wang, Professor of Finance, Queen's University, to David Skeel, S. Samuel Arsht Professor of Corporate Law, University of Pennsylvania Carey Law School (June 21, 2020)(hereinafter, "Wang Email (June 21, 2020)"].

[35] For discussion of the asymmetric information issue, see Kenneth Ayotte & David A. Skeel, Jr., *Bankruptcy Law as a Liquidity Provider*, 80 U. CHI. L. REV. 1557, 1579-85 (2012)(discussing information asymmetry (or "adverse selection")).

[36] This is known as a "debt overhang" problem in the finance literature. *See* Stewart C. Myers, *Determinants of Corporate Borrowing*, 5 J. FIN. ECON. 147, 149–55 (1977). *See also* Christopher A. Hennessy, *Tobin's Q, Debt Overhang, and Investment*, 59 J. FIN. 1717, 1727–36 (2004) (providing empirical evidence supporting the presence of debt overhang).

[37] When would an inside lender consent? When the inside lender is the one making the new loan and the priming lien is simply further securing its own loan. This is almost the only time priming liens currently are approved. *See, e.g.,* Kenneth M. Ayotte & Edward R. Morrison, *Creditor Control and Conflict in Chapter 11*, 1 J. LEGAL ANALYSIS 511 (2009).

[38] Fred Tung found that insiders made 75% of DIP loans, while an even more recent study by Espen Eckbo, Kai Li, and Wei Wang found 80%. Tung, *supra* note 33, at 655 n.13 (2020); Eckbo, Li & Wang, *supra* note 32.

that we conducted for this Article, we found that 73.49% of companies with assets over $200 million and 61.94% of companies with assets of $100-200 million obtained bankruptcy financing, whereas only 27.58% of companies with assets of $10-50 million and 4.06% with less than $10 million of assets did. It is important not to overstate the implications of smaller firms' inability to obtain financing. By the time smaller firms file for bankruptcy, many are not viable. The principal purpose of bankruptcy for them is to receive a discharge of their debts, so that they can move to something else.[39]

Unfortunately, the structure of the DIP financing market undermines access to credit even for smaller firms that are viable, increasing the likelihood these firms will fail. The bankruptcy financing market is dominated by the largest banks—banks such as J.P. Morgan and Bank of America.[40] The local and regional banks that are often the principal lenders of smaller firms play little role in this market.[41] The dearth of DIP financing from smaller banks is worrisome even under ordinary market conditions. If there were even a minor disruption to market liquidity-- a moment when a larger number of viable firms lack sufficient cash for their operations and may be forced to file for bankruptcy—the consequences of this structural flaw in the market would be far more severe.

The third warning sign may be the most important. There is suggestive evidence that the reason we did not see the wave of bankruptcies that many—including us[42]—anticipated is that the combination of unprecedented, globe-leading fiscal support and creative, politically risky monetary support staved off the most dire of these outcomes for small and medium-sized businesses. Reliance on both fiscal support and creative emergency lending have enormous downside risks. First, fiscal support may not have survived the bipartisan comity of 2020. Second, the Fed's willingness to be creative in these kinds of emergencies faces significant political constraints that make it less reliable in the event of another crisis.

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[39] *See* Douglas G. Baird & Edward Morrison, *Serial Entrepreneurs and Small Business Bankruptcies*, 105 COLUM. 2310 (2005)(typical Chapter 11 debtors are small businesses whose businesses are not viable when they file for bankruptcy).

[40] Wang Email (June 21, 2020), *supra* note 34 (describing findings in a large dataset of 267 cases with DIP loans).

[41] For discussion of the importance of relatively small banks as lenders to small corporations, see Leonard I. Nakamura, *Small borrowers and the survival of the small bank: is mouse bank Mighty or Mickey?*, BUS. REV., FED RES. BANK OF PHILADELPHIA, Nov., 1994, at 3. The classic theory of banks as relational lenders to small businesses is Robert E. Scott, *A Relational Theory of Secured Financing*, 86 COLUM. L. REV. 901 (1986).

[42] See Peter Conti-Brown & David Skeel, *Using the Federal Reserve's Discount Window for Debtor-in-Possession Financing During the COVID-19 Bankruptcy Crisis*, Brookings Institution, July 2020.

By creating a discount window facility for DIP financing, the Federal Reserve could counteract the dysfunction at both ends of the market and at both ends of the political system. The DIP Discount Window facility we envision would be similar in many respects to other discount window facilities already in place at the Fed. It would provide the funds for lenders to use when they make loans to bankruptcy debtors. As with most discount window programs, only depository institutions—that is, banks, not non-bank lenders—would have access to the facility.[43] A bank that wished to use the facility also would need to show that its DIP loans were "secured to the satisfaction" of the lending Federal Reserve Bank.[44]

A discount window so designed would also provide a cushion against failure for both fiscal policy and emergency lending policy. The reactions to the 2020 fiscal policies, historic in their reach, have been swift and severe, with fears that they stroked inflation, reduced the labor force, or otherwise created problems for the economy. For emergency lending policy, critics think the Fed did too much, exacerbated inequality, displaced the political process, or otherwise corrupted its original purpose as a central bank.

We take no view on the merits of these critiques. We note only that they are growing in prominence, on both the fiscal and monetary side of the policy divide. This represents, then, an opportunity—potentially a very important one—for the Fed to try something that is less reliant on both fiscal policy and less interventionist and creative in its emergency lending processes. Seen within that context, the DIP Discount Window Facility can put the Fed back in its position of supporting dysfunctional markets through the banking system, in a style that is both slightly more engaged in credit intermediation but also much less forceful than its emergency responses in either 2008 or, especially, 2020.

Starting from this basic template, the Fed could shape a discount window facility to fit the needs of any credit market that is not functioning effectively. This flexibility is especially important for the DIP Discount Window we devote our attention to in this Article. Given that the monopoly enjoyed by inside lenders is the key problem in large corporate bankruptcies, only outside lenders should be permitted to use the facility to make loans to large debtors. With smaller debtors, by contrast, the Fed should not impose an outsider-only restriction. The problem for these debtors is that even their

[43] *See generally* Public Law 96-221, 94 Stat. 132 (1980)(extending access of the discount window to all banks).

[44] For discussion of this requirement and its lack of legal antecedents, see Peter Conti-Brown, Yair Listokin & Nicholas Parrillo, *Towards an Administrative Law of Central Banking*, 38 YALE J. ON REG. 1 (2021).

current lenders do not offer bankruptcy financing. The facility should therefore be used to entice the debtors' current lenders to provide bankruptcy financing.

To be sure, there would be a variety of line-drawing issues with this or other discount window facilities. The Fed would need to adopt definitions of large and small corporate debtors, for instance,[45] and it would need to determine whether a bank qualifies as an outside lender if it has a small stake in a loan made to the debtor prior to bankruptcy.[46] It is also possible that inside banks might try to circumvent the restrictions by coordinating with outside banks on loans to large corporate debtors. We believe these issues are easily addressed, and that the risk of manipulation by banks that are subject to ongoing Fed oversight is actually quite small.

After developing our proposal for a new credit channeling role for the Fed, and using the DIP Discount Window as an illustration, we compare our approach to three possible alternatives. The first possibility is to rely on the U.S. Treasury, either alone or together with the Fed, to channel credit, as it did with a small part of the TARP program during the Great Recession of 2008-2009 and more recently—and even more aggressively—with the CARES Act legislation enacted during the pandemic.[47] Where a program requires that one or a handful of major institutions be signaled out for funding, as with the TARP loans to General Motors and Chrysler, Treasury involvement is preferable, given that the Treasury is more politically accountable than the Fed. This preference is why, following the passage of Dodd-Frank, such Treasury involvement is also required under law for the Fed's emergency lending. But the programs we have in mind do not have this quality—they would be available for any banks that qualify, for any corporate-debtor counterparty that the banks deem eligible. The key point is that the banks, not the politicians and not the technocrats, would be the ones making the actual loans.

Similar considerations show why the discount window strategy is preferable to a second alternative, amending the Fed's emergency lending powers to enable the Fed to make loans to particular debtors in bankruptcy.[48] When it uses its emergency powers, the Fed ordinarily makes loans directly, which could raise political concerns if, invariably, some of the loans did not

[45] We propose $50 million in assets as the dividing line between large and small corporate debtors, as discussed in Part II(B)(2), *infra*.

[46] This issue arises because large firms generally borrow from syndicates of banks, and under other arrangements that involve multiple lenders.

[47] This possibility is discussed in Part III(C)(1), *infra.*

[48] *See* Part III(C)(2), *infra.*

pay out or otherwise proved controversial. Preserving the Fed's emergency powers for true emergencies would also help it navigate the political controversies better than the alternative.

Finally, several scholars have proposed that Congress create a new investment authority to make loans and other investments.[49] Modeled on the Reconstruction Finance Corporation in the New Deal, this approach could easily be extended to the DIP financing market. The problem with this approach is that it would again put the government in the position of deciding which loans to make and could, arguably, destabilize financial intermediation as we know it. Although a discount window program would include clear lending requirements, it would rely on banks to do the actual lending. It also would be temporary, and could be ended as soon as the financing market was functioning more effectively.

We are not suggesting, of course, that the Fed is the optimal regulator to correct structural flaws in every part of the credit markets. Indeed, as noted earlier, the Consumer Financial Protection Bureau was created precisely because the Fed and other regulators that had consumer protection responsibilities had not effectively protected consumers' interests.[50] But the Fed is well-positioned to intervene, through the financial system, in contexts where insufficient lending or a lack of competition undermine the credit markets. Indeed, the Fed was designed for *precisely* this purpose. Its discount window lending authority is the supple tool Congress originally designed for this purpose.

The Article proceeds as follows. Part I describes the fiscal-monetary response to the Covid-19 crises—financial and economic—and the backlash that those responses provoked. These backlashes call into question the very economic support that likely staved off the worst of a bankruptcy crisis and prompts the effort to design governmental responses better tailored to the occasion, with fewer risks of destabilizing the political system in the name of stabilizing the economy. Part I also describes the unique features of the DIP Financing market and other proposals that arose during the 2020 crisis meant to address them.

Part II describes the history and evolution of the discount window, including its atrophy beginning in the middle of the 20th century until its partial revival in 2008. We also discuss why its use to correct credit market dysfunction is superior to the alternatives of open-market operations,

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49 *See* Part III(C)(3), *infra.*

50 *See supra* notes 9-10 and accompanying text.

unconventional monetary policy, and emergency lending. Part II then introduces the DIP Discount Window, the restrictions it would have, and how the Fed would be made whole in the event of bank defaults on these loans.

Part III describes the benefits of costs of a DIP Discount Window and other forms of forward-leaning discount window facilities, especially as compared to its alternatives, including oversight by the U.S. Treasury; using the Fed's emergency lending powers, or performing the credit channeling function through a National Investment Authority. Discount window facilities are not perfect, but they do represent real benefits not obtainable through these alternatives.

We conclude by briefly summarizing our case for a new credit channeling role and the benefits it would provide.

I. EMERGENCY LENDING, POLITICAL ECONOMY, AND THE DIP DISCOUNT WINDOW FACILITY

Given that the Covid-19 pandemic and its associated financial and economic crises did not require credit intervention in bankruptcy markets, an important question we must answer is why should such interventions be necessary in the next crisis. After all, if institutions are layered[51] and crisis responders expand the playbook from the last crisis in responding to the next, shouldn't we expect the Fed and Congress to respond in the same ways in that future crisis as they did in 2020?

In a word, no. There is good reason to expect that neither Congress nor the Fed will be well-suited to the kind of crisis we envision, a time when the economic is tanking and credit support for companies is disappearing. In this Part, we explain how Covid-19 arguably destabilized both Congress's and the Fed's ability to rerun its 2020 playbook and then explain how DIP financing in general and our proposal in particular would function in that new crisis.

A. The Covid-19 Crisis and the Fiscal-Monetary Response

The state of the global economy in January 2020 was unusually robust. Global growth rate in 2019 was estimated at a brisk 3%.[52] In the United States,

[51] See Jeroen van der Heijden, *Institutional Layering: A Review of the Use of the Concept*, 31 POLITICS 9 2011 for an overview of this literature.

[52] *World Economic Outlook, January 2020: Tentative Stabilization, Sluggish Recovery?*, INT'L MONETARY FUND (Jan. 20, 2020), https://www.imf.org/en/Publications/WEO/Issues/2020/01/20/weo-update-january2020.

the unemployment rate had continued to tick down, to its low of 3.5% in February 2020, a figure not reached since 1969.[53] Sky-high asset valuations led to uncertainty, and inflation remained persistently lower than central bank targets and projections, to be sure, but the state of the economy was unprecedentedly strong.

How much had changed by January 2022. In the two intervening years, the world had been whipsawed by the novel coronavirus and the disease it created, Covid-19. The United States entered into recession in March 2020, the same time that the Fed launched an all-out war against that threat and the quickly-materializing financial crisis that loomed over the economy.[54] Unemployment, as measured later, skyrocketed in mid-March to above 20%, the largest numbers since the Great Depression, only to fall back to 3.9% in December 2021.[55] Meanwhile, the national debt increased from $23.2 trillion in January 2020 to $29.6 trillion in December 2021, a 26% increase. (For context, during the previous two-year period, from January 2018 to December 2019, the debt rose from $20.5 trillion to $23.2 trillion, or an increase of 13%).[56]

The question of how the economy responded to the exogenous shock of Covid-19 and the endogenous policies of the government will likely be one to occupy scholars and policymakers for generations to come. But we do know the basic contours of fiscal and monetary policy. In early March 2020, the Fed dropped its target interest rate 175 basis points, the largest such drop in the Fed's history.[57] It announced a significant interjection of liquidity into short-term funding markets, expanding a similar intervention it had engineered in September 2019. It announced an initially limited, eventually unlimited, large-scale asset purchasing program. It broke the glass on an array of emergency lending policies first engineered in response to the 2008 financial crisis,

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[53] *Unemployment Rate*, FRED ECON. DATA (2021), https://fred.stlouisfed.org/series/UNRATE.

[54] *See, e.g.*, *Business Cycle Dating Committee Announcement*, NAT'L BUREAU OF ECON. RESEARCH (June 8, 2020), https://www.nber.org/news/business-cycle-dating-committee-announcement-june-8-2020. *See* Justin Baer, *The Day Coronavirus Nearly Broke the Financial Markets*, WALL STREET J. (May 20, 2020), https://www.wsj.com/articles/the-day-coronavirus-nearly-broke-the-financial-markets-11589982288.

[55] *See* FRED Economic Data, *supra* note 32.

[56] Data available from US DEPT OF TREAS'Y, MONTHLY STATEMENTS OF THE PUBLIC DEBT, available at https://www.treasurydirect.gov/govt/reports/pd/mspd/mspd.htm (accessed on January 24, 2022).

[57] *See* Board of Governors Press Release, *supra* note 17.

including a commercial paper funding facility,[58] a primary dealer lending facility,[59] a money-market fund liquidity facility,[60] and renewing its international swap lines for a select number of foreign central banks.[61]

These tools in the face of the pandemic represented a renewal of earlier commitments forged during the 2008 crisis. But the Fed also quickly departed from that 2008 baseline by continuing to innovate, including by--controversially—supporting bond issuances for corporate debt issuers in the primary and secondary debt markets.[62] It later created a facility to purchase the bonds of state and local governments, revising the parameters of the facility to increase its reach.[63] The Fed also attempted, with minimal success and even more political controversy, to lend through banks to small businesses in need of more assistance.[64] All told, the Fed's monetary policy and emergency lending doubled its balance sheet from $4.1 trillion in January 2020 to over $8.7 trillion in the fall of 2020. Figure 1 illustrates the expansion.

Figure 1: Federal Reserve Balance Sheet, January 2020 to December 2021.

[58] *Commercial Paper Funding Facility*, BOARD OF GOVERNORS OF THE FED. RESERVE SYS. (Jan. 11, 2021), https://www.federalreserve.gov/monetarypolicy/cpff.htm.

[59] *Primary Dealer Credit Facility*, BOARD OF GOVERNORS OF THE FED. RESERVE SYS. (Jan. 11, 2021), https://www.federalreserve.gov/monetarypolicy/pdcf.htm.

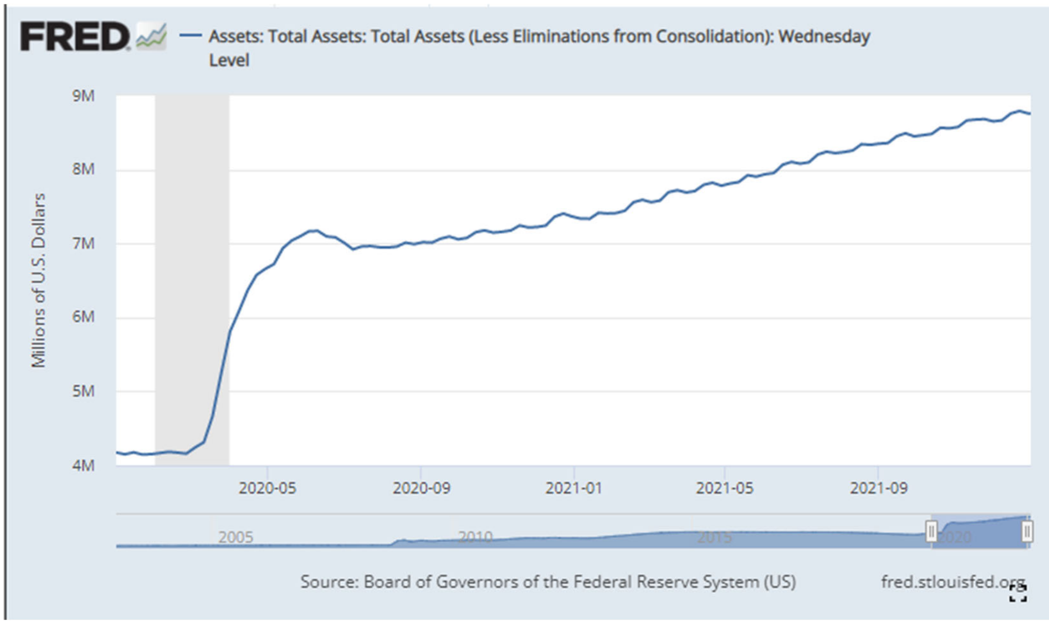
[60] *Money Market Mutual Fund Liquidity Facility*, BOARD OF GOVERNORS OF THE FED. RESERVE SYS. (Jan. 11, 2021), https://www.federalreserve.gov/monetarypolicy/mmlf.htm.

[61] *Central Bank Liquidity Swaps*, BOARD OF GOVERNORS OF THE FED. RESERVE SYS. (July 29, 2020), https://www.federalreserve.gov/monetarypolicy/central-bank-liquidity-swaps.htm.

[62] *See* Menand, *supra* note 11.

[63] *Municipal Liquidity Facility*, BOARD OF GOVERNORS OF THE FED. RESERVE SYS. (Aug. 11, 2020), , https://www.federalreserve.gov/monetarypolicy/muni.htm.

[64] For an overview and postmortem of the Main Street Lending Program, *see* Nick Timiraos, *Fed Had a Loan Plan for Midsize Firms Hurt by Covid. It Found Few Takers*, WALL STREET J. (Jan. 4, 2021), https://www.wsj.com/articles/fed-had-a-loan-plan-for-midsize-firms-hurt-by-covid-it-found-few-takers-11609774458.



Despite accusations that dysfunctional gridlock was leading Congress to defer entirely to the Fed, Congress acted quickly, too. After a series of smaller packages meant to prepare for the economic instability of Covid-19,[65] on March 27 Congress passed the largest fiscal stimulus in U.S. history, the $2.2 trillion CARES Act. The Act created stimulus checks to families below certain income limits, supplemented unemployment insurance, created a forgivable loan system for firms that committed to protect their payroll, and, as relevant to the Federal Reserve, created a $454 billion fund, appropriated to the U.S. Treasury, to invest in programs operated by the Fed under its 13(3) emergency lending authority.[66]

Remarkably, although unemployment surged from 3.5% in February 2020 to 14.7% in April, it then steadily declined, dropping to 7.9% by September 2020 (before settling into 3.9% by December 2021). And after significant give-and-take, Congress passed an omnibus spending bill that included significant fiscal stimulus on December 23, 2020 and another on March 11, 2021.[67]

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[65] Pub. L. 116-127, 134 Stat. 178 (2020).

[66] Pub. L. 116-136, 134 Stat. 281 (2020).

[67] *See* Seung Min Kim, Jeff Stein, Mike DeBonis & Josh Dawsey, *Trump Signs Stimulus and Government Spending Bill into Law, Averting Shutdown*, WASH. POST (Dec. 27, 2020), https://www.washingtonpost.com/us-policy/2020/12/27/trump-stimulus-shutdown-congress/.

Commentators attribute the lower-than-expected unemployment rate to a number of factors, not least is the overwhelming monetary and fiscal response from the Fed and Congress in March 2020, but there are signs of trouble on the horizon: in December 2020, U.S. employment fell by 140,000, reversing a trend since April of job growth.[68] And while some scholars and policymakers expected a significant rise in business bankruptcies, state financial distress, and household and individual insolvency,[69] the reality is that 2021 ended up being an economically buoyant one. It seemed that Congress and the Fed did what they were designed to do: they supported the economy and softened the landing in the face of generational calamity.

And then came the pushback.

B. The Fragility of the 2020 Fiscal-Monetary Consensus

The arguments against the fiscal-monetary consensus of 2020—with the Fed and Treasury yoked closely together in favor of deep fiscal and monetary commitments to financial stability and economic accommodation—have come in three principal veins: (1) that such efforts are inherently inflationary, (2) that such efforts exacerbate inequality, and (3) that such efforts place the Fed out of its core commitments and into new areas of experimentation that it should avoid.

1. The Inflation of 2021

At the end of December 2020, with the Covid-19 vaccines in full production and emergency approval, economic forecasters were optimistic. The Fed anticipated that GDP would grow at 4.2% (it grew at 2.3%); it anticipated that unemployment would be 5.0% (it ended at 4.2%); and it expected core personal consumption expenditures inflation at 1.8% (it ended at 7%).[70]

That the Fed was off its forecast on unemployment and GDP growth is perhaps not surprising. Few others anticipated the surge in inflation either.

[68] BUREAU OF LABOR STATISTICS, ECON. NEWS RELEASE (2021), https://www.bls.gov/news.release/empsit.nr0.htm.

[69] Jerome H. Powell, Chair of the Federal Reserve, Speech at the National Association for Business Economics Virtual Annual Meeting: Recent Economic Developments and the Challenges Ahead (Oct. 6, 2020), https://www.federalreserve.gov/newsevents/speech/powell20201006a.htm.

[70] See Federal Open Market Committee, Summary of Economic Projections, December 2020, available at https://www.federalreserve.gov/monetarypolicy/files/fomcprojtabl20201216.pdf (accessed January 24, 2022).

But inflationary jump was the largest since 1982, when the Fed's primary interest rate was 12.24%. What is more striking is how quickly the question of inflation has become the dominant macroeconomic narrative of early 2022.

Where does this inflation come from? There are a variety of views. Some view the inflation as driven primarily by the exogenous shock of pandemic-related supply chain disruptions.[71] Others as reflecting the failures of overreactive fiscal policies.[72] The Fed's own view is evolving, but the central bankers regard combating inflation as the central challenge for 2022.

The unexpected surge in inflation will complicate, perhaps dramatically, Congress's and the Fed's ability to rerun the fiscal-monetary approaches of 2020 in the future. That rare moment of bipartisanship in 2020 around the CARES Act and the enthusiasm for the Fed's experimentation has already waned substantially and become an important flash point in partisan politics. Should the economy teeter on the edge of calamity again—potentially causing a wave of small- and medium-sized bankruptcies—there is significant risk that neither the Fed nor Congress will be available to provide that relief in the same way.

2. The Rise of the Hawkish Left

Historically, the partisan cleavages around central banking consisted of doves and hawks: the former likelier to weigh risks to the economy in favor of supporting employment, the latter likelier to emphasize price stability. Doves were likelier to be associated with economic policy ideas within the Democratic Party; hawks with the Republicans.[73]

The aftermath of the 2008 and especially 2020 crises have scrambled this old political order, with a growing chorus from the "hawkish left."[74] This group is characterized by intense criticism of the Fed's accommodative policies, but not because they are likely to cause inflation. They are critical because these policies are likely to exacerbate inequality or otherwise reward bankers and investors at the expense of working people. As Christopher Leonard, one of the

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[71] David Beckworth and Patrick Horan, *The Inflation Surge is Coming to an End*, DISCOURSE, December 20, 2021.

[72] Larry Summers, *On Inflation, It's Past Time for Team 'Transitory' to Stand Down*, WASHINGTON POST, November 15, 2021.

[73] Michael D. Bordo & Klodiana Istrefi, *Perceived FOMC: The Making of Hawks, Doves, and Swingers*, NBER Working Paper 24650, May 2018, available at https://www.nber.org/papers/w24650 (accessed January 24, 2022).

[74] Peter Conti-Brown, *The Rise of the Hawkish Left*, Brookings Institution, forthcoming 2022.

intellectual leaders of this movement describes it, these are the "Lords of Easy Money," or, in another leading critical view, "the engine of inequality."[75] It may be too early to label this political upheaval as a fundamental restructuring of monetary politics in America. But this rising critique from the left in favor of *less* economic accommodation bodes ill for future Fed experimentation during crises. The Fed depends on bipartisan support for politically risky activities. This support is part of the Fed's DNA and gives it cover to do the sometimes politically difficult work of "leaning against the wind," in one favored central banking metaphor.[76] In the absence of this kind of support, the Fed's ability to intervene in crises is diminished, leaving the plausibility of such interventions, on the scope of the fiscal-monetary consensus of 2020, much less likely.

C. Credit Market Dysfunction: DIP Finance in Bankruptcy

Given the sensitivities identified above, while we argue in the Article for a robust role for the Fed in channeling credit policy, the Fed should not simply become a roving commission to meddle in every corner of the credit markets. Some credit markets are relatively efficient. In these markets, intervention is unnecessary under ordinary circumstances, although it may be needed in a market-wide crisis or other economic disruption. If the Federal Reserve identifies a market that has structural deficiencies, by contrast, the credit channeling function may be warranted even in the absence of a crisis.

In this section, we highlight an area of the credit markets that, without the fiscal-monetary support of 2020, could turn quickly into economic calamity: the market for Debtor in Possession financing in bankruptcy. Although the market appears to be robust by some measures, it suffers from persistent structural deficiencies that call for some kind of structured, flexible, and seasonal regulatory intervention. We begin the section by briefly describing the history of DIP financing, which hints at a strategy that could be incorporated into the Federal Reserve discount window facility we propose in the next part. We then give an overview of the current DIP financing market, highlighting the two dysfunctional elements that are sufficiently serious to warrant intervention by the visible hand.

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[75] CHRISTOPHER LEONARD, THE LORDS OF EASY MONEY: HOW THE FEDERAL RESERVE BROKE THE AMERICAN ECONOMY (2022); KAREN PETROU, ENGINE OF INEQUALITY: THE FED AND THE FUTURE OF WEALTH IN AMERICA (2021).

[76] These metaphors are documented in PETER CONTI-BROWN, THE POWER AND INDEPENDENCE OF THE FEDERAL RESERVE (2016)

1. <u>The Origins of Debtor-in-Possession Financing</u>

Well over a century ago, the foundations of debtor-in-possession financing emerged in connection with a common law process called equity or railroad receivership that was used to reorganized troubled railroads.[77] Then as now, corporate debtors needed new financing to fund their operations during the restructuring process. A new lender would be extremely reluctant to lend, however, because all of the debtor's assets were usually encumbered by previous lenders (generally the holders of mortgage bonds). Unless the new lender could be given priority status, the proceeds of its loans would simply serve to benefit the prior lenders—a classic "debt overhang" problem.[78]

Courts devised an ingenious solution to the dilemma. To address a railroad's financing needs in an equity receivership, the court authorized the receiver to issue a "receiver's certificate," which was a promissory note "by which the railroad borrowed from investors against the credit of the 'whole estate' of the railroad" on a short-term basis.[79] Because the railroad's assets were in receivership, the reasoning went, bondholders and other creditors of the debtor were entitled to payment only after expenses of the receivership were paid. In current lingo, they now had a net pledge rather than a gross pledge.[80] As an expense of the receivership, the receiver's certificate therefore slipped in front of the bondholders' mortgages in payment priority: the receiver's certificate was entitled to be paid first, and it also had first claim on the proceeds of the sale of any property securing the receivership. Given this priority, and the high probability the obligation would be repaid, investors were happy to help finance the receivership by investing in receiver's certificates.

In the early years, the receiver would identify the immediate cash needs for protecting the railroad's tangible assets and ask the court to authorize receiver's certificates to cover the expenses. In time, courts began authorizing certificates for the costs of operating the railroad, even where

[77] *See, e.g.*, Peter Tufano, *Business Failure, Judicial Intervention, and Financial Innovation: Restructuring U.S. Railroads in the Nineteenth Century*, 71 BUS. HIST. REV. 1, 8 (1997).

[78] The discussion in this paragraph and the next draws on David A. Skeel, Jr., *The Past, Present and Future of Debtor-in-Possession Financing*, 25 CARD. L. REV. 1905, 1911-12 (2004).

[79] Tufano, *supra* note 55, at 8. The nuances of early receiver's certificate doctrine are discussed in detail in William A. Car, *Receiver's Certificates*, 1 PA. L. SERIES 595 (1886).

[80] In current municipal bankruptcy, section 928(b) has a similar effect, making revenue bonds subject to any operating expenses. 11 U.S.C. § 928(b).

these costs didn't relate directly to protecting tangible collateral. Under the distinction that emerged, receiver's certificates could be used for "preservation" but not for "operations."[81] When Congress codified large-scale corporate reorganization for the first time in the 1930s, it authorized the use of receiver's certificates for short-term borrowing, without any reference to preservation and operations.[82] The distinction gradually disappeared in practice as well.

The most striking feature of this history for our purposes is courts' ingenuity in facilitating lending even when the debtor's assets were already fully encumbered. This tradition of ingenuity will inspire one feature of the solution we advocate in the next part.[83]

2. The Structural Flaws in the DIP Financing Market

When Congress enacted the current bankruptcy laws in 1978, it included an extremely expansive provision for Debtor-in-Possession financing.[84] Gone was any reference to preservation or operations, or any restriction on which debtors can obtain DIP financing and what they can use it for.

The current provision envisions that a business that is seeking to reorganize under Chapter 11 will first attempt to borrow funds on an unsecured, administrative expense basis, without a lien on any of the debtor's assets.[85] Administrative expenses are one of the highest priorities of creditors that do not have a lien,[86] but they come after liens in priority.[87] If lenders will not make a loan on an unsecured, administrative basis alone, the court is authorized to give the lender a lien on any assets that do not already have a lien, and/or a second priority lien on assets that other creditors have liens

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81 These developments are recounted in Harvey J. Baker, *Certificates of Indebtedness in Reorganization Proceedings: Analysis and Legislative Proposals*, 50 AM. BANKR. L.J. 1, 8-16 (1976).

82 *Id*.

83 *See* Part III(C), *infra*.

84 11 U.S.C. § 364.

85 11 U.S.C. § 364(b).

86 Administrative expenses also must be paid in full in cash at the time the debtor's reorganization plan is confirmed and becomes effective 11 U.S.C. § 1129(a)(9).

87 11 U.S.C. § 725 (treatment of property interests); 11 U.S.C. § 726(1)(A)(treatment of unsecured priority claims).

on.[88] Due to the debt overhang problem discussed earlier, DIP lenders nearly always insist on receiving a lien.[89]

Finally, and most dramatically, the court can authorize a so-called "priming lien"—a lien that takes priority even over existing liens.[90] Before granting a priming lien, the court must conclude that the prior lenders who are being trumped will be "adequately protected."[91] This, as we shall see, has proven to be a very significant obstacle.

During the recent pandemic, the DIP financing market was remarkably robust by some measures. According to one estimate, corporate debtors obtained roughly $20.762 billion of DIP financing in 2020, amid the pandemic. Not only is this a large amount in absolute terms; it is over $5 billion more than debtors obtained in 2019,[92] which was itself a considerable amount.

On the surface, these numbers seem to suggest all is well in the DIP financing markets. But a closer look tells a very different story. There are two major structural problems in the market: the pricing for DIP financing is seriously out of kilter; and DIP financing is generally available for the largest corporate debtors, but almost entirely unavailable for small debtors.

Start with the first problem, the unusually high cost of DIP financing. In an ordinary market, one might have expected lenders to earn supra-competitive profits for a few years after the current Bankruptcy Code was adopted, given the breadth of the new DIP financing provision and the other changes brought by the new law.[93] Within a few years, however, profits should

[88] 11 U.S.C. § 364(c).

[89] Neiman Marcus's request for approval of its bankruptcy financing in 2020 is typical. Neiman's motion stated that "the Debtors, together with their advisors, sought and marketed alternative sources of postpetition financing to determine whether the Debtors could obtain debtor-in-possession financing as an administrative expense. No parties were willing to provide postpetition financing solely on an unsecured, administrative priority basis." Debtors' Emergency Motion for Entry of Interim and Final Orders (I) Authorizing the Debtors to (A) Obtain Postpetition Financing and (B) Utilize Cash Collateral, (II) Granting Adequate Protection to Prepetition Secured Parties, (III) Modifying the Automatic Stay, (IV) Scheduling a Final Hearing, and (V) Granting Related Relief, *In re Neiman Marcus Group Ltd LLC, et al,* Case No. 20-32519 (Bankr. S.D. Tex. May 7, 2020) at 41.

[90] 11 U.S.C. § 364(d).

[91] *Id.*

[92] Our thanks to David Smith for these numbers, which he compiled from information in the Deal database. *See* Email from David C. Smith to David Skeel (June 7, 2021, 2:37pm).

[93] For a recent description of this dynamic in competitive markets and factors such as monopoly that can interfere, see PHILIPPE AGHION, CELINE ANTONIN, & SIMON BUNEL, THE

have declined as new lenders entered and offered more competition to the early entrants.

The DIP financing market has developed quite differently. More than forty years after the financing provision was enacted, the lenders that provide bankruptcy financing continue to earn extraordinary profits—profits that suggest the market is not genuinely competitive. One recent study found that lenders charge several percentage points higher than a competitive interest rate;[94] another concluded that DIP loans are priced similarly to junk debt, despite being far less risky.[95] The wave of financing during the pandemic does not appear to have corrected the dysfunction, as reflected in the extremely high cost of much of this financing: J.C. Penny was forced to pay 11.75% above the risk-free rate for bankruptcy financing, Horbeck Offshore paid 12.5% more, and LA Fitness $10%.[96]

For a clue as to why lenders are able to charge such high rates for financing, we need only look at the source of the funds. Recent empirical studies have found that at least 75% of the loans come from the debtor's prebankruptcy lenders—thus, from insiders.[97] The most recent data pegs the number at 80%, and its author suggests the percentage is even higher in the past five years or so.[98]

Several factors seem to create the monopoly enjoyed by debtors' inside lenders. The first is an information asymmetry. Because the debtor's principal lenders have more and better information about the debtor (due, for instance, to their access to ongoing financial information from the debtor as they monitor the loan) than outside lenders, outside lenders are discouraged from competing to finance corporate debtors.[99] Second, and even more important, this competitive advantage is magnified by the debt overhang issues discussed

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[94] Eckbo, Lang, and Wang, *supra* note 32.

[95] Tung, *supra* note 33.

[96] Wang Email (June 21, 2020), *supra* note 34.

[97] Tung, *supra* note 33.

[98] Eckbo et al, *supra* note 32. Wang Email (June 21, 2020), *supra* note 34)(noting that "between 2015 and 2019, about 90% of DIP loans for large firms are provided by prepetition lenders").

[99] *See, e.g.,* Kenneth Ayotte & David A. Skeel, Jr., *Bankruptcy Law as a Liquidity Provider*, 80 U. CHI. L. REV. 1557, 1579-85 (discussing information asymmetry (or "adverse selection") issues).

earlier.[100] Outside lenders will be reluctant to offer alternative financing unless their loan is given priority treatment; but the inside lenders usually have a lien on all of the debtor's assets, which means that priority is only possible if the bankruptcy court can be persuaded to give the outside lender a priming lien, based on the court's conclusion the insider's interests will not be adversely affected (they will be "adequately protected").[101] Courts rarely grant so-called nonconsensual priming liens—that is, a priming lien to an outside lender over the objection of the insider lender.[102] These factors make it extremely difficult for an outside lender to compete.[103]

The discussion thus far involves bankruptcy financing of large corporate debtors. These debtors often do receive DIP loans (73.49% of the time for the largest debtors, according to our data),[104] but at highly noncompetitive prices. The second structural problem in the DIP financing market is with smaller debtors. Unlike their larger peers, most smaller corporate debtors are unable to get any DIP financing at all.

Prior research has found a strong correlation between receiving DIP loans and successfully reorganizing; firms that obtain DIP financing are much more likely to reorganize than those that do not.[105] The existing research also

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100 *See supra* note 36 and accompanying text.

101 11 U.S.C. § 364(d)(2). For evidence that debtors' assets are fully encumbered, see Kenneth M. Ayotte & Edward R. Morrison*, Creditor Control and Conflict in Chapter 11,* 1 J. LEGAL ANALYSIS 511, 513-14 (2009)(finding that found that 75% of bankruptcy debtors obtain senior secured financing before bankruptcy and the loans are secured by all of the debtor's assets 97% percent of the time").

102 For discussion of this phenomenon and other obstacles to obtaining outside financing, see David Skeel, *Pandemic Hope for Bankruptcy Financing*, 131 YALE L.J. FORUM 315 (2022).

103 A final factor also may further deter outside bids: in recent cases, inside lenders have often provided DIP financing as part of a larger set of agreements that gives the inside lenders control of the case and may enable to insiders to acquire the company (sometimes while also offering benefits to the debtor's managers). Ayotte & Ellias emphasize this feature of many DIP loans in their recent work. Kenneth Ayotte & Jared A. Ellias, *Bankruptcy Process for Sale*, YALE J. REG. (forthcoming, 2022). If the insider lenders expect significant profits from the arrangement, they could underbid any outside lender and still expect to profit overall.

104 Our findings are discussed in note [XX] and accompanying text *infra*.

105 *See, e.g.,* Sreedhar Bharath, Sandeep Dahiya, Anthony Saunders, and Anand Srinivasan, *So What Do I Get? The Bank's View of Lending Relationships*, 85 J. FIN. ECON. 368 (2003); Maria Carapeto, *Does Debtor-in-Possession Financing Add Value?* (IFA Working Paper No. 294-1999), online at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=161428; B. Espen Eckbo, Kai Li, & Wei Wang, *Rent Extraction by Super-Priority Lenders* (Tuck School of Business, Working Paper No. 3384389, 2019).

has found that the largest firms are the one most likely to obtain financing.[106] There is very little empirical evidence about small firms, because several of the most widely used databases only include large firms.[107] Prior anecdotal evidence suggested that smaller firms are much less likely to obtain financing, but this tendency has not previously been document, due to the limitations of the most commonly used sources of data

Using a much larger body of data than existing studies, we sought to provide of more systemic assessment.[108] Our analysis is, to our knowledge, the first empirical documentation that smaller firms do indeed fare far worse than larger firms in obtaining bankruptcy financing. In fact, we find that the financing gap is even larger than is commonly assumed.

Based on data on nearly every corporate debtor that filed for bankruptcy between 1987 and 2020—and which, importantly, includes even very small debtors—we determined the percentages of firms of various sizes that obtained DIP financing. We found that 73.49% of companies with over $200 million in assets and 61.94% of companies with assets of $100-200 million obtained bankruptcy financing, whereas only 27.58% of companies with assets of $10-50 million and 4.06% with less than $10 million of assets did. The general pattern is reflected in the figure below.

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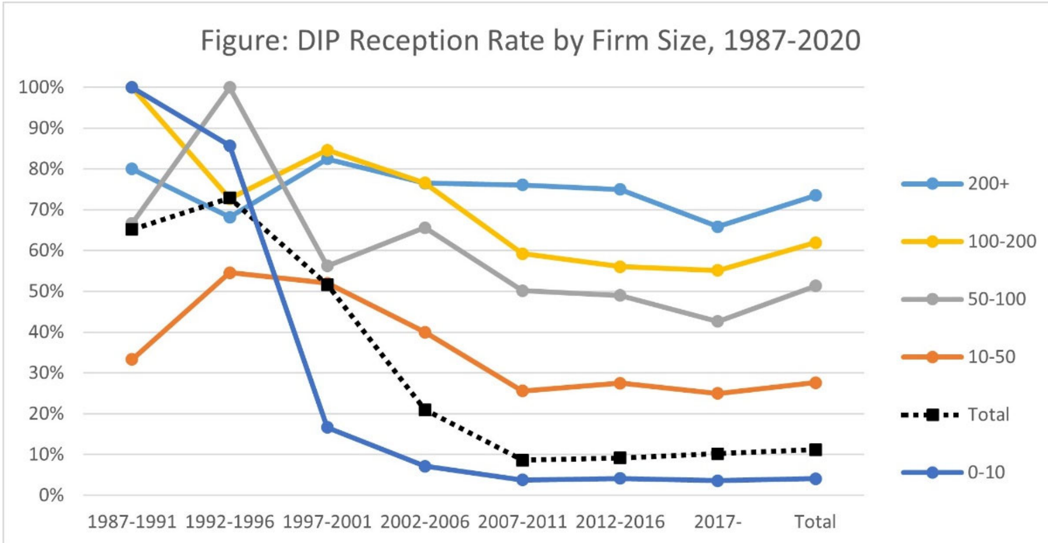
106 *Id.* Eckbo, Lang and Wang; Tung; and our own data also find a direct correlation between size and likelihood of obtaining DIP financing. *See* Eckbo, Lang & Wang, *supra* note 32; Tung, *supra* note 33. Our data also reveal an additional dimension on which smaller firms do poorly: the loans they do receive are smaller as a percentage of assets (4.17% for the smallest firms) than the loans obtained by largest firms (73.49%).

107 The *Bankruptcy Datasource* "Public and Major Company Database," for instance, is limited to publicly held companies and privately held companies that issue public debt or are "significant and newsworthy." *See* http://www.bankruptcydata.com/findabrtop.asp. Similarly, Lynn LoPucki's Bankruptcy Research Database (BRD) includes "large" public company bankruptcy filings since October 1, 1979, defined as debtors with at least $100 million in assets measured in 1980 dollars (currently, roughly $300 million).

108 Our thanks once again to David Smith, who generated the data from the Deal Pipeline.



It is important to emphasize that the absence of financing does not mean that large numbers of viable, small corporate debtors are forced to liquidate due to an inability to obtain bankruptcy financing. Many small businesses are not viable when they file for bankruptcy—they are restaurants that never attracted a clientele or business ideas that did not succeed.[109] For them, bankruptcy is an opportunity to extinguish their debts and start over. But at least some of these corporate debtors are potentially viable companies that do not obtain the financing they need for their operations in bankruptcy and fail as a result.[110] Moreover, if there were an economic crisis or other disruption in the markets that caused otherwise healthy businesses to default, large numbers of potentially viable smaller firms could fail if DIP financing were not available.

Perhaps there are few viable firms among that small debtors that file for bankruptcy. But a worrisome feature of the DIP financing market strongly

[109] Baird and Morrison refer to these small businesses as "serial entrepreneurs." *See* Douglas G. Baird & Edward Morrison, *Serial Entrepreneurs and Small Business Bankruptcies*, 105 COLUM. 2310 (2005)(typical Chapter 11 debtors are small businesses whose businesses are not viable when they file for bankruptcy).

[110] This statement is not inconsistent with findings that courts generally do a good job of lifting the automatic stay or dismissing the case if the debtor is unlikely to reorganize. *See, e.g.,* Edward R. Morrison, *Bankruptcy Decision Making: An Empirical Study of Continuation Bias in Small Business Bankruptcies*, 50 J. L.& ECON. 381 (2007); Elizabeth Warren & Jay L. Westbrook, *The Success of Chapter 11: A Challenge to the Critics*, 107 MICH L. REV. 603 (2009). Failure to persuade the debtor's principal lender to extend DIP financing is likely to be the death knell for such a business, whether or not the business is viable.

suggests that the market is poorly structured to provide financing for small, viable firms. Unlike with large businesses, which borrow from a range of bank and non-bank lenders, the principal lender for most small businesses is a single bank.[111] Not surprisingly, the banks that lend to smaller businesses tend to be local and regional banks. Although banks in general do play a major role in the DIP financing market,[112] the banks that play this role are large banks, not local and regional banks. The two most frequent DIP lenders in a large recent study were JP Morgan Chase and Bank of America, followed by Wells Fargo and Citigroup.[113] These are, by far, the largest four banks in America. All ten of the top DIP lenders that were banks were very large banks.[114]

The structure of the DIP financing market is thus poorly designed to meet the needs of smaller businesses in bankruptcy. Under ordinary conditions, this means that some potentially viable businesses will fail due to their inability to obtain DIP financing. In the event of an economic disruption that caused previously healthy businesses to default, the costs of this flaw in the market could be significant unless local and regional banks that currently eschew DIP financing can be encouraged to enter the market. Such a tipping point, in the absence of a fiscal-monetary response similar to that of 2020, could have devastating consequences to the broader economy, far beyond the businesses themselves.

Notice that the two structural flaws in the DIP financing market have very different implications for intervention. The optimal corrective for the excessive premia large corporate debtors are forced to pay for financing would be to render that market more competitive: that is, to loosen the stranglehold that these debtors' inside lenders have on them. With small firms, by contrast, the best solution is to give the debtor's current lender—the inside lender— a greater incentive to lend. For large firms, the inside lenders are, in a sense, the problem; for smaller firms, they are the solution.

A nuanced Fed intervention to correct the dysfunction in this market could thus aim at different targets in the two contexts and resolve these

[111] *See, e.g.,* Scott, *supra* note 42.

[112] Seventy-eight percent of DIP financing is provided by banks. Eckbo. et al., *supra* note 61, at 12. Eckbo at al. distinguish between insider-provided and new loans. We have combined the two.

[113] Email from Wei Wang, Professor of Finance, Queen's University, to David Skeel, S. Samuel Arsht Professor of Corporate Law, University of Pennsylvania Carey Law School (June 21, 2020) (describing findings in a large dataset of 267 cases with DIP loans).

[114] *Id.* The top lenders were JP Morgan Chase and Bank of America, which each have several trillion dollars of assets. Number ten was Credit Suisse First Boston.

problems. The DIP Discount Window Facility we propose in the next part can accomplish precisely this task.

D. The Stanford Proposal

We are not the first to advocate that the Fed turn its attention to the DIP financing market. In a widely cited policy brief posted to their websites at the onset of the 2020 pandemic, just as the fiscal-monetary response was taking rot, Stanford economists Peter DeMarzo, Arvind Krishnamurthy, and Joshua Rauh argued for a "Debtor-in-Possession Financing Facility" under which the Fed would directly finance bankrupt entities.[115] They note that most systemic efforts, through conventional monetary policy, large-scale asset purchases, and market-level emergency lending facilities, however useful for economic stability, are too "diffuse" in their benefits to do much more than stabilize marginal firms. Instead, they argued for the creation of the DIP Financing Facility to intervene directly into these markets to "offer DIP financing at an interest rate equal to the Federal Reserve Discount Rate (currently zero)."[116] They also envisioned that the Treasury would participate in making an "equity investment" in the special-purpose vehicle designed to accomplish this purpose.[117] The authors also indicated that such a facility should be directed as part of the Fed's emergency authority, under 13(3).

Many of the benefits of the Stanford proposal are the same for any emergency Fed intervention in these markets during a crisis: stabilization would permit far more firms to weather the crisis and emerge ready to participate in the macroeconomy as producers, consumers, and employers. There are three major problems with the proposal. First, and most basically, the Stanford proposal is illegal. As the proposal indicates, the authority under which it would putatively operate is Section 13(3), the same provision that authorized nearly all of the Fed's emergency authorities..[118] But after the extensive use of this authority in 2008-2010, Congress substantially altered the basis on which the Fed may make emergency loans. As relevant here, the revised Section 13(3) requires "a certification from the chief executive officer (or other authorized officer) of the borrower . . . that the borrower is not insolvent." Lest there be any doubt whether a bankrupt entity is insolvent, the

[115] Peter M. DeMarzo, Arvind Krishnamurthy & Joshua D. Rauh, *Debtor-in-Possession Financing Facility (DIPFF) Proposal*, STAN. GRADUATE SCH. OF BUS. (June 20, 2020), https://www.gsb.stanford.edu/sites/default/files/publication-pdf/dipff.pdf.

[116] *Id.*

[117] *Id.*

[118] 12 U.S.C. § 343.

statute clarifies that "[a] borrower shall be considered insolvent for purposes of this subparagraph if the borrower is in bankruptcy."[119]

The illegality of using § 13(3) to finance DIP financing isn't the only problem with the Stanford Proposal: we will discuss in more detail below why intermediated finance is a superior alternative. But for now, its most important virtue its legality: to use a section 13(3) facility is forbidden by law.

* * *

A Debtor-in-Possession lending facility must accomplish a number of tasks. It must be tailored the needs of the market dysfunction it is intended to address, it must be legally authorized by the Federal Reserve Act, and it must be designed such that there is reasonable incentive for participation. It must also fit within the traditions of the Federal Reserve and central banking, a proposition that requires some elaboration.

II. FEDERAL RESERVE LENDING, EMERGENCIES, AND THE DISCOUNT WINDOW

Using the discount window as a tool of directed credit policy would admittedly be a change—potentially, a large one—to the current operating system. The current system of Fed interventions in the financial markets consists of two extremes. In good times, the Fed sits above the financial system, using regulatory and supervisory tools to manage the government's role in the economy and monetary tools to intervene in the secondary markets of federal governmental debt with an eye to influencing the rates at which banks lend to each other on a short-term basis. This is "conventional monetary policy" that, although it has had several changes along the way, it has been a relatively stable basis of Federal Reserve policy since the mid-1950s.[120]

At the other end of the extreme, when crisis hits (as in 2008 and 2020) the Fed breaks the glass on a broad sweep of emergency lending facilities and unconventional monetary policies that have grown in complexity and creativity as crises wear on. The twin invocations of this emergency authority in a dozen years appear not to bode well for the proposition that the Fed will only resort to these tools rarely, but the political fallout of their usage suggests that these invocations are problematic, to say the least.

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[119] 12 U.S.C. § 343.

[120] *See* Glenn D. Rudebusch, *A Review of the Fed's Unconventional Monetary Policy*, FED. RESERVE BANK OF S.F. ECON. LETTER (Dec. 3, 2018), https://www.frbsf.org/economic-research/publications/economic-letter/2018/december/review-of-unconventional-monetary-policy/.

A storied mechanism for bank lending that, with a few exceptions, has mostly fallen into disuse, the discount window sits between these two extremes. In this Part, we explain what the discount window is, how it has evolved, and why it should be used as the foundation for the new credit channeling role we advocate for the Fed. As the historical analysis will show, there have been hints of this approach in the Fed's adaptation of the discount window to particular exigencies in the past. We are arguing, in a sense, that the mission be made more explicit. This Part also develops the details of a DIP Discount Window facility design that would address the dysfunctional features of the market and explains how lending through that facility would work.

A. The Discount Window: Evolution Toward Credit Policy

When the Fed was first organized in 1913, the discount window served as its primary mechanism for lending.[121] The Fed offers the discount window to depository institutions so that they can "manage their liquidity risks efficiently and avoid actions that have negative consequences for their customers, such as withdrawing credit during times of market stress."[122] The Fed used the discount window as its principal strategy for intervening in banking markets to, in the words of the Federal Reserve Act, "furnish an elastic currency" and "to afford means of rediscounting commercial paper."[123] In jargon-free terms, a "discount" is just a collateralized loan to eligible banks. From 1914-1980, those eligible banks had to be members of the Federal Reserve System, subject to Fed supervision and regulation. After the passage of the Monetary Control Act of 1980, any depository institution can access the Fed's discount window.[124]

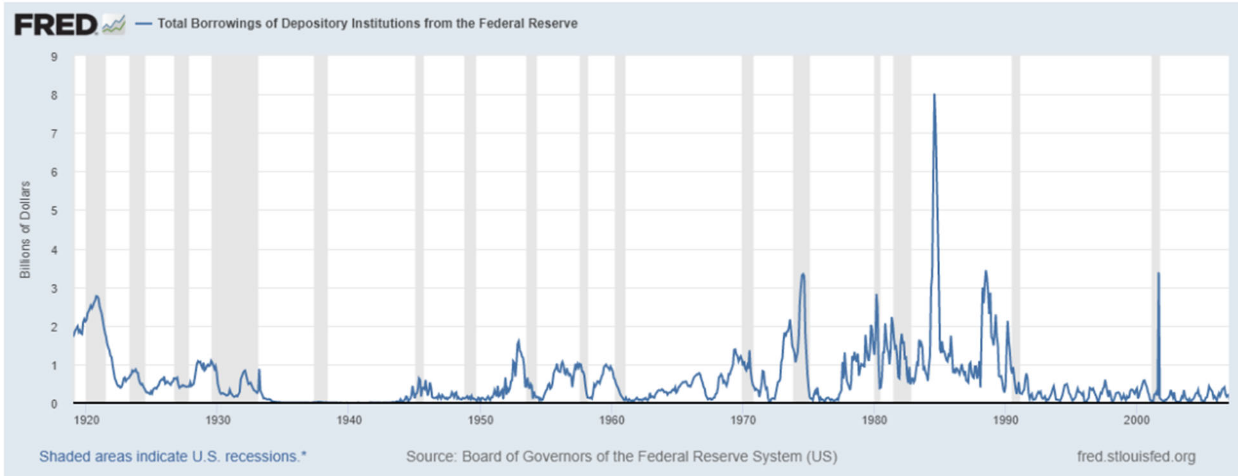
Figure 2 shows the take-up (in billions) from the Fed's discount window from 1919-2007.

[121] *See* Anna J. Schwartz, *The Misuse of the Fed's Discount Window*, 74 FED. RESERVE BANK OF ST. LOUIS REV. 58 (1992).

[122] *Discount Window Lending*, BOARD OF GOVERNORS OF THE FED. RESERVE SYS. (Dec. 31, 2020), https://www.federalreserve.gov/regreform/discount-window.htm.

[123] Public Law 63-43, ch. 6, 38 Stat. 251 (1913).

[124] Public Law 96-221, 94 Stat. 132 (1980).



Shortly after the passage of the Federal Reserve Act and accelerating (with important exceptions) ever since, the discount window began to decline in prominence in favor of the Fed's open-market operations, whereby the Fed buys and sells securities in the open market to influence their prices. Open-market operations constituted the dominant monetary regime from the 1930s through 2008.[125]

The impetus came from an intellectual change in the understanding of banking and finance and an appreciation for how different parts of the Federal Reserve Bank balance sheets operated. Indeed, the use of the discount window in 1970 and in the 1980s led several prominent economists—including Anna Schwartz,[126] Marvin Goodfriend and King,[127] and Michael Bordo[128] to call for its elimination because of perceived abuses. The basic critique is two-fold: (1) any reasonable macroeconomic function that the Fed needs to perform around the availability of money can be most efficiently accomplished through open-

[125] For a defense of the regime that succeeded it, interest-on-excess reserves, *see* Ben Bernanke & Donald Kohn, *The Fed's Interest Payments to Banks*, BROOKINGS INSTITUTION (Feb. 16, 2016), brookings.edu/blog/ben-bernanke/2016/02/16/the-feds-interest-payments-to-banks/. For a critical view, *see* GEORGE SELGIN, FLOORED!: HOW A MISGUIDED FED EXPERIMENT DEEPENED AND PROLONGED THE GREAT DEPRESSION (2018).

[126] *See* Schwartz, *supra* note 121.

[127] Marvin Goodfriend & Robert G. King, *Financial Deregulation, Monetary Policy, and Central Banking*, *in* RESTRUCTURING BANKING AND FINANCIAL SERVICES IN AMERICA 216 (William S. Haraf and Rose Marie Kushmeider, eds., 1988).

[128] Michael D. Bordo, *The Lender of Last Resort: Alternative Views and Historical Experience*, 76 FED. RESERVE BANK OF RICHMOND ECON. REV. 18 (1990).

market operations, and (2) discount-window lending invites strategic use by insolvent banks.[129]

Charles Calomiris argued that the discount window actually accomplished a different set of goals: to defuse "liquidity crises that occur in particular non-bank financial markets," especially in "periods of financial disruption."[130] In that way, Calomiris viewed the discount window as an answer to a collective action problem, a "mutually beneficial agreement among depositors not to reduce their deposits during panics."[131] The advent of deposit insurance rendered some of the need for this collective action moot, but not for those within the economic and financial system who operated outside the formal banking system, such as participants in the commercial paper market when the Penn Central railroad defaulted in the 1970s.

Until the 2008 financial crisis, there were three primary mechanisms for borrowing through the discount window: primary credit, secondary credit, and seasonal credit.[132] In that crisis, the Fed modified its primary credit facility to create a Term Discount Window Program that extended the maturities of discount window lending beyond the overnight markets that had come to dominate this lending. It also created a fourth facility, the Term Auction Facility (TAF), in December 2007. TAF, an auction with a large number of participants and a three-day lag between auction and settlement, was designed to resolve the so-called "stigma problem" associated with discount window lending.[133] TAF carried the bulk of the Fed's discount-window lending during the crisis, reaching $700 billion at its peak. To put the point differently, between 2003 and 2006, discount window lending across the

[129] According to data released after the surge in discount-window lending in the S&L crisis, fully 60% of failed institutions had outstanding Fed loans from the discount window. *See* Schwartz, *supra* note 121.

[130] Charles W. Calomiris, *Is the Discount Window Necessary? A Penn Central Perspective*, FED. RESERVE BANK OF ST. LOUIS REV.31 (1994).

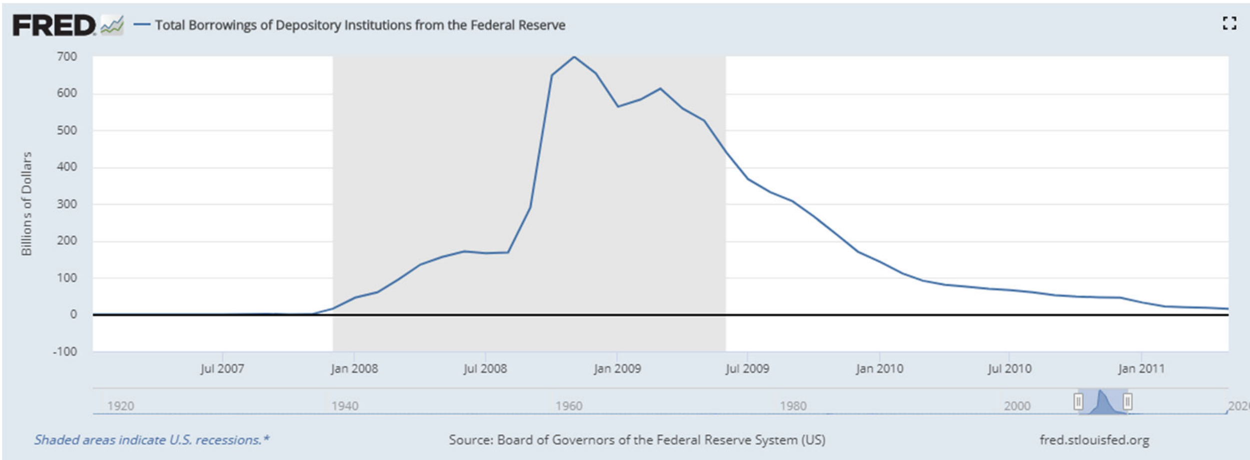
[131] *Id*. at 4.

[132] For an overview of the Term Discount Window Program and other discount window interventions, *see* Allen N. Berger, Lamont K. Black, Christa H.S. Bouwman & Jennifer Dlugosz, *The Federal Reserve's Discount Window and TAF Programs: "Pushing on a String?,"* (University of Pennsylvania, Wharton School, Weiss Center, Working Paper No. 14-06, 2016).

[133] *See* Ben S. Bernanke, Former Chairman, Fed. Reserve Sys., Speech at the Federal Reserve Bank of Richmond 2009 Credit Markets Symposium: The Federal Reserve's Balance Sheet (Apr. 3, 2009), https://www.federalreserve.gov/newsevents/speech/bernanke20090403a.htm.

system averaged $170 million per day; between 2007 and 2009, the number became $221 *billion*, or a 129,900% increase.[134]

Figure 3 presents the Fed's total discount window lending during the 2008 crisis.



To be clear, as legal scholar Kathryn Judge has argued, the Fed's 2007-2009 discount window lending, however massive, came nowhere near matching the liquidity demands that banks required. This caused them to turn to alternatives, such as deposits or loans from the Federal Home Loan Bank System.[135] Even so, the discount window was a key part of the crisis response. Taken together, the funds lent through the 2008 crisis through these four discount window facilities constituted the single largest directed lending to banks in the Fed's history. The results indicate something of an evolution of discount window lending in two key ways. First, lender-of-last-resort theory would predict that discount window lending would target weaker banks facing liquidity crises that they could not meet. Discount window lending did indeed target smaller banks so constrained, but larger banks simply used discount-window funding strategically, whatever their strength.

Second, lender-of-last-resort theory is not specifically about credit policy in the real economy, but about stabilizing the financial system in a panic. Thus, discount-window lending has not historically been viewed as the appropriate mechanism for encouraging bank lending to credit-deficient entities in the economy. In 2008, however, the Fed used discount-window lending for precisely that purpose. In its Monetary Policy Report in 2009, the Fed reported to Congress its justification for the dramatic expansion of the discount

[134] Data reported in Berger et al., *supra* note 132, at 2.

[135] Kathryn Judge, *Three Discount Windows*, 99 CORNELL L. REV. 795 (2014).

window: "By increasing the access of depository institutions to funding, the TAF has supported the ability of such institutions to meet the credit needs of their customers."[136] In this effort, they succeeded: according to the most comprehensive analysis of discount window lending in the crisis, "for both small and large banks, an increase in [discount window] usage is associated with increased total lending, increased short-term and long-term lending, and increases in all of the loan types with the exception of residential real estate loans."[137]

In sum, the 2008 crisis not only changed the way the Fed did business through its controversial and well-documented use of emergency lending authority to support individual firms (AIG, Bear Stearns) and broader facilities (money markets, primary dealers); it also represented a shift in the use of the discount window. The discount window was now viewed as a tool for implementing credit policy.

In 2020, the Fed once again deployed the discount window for credit purposes. On March 15, 2020, the Fed announced that its primary credit discount window rate would drop to 0.25%, to match the target rate for its open market operations. It also extended the maturity of the loans to 90 days, consistent with the statute, "prepayable and renewable by the borrower on a daily basis" (thus providing much more stability than the 90-day maturity suggests).

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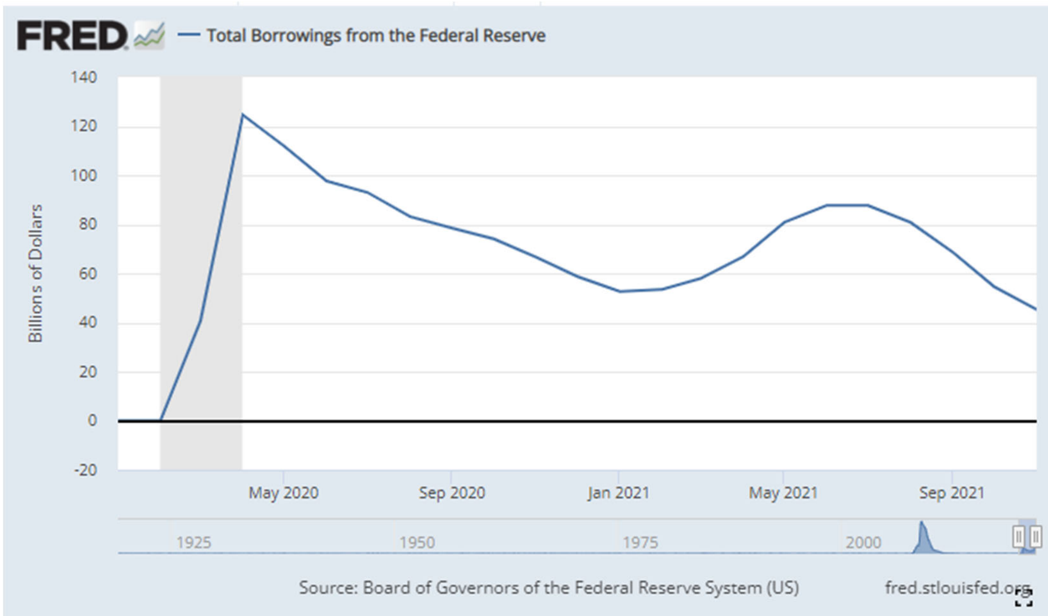
[136] BOARD OF GOVERNORS OF THE FED. RESERVE SYS., MONETARY POLICY REPORT TO THE CONGRESS 47 (2009), https://www.federalreserve.gov/monetarypolicy/files/20090224_mprfullreport.pdf.

[137] Berger et al., *supra* note 132, at 4.

Figure 4 shows the usage of the discount window from January 2020 through November 2021 (the last month of available data as of this writing).



Once again, the Fed views the discount window not in the traditional lender-of-last-resort frame for preventing panic in the financial system, but as a mechanism to influence credit policy, as exemplified by the first sentence of its press release issued four days after its announced changes to the discount window: "The Federal Reserve Board is encouraged by the notable increase in discount window borrowing this week with banks demonstrating a willingness to use the discount window as a source of funding to support the flow of credit to households and businesses."[138]

B. The DIP Discount Window

As discussed earlier, several prominent scholars advocated the use of the Fed's section 13(3) powers to facilitate DIP financing during the pandemic, a proposal that would violate the law. Our discount window strategy, by contrast, would not be limited to emergencies and would be governed by a

[138] Press Release, Board of Governors of the Federal Reserve System, Federal Reserve Board Encouraged by Increase in Discount Window Borrowing to Support the Flow of Credit to Households and Businesses (Mar. 19, 2020), https://www.federalreserve.gov/newsevents/pressreleases/monetary20200319c.htm.

separate provision of the Federal Reserve Act, Section 10B, which does not forbid bankruptcy lending. This solution is not only legal; it also is superior from policy and institutional perspectives, since it would not require the Fed to be a party to a bilateral lending arrangement, would not impose interest rate requirements, and would not need Treasury approval. It would also avoid the temptation for the Fed to use emergency lending as the solution to all market failures. And it would be available even if the political heat for fiscal and monetary experimentation meant that such experimentation was not in the offing.

Our approach to addressing structural flaws in the credit markets through the discount window builds on two historical and theoretical insights about the discount window discussed above: first, the Fed's evolution of the discount window toward credit policy and away from emergency lending policy, and second, the insight (from Calomiris) that, post-deposit insurance, the discount window is best justified for its ability to provide relief not only to banks, but to their fragile customers and counter-parties.

1. Structuring the Facility

There are three ways that a DIP Discount Window Facility might be structured: (1) as primary credit to a depository institution, (2) as seasonal credit to a depository institution, or (3) as a new regulatory category that the Fed would define as being available specifically for DIP financing, and subject to specified conditions. We think the Fed could proceed with either (1) or (2) immediately, but that the best course would be to create a new facility entirely with (3).

The first approach would be designed to mirror the existing discount window facilities with some modifications. The law governing the permissible design of such facilities is found in Section 10B of the Federal Reserve Act and Regulation A, the regulation that the Fed promulgated to implement this authority. The counterparty must be a depository institution, which means that hedge funds, investment funds, and other entities outside the regulatory and supervisory apparatus of banking cannot participate.[139] The maturity of discount window lending is limited to four months, but can be renewed at the Fed's discretion (as it committed to do both in 2008 and 2020).[140] The counterparty depository institution must not be "undercapitalized" at the time of the advance, with exceptions for "viable" depository institutions as certified by the relevant federal banking agency. These restrictions are largely

[139] 12 U.S.C. § 347b (2012).

[140] 12 U.S.C. § 347b(b)(4) (2012).

statutory and would apply whether the Fed structured a DIP facility as primary, seasonal, or DIP-specific credit.

The Fed treats seasonal credit slightly more flexibly by permitting lending to occur "for periods longer than those permitted under primary credit." Seasonal credit has historically been available for those banks whose customers truly face "seasonal" demands—in agriculture, primarily, but not exclusively.[141] But a "seasonal" wave of bankruptcies associated with recessions and the steep financing that is imposed on otherwise viable entities in a recession could be enough on its own to trigger a discount window facility. Structuring it in this way would not require the Fed to alter Regulation A necessarily, even as it tailored DIP lending to meet these regulatory requirements.

These two alternatives notwithstanding, the far superior approach would be to issue an amendment to Regulation A. In the quieter times that the Fed faces, it should make such a proposed rulemaking subject to usual notice-and-comment procedures; but even if it did not do so, it could issue such an amendment under the emergency provisions of the Administrative Procedures Act that permit a "good cause" exception to notice-and-comment rulemaking when those procedures are "impracticable, unnecessary, or contrary to the public interest."[142] This approach also permits the Fed to be more deliberate about structuring a DIP facility for purposes unique to the DIP financing.

The most important regulatory decisions the Fed will face in determining the scope of DIP financing as a separate category of discount-window lending will be (1) eligibility, to the extent that specific capital standards will apply for depository institutions that participate; (2) acceptable collateral, which will likely differ from traditional collateral presented for discount-window lending; and (3) incentives, positive and negative, for bank participation; and the appropriate scope for triggering a DIP lending facility, including whether such a facility would be established permanently, seasonally, or only in emergencies. We also consider (4), suasion, as a strategy for encouraging bank participation.

1. *Eligibility*

Eligibility for participation is limited to depository institutions, a broad category that requires a banking charter and excludes financial institutions such as mortgage banks and credit unions. Eligible depository institutions

[141] 12 U.S.C. § 461(b)(7) (2012).

[142] 5 U.S.C. § 553(b)(3)(B).

cannot be "critically undercapitalized,"[143] but otherwise the Fed retains the discretion, in practice and by rulemaking, to choose its counterparties: there is no legal "obligation to make advances" through the discount window.[144]

We see no need to alter that level of eligibility and discretion for specialized discount window facilities. One of the primary benefits outlined below to this system is the marriage of exigent lending and bank supervision. Initially, participation in discount-window facilities will likely require incentives, so the Fed should avoid imposing barriers to eligibility in the beginning. In the event that take-up of the program succeeds, and demand introduces questions about risk management for the Fed, further restrictions linked to supervisory ratings or other metrics may be appropriate.

The final eligibility requirement is not as straightforward. Recall that the structural flaws in the DIP financing market manifest themselves quite differently with the largest and smaller corporate debtors.[145] In large corporate bankruptcies, the problem is the near monopoly enjoyed by the debtor's inside lenders, which has led to an unusually high cost of credit. At the other end of the size spectrum, the principal problem is the absence of funding. The eligibility requirements of the DIP Discount Window would need to be different in the two contexts.

Start with lenders to the largest corporate debtors. In addition to setting a size threshold to distinguish this market from smaller firms—we would suggest $50 million of assets as the dividing line—the program should only be available to outside lenders, so that it would facilitate competition in this market. Giving inside lenders access to the DIP Discount Window subsidy would simply reinforce the competitive advantage inside lenders already have.

Given the dearth of competition, a key question with the large firm facility would be whether to give access to non-bank lenders such the hedge funds and equity funds that current provide roughly 22% of DIP financing.[146] Although broader access would further increase the universe of outside lenders, we believe the facility should be limited to banks. The positive regulatory externalities of the DIP Discount Window that we discuss below arise from the Fed's existing bank regulatory role, and banks already provide

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143 12 U.S.C. § 347b(b)(3) (2012) (codifying Federal Reserve Act § 10B(b)(3)).

144 *Id*. § 347(b)(4).

145 *See supra* notes 105-116 and accompanying text.

146 Eckbo, Li, & Wang, *supra* note 32, at 12.

most DIP financing.[147] This restriction would not be locked in stone, however, and could be revisited if a bank-only facility proved insufficient.

As several commentators have pointed out to us, it is possible that inside banks would try to circumvent the outsiders-only stricture of the facility by coordinating with another, ostensible outside bank to tap the program. The Fed would need to be alert to this possibility, of course, but we think it is unlikely manipulation would be rife. Even if an inside bank were tempted engage in such behavior, they would be likely to think twice, given that they are subject to continuous Fed oversight and would be subject to draconian penalties. This is another benefit of limiting the facility to banks.

Shift now to the facility for smaller corporate debtors—that is, debtors with less than $50 million in assets. Here, an outsiders-only restriction could be disastrous. Given the absence of financing for these debtors, it is important to entice local and regional banks into this credit market. The debtor's current lender is the most promising lender in this context. By subsidizing loans made by debtors' principal bank lenders as well as those made by outside banks, the facility not only could encourage lenders to make DIP loans; it might also encourage them to do so at reasonable rates.

2. *Collateral*

The Federal Reserve Act provides ample discretion for the Fed to determine the value and nature of collateral presented to the discount window, so long as the loans offered are "secured to the satisfaction" of the lending Federal Reserve Bank.[148] This phrase has become important, used as it was to justify the failure to prevent the bankruptcy of Lehman Brothers in 2008. It lacks statutory definition and had no meaning in common law.[149]

The critical question with collateral arises from the fact that most of the businesses needing access to DIP financing already have lenders to which the debtor has pledged all of its assets as collateral. This is not likely to be a problem if the existing lender will be making the new DIP loan, as will often be the case under the small debtor facility. Under the large debtor facility, by contrast-- which would be available only for new, outside lenders—the collateral requirement is more problematic. It is not immediately clear how a

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[147] *Id.*

[148] 12 U.S.C. § 347b(a) (2012) (codifying Federal Reserve Act § 10B(a)).

[149] *See* Peter Conti-Brown, Yair Listokin & Nicholas Parrillo, *Towards an Administrative Law of Central Banking*, 38 YALE J. ON REG. 1 (2021).

loan by a new lender could be "secured to the satisfaction" of the Fed. Bankruptcy's DIP financing provision provides a potential solution to this problem— the "priming lien"—as discussed earlier and discussed in more detail in Part II(C) below.

The only other restriction on collateral by statute is that such collateral must not have maturities "longer than four months."[150] At first glance, this restriction appears to be a major impediment to the facility we propose. In reality, it is not. The time restriction is easily avoided, since the Fed, by regulation, can commit to roll over debt on these maturities during the pendency of the bankruptcy proceedings. Moreover, given that DIP loans often do not have a long duration—they usually are paid off or refinanced when the debtor emerges from bankruptcy—the maturities usually would not have to be rolled over numerous times.

3. Program Incentives

A very real concern with creating a discount window facility for credit policy, rather than emergency financial policy, is that banks will simply boycott the process because the economics are not favorable. There is some concern that, in credit-policy facilities aimed at the real economy via Section 13(3) during the recent pandemic, banks did just this.[151] The Main Street Lending Program is a primary example.[152] The MSLP was open to banks on behalf of other counterparties. There were no clear eligibility requirements for banks; the secondary counterparties were required to be relatively small (15,000 employees and $5 billion in annual revenues).[153] The Fed's explanations for the MSLP were hardly a model of clarity—the Frequently Asked Questions sheet is 66 pages long and full of jargon. It appears, though, that loans had "a five-year maturity, deferral of principal payments for two

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[150] 12 U.S.C. § 347b(a) (2012) (codifying Federal Reserve Act § 10B(a)).

[151] Paul Kiernan, *Fed's $600 Billion Main Street Lending Program Sees Lukewarm Interest*, WALL STREET J. (July 1, 2020), https://www.wsj.com/articles/feds-600-billion-main-street-lending-program-sees-lukewarm-interest-11593608400.

[152] *See* William B. English & Nellie Liang, *Designing the Main Street Lending Program: Challenges and Options*, BROOKINGS INSTITUTION (June 18, 2020), https://www.brookings.edu/research/designing-the-main-street-lending-program-challenges-and-options/ for a cogent critique of the program.

[153] BOARD OF GOVERNORS OF THE FED. RESERVE SYS., TERM SHEET: MAIN STREET NEW LOAN FACILITY, (2020), available at https://www.federalreserve.gov/newsevents/pressreleases/files/monetary20200608a1.pdf.

years, deferral of interest payments for one year."[154] Banks had to retain 5% of the loans, which were priced uniformly at LIBOR + 3%.

A DIP Discount Window Facility should avoid some of the mistakes of the MSLP. First, the credit availability should be more highly subsidized, perhaps even beyond the levels of the generic discount window facilities. We recognize that, with the discount rate currently near the zero-lower bound, this would amount to paying banks to borrow instead of charging them interest. In other times, this differential will not be so pronounced. But the fact that the specialized facility would have a rate different than the primary discount window is itself not remarkable: the three main discount window facilities—primary, secondary, and seasonal—are also priced differently.[155] And the Term Auction Facility had a rate set by auction.[156]

The subsidy is appropriate for the aims of this discount window and for others that might follow. The point of Fed intervention in DIP financing markets is to prevent the liquidation of viable companies for whom efficiently priced DIP financing would mean the difference between survival and liquidation.

Another approach would be a form of regulatory subsidy that would reclassify the liquidity requirements for discount window loans obtained for credit policy purposes. Following the attacks on the United States on September 11, 2001, the Fed issued a statement that the discount window was available for all liquidity needs that banks might have in an effort to remove the stigma often associated with discount window lending.[157] In 2003, the Fed amended Regulation A, the implementing regulation for direct Fed lending, to turn the discount window into a "no questions asked" facility.[158] But there remains an important impediment: loans obtained through the discount window count against a bank's liquidity requirements. If this treatment were removed, as we believe it should be, the cost of borrowing would plummet with little consequence for financial stability. So long as underwriting remains

[154] *Main Street Lending Program*, BOARD OF GOVERNORS OF THE FE. RESERVE SYS. (Feb. 1, 2021), https://www.federalreserve.gov/monetarypolicy/mainstreetlending.htm.

[155] *The Discount Window and Discount Rate*, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM (Jan. 12, 2021), https://www.federalreserve.gov/monetarypolicy/discountrate.htm.

[156] *Term Auction Facility*, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM (Feb. 12, 2021), https://www.federalreserve.gov/regreform/reform-taf.htm.

[157] *See* Christopher Neely, *The Federal Reserve's Response to the September 11 Attacks*, REGIONAL ECONOMIST (Jan. 2002).

[158] Bill Nelson, *The Discount Window Is Available To Meet Liquidity Needs*, BANK POLICY INST. (Feb. 24, 2020), https://bpi.com/the-discount-window-is-available-to-meet-liquidity-needs/.

robust and banks retain skin in the game, this simple regulatory change would increase incentives for participation and eliminate the stigma problem associated with discount-window lending, without creating significant new risks to bank stability.

4. *Suasion*

Although the economics of a Discount Window DIP Facility should be favorable for bank participation—whether through subsidy or the nudge that the facility's institutional design would offer to first-time DIP financers—the Fed has an additional, often underappreciated option to spur additional interest if needed: the informal leverage the Fed has as bank supervisor. Bank supervision is a unique and uniquely powerful set of institutional practices distinct from regulatory authority. The Fed has in the past often invoked its supervisory authority, a kind of "moral suasion," to put pressure on market participants to act in pro-social ways.[159] Given the importance of the banks to the implementation of credit, financial, and monetary policy, it may be appropriate for supervisors to advocate for banks' participation in these programs as part of the supervisory process.

Bank participation in the Fed's credit policies is an important part of the debate about emergency relief. Some scholars conceive of banking as essentially a public function, using sovereign control over money creation to accomplish public ends.[160] Banks themselves, however, have tended to act very differently. The banks' lack of participation in the Main Street Lending Program has many reasons, but one concern, as with some failures of participation in the Payroll Protection Program, is that banks simply don't see the upside to their shareholders in participating.

Banks—and their supervisors—should rethink this shareholder-only commitment. The Fed has backstopped these instruments of credit-policy such that even if they are not profitable, participants will not incur losses. This kind of encouragement should not be altruism, but reflect part of the bargain of deposit insurance and the benefits associated with bank supervision.[161]

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[159] Examples of suasion in supervision to accomplish pro-social goals are legion. *See* PETER CONTI-BROWN, THE POWER AND INDEPENDENCE OF THE FEDERAL RESERVE 235-242 (2016). Most recently, the borrowing from the discount window by eight major banks was effectively an answer to this same problem. *See* Kate Kelly, Andrew Ross Sorkin &Jeanna Smialek, *As Market Convulses, Big Banks Plan to Borrow Funds from Fed*, N.Y. TIMES (Mar. 16, 2020), https://www.nytimes.com/2020/03/16/business/fed-discount-window.html.

[160] *E.g.*, Morgan Ricks, *Money as Infrastructure*, 2018 COLUM. BUS. L. REV. 757 (2018).

[161] In December 2020, Harvard, Wharton, and the Federal Reserve co-hosted a conference on bank supervision that yielded substantial literature reviews of scholarly and

More concretely, the banks have *already* benefitted from supervisory suasion in their favor, through supervisory forbearance.[162] As part of the Fed's response to Covid-19, it issued statements and emergency regulations that explicitly excused banks from counting nonperforming assets in their calculations of capital. This is a commitment to let banks ride out their clients' challenges, even if the consequence would be, in better times, the deterioration of bank capital and other increased supervisory penalties (as well as the risk of failure). For banks to take advantage of these benefits, especially during a period of surprising resiliency, suggests that bank supervisors have more space to condition some of that supervisory flexibility on participation in other aspects of their credit policy.

C. The Priming Lien

The Fed's obligation to be "secured to [its] satisfaction" in its discount-window facilities is both vague (since neither Congress nor the Fed has ever defined these terms) and ambiguous (since security need not necessarily be collateral). The term therefore does not serve as a useful legal limitation on Fed lending. But it is practically very important: we take for granted that the Fed will not create specialized discount window facilities without the banks who receive the loans receiving priority in bankruptcy.

This security requirement is the most significant potential complication for a DIP Discount Window facility. The assets of businesses that file for bankruptcy are usually fully encumbered by the lien of an existing lender or lenders.[163] If the incumbent lender provides the DIP loan, the concern is not serious, because the lender can simply rely on its existing collateral as security. But an outside lender does not have this luxury. If the debtor has few or no unencumbered assets, it may be very difficult to secure a loan by a outside lender "to the satisfaction." This is a particular concern for the large debtor facility, since its principal objective is to attract outside lenders. The small

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policy engagement for this growing subject. *See* Beverly Hirtle, *Banking Supervision: The Perspective from Economics*, Staff Report No. 952, FED. RESERVE BANK OF N.Y. (Dec. 2020), https://www.newyorkfed.org/medialibrary/media/research/staff_reports/sr952.pdf for a summary of this literature in economics; Julie Hill, *Bank Supervision: A Legal Scholarship Review*, available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3777580; and Sean Vanatta, *Histories of Bank Supervision*, available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3749116

[162] *Id*. at 17.

[163] *See, e.g.,* Tung, *supra* note 33, at 658 ("A pre-bankruptcy lender … typically has pre-bankruptcy liens on all the debtor's assets by the time bankruptcy approaches").

debtor facility is designed encourage inside lenders to provide DIP financing, so the concern is less serious with the small debtor facility.

Bankruptcy law provides a potential solution to this problem: the priming lien. The bankruptcy financing provision permits the court to "authorize the obtaining of credit . . . secured by a senior or equal lien on property of the estate that is subject to a lien," so long as the pre-bankruptcy lender is given "adequate protection."[164] The prospect of a superior lien would give a new lender a significantly greater incentive to provide bankruptcy financing.

In practice, bankruptcy judges often approve consensual "self-priming" liens—that is, a lien given to the insider loan that is deemed to prime the insider's prebankruptcy loan secured by the same collateral; but they rarely authorize nonconsensual priming liens for the benefit of new, outside lenders.[165] To some extent, this reluctance is invited by the statute, which makes clear that the debtor has the burden of proof to demonstrate that the pre-bankruptcy lender will be "adequately protected."[166]

For a truly effective DIP Discount Window Facility, bankruptcy courts would have to adopt more flexible standards for approving priming liens (or, alternatively, Congress could amend the financing provision to require them to do so). Absent Congressional intervention,[167] a key factor is outside lenders' willingness to challenge inside lenders by offering alternative financing. Currently, few outsiders do. But there is some basis for optimism this may change as the range of financing options for debtors increases.[168] In 2020, for example, a lender group led by Mudrick Capital challenged the favored, insider loan in the Neiman Marcus bankruptcy. The court unfortunately rejected the challenge, but an uptick in the number of challenges may lead to greater willingness to approve nonconsensual priming liens.[169]

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164 11 U.S.C. § 364(d).

165 *See* Ayotte & Morrison, *supra* note 37.

166 11 U.S.C. § 364(d)(2).

167 The principal limitation on Congress's flexibility in authorizing priming liens is the Takings Clause in U.S. CONST. amend. V, which requires an existing lender's property rights be protected. For an argument this is a less significant constraint than is often believed, see Charles J. Tabb, *The Bankruptcy Clause, the Fifth Amendment, and the Limited Rights of Secured Creditors in Bankruptcy*, 2015 U. ILL. L. REV. 765.

168 For an argument that the increasing fragmentation of firms' capital structures is likely to prompt more challenges to insider DIP loans from other lenders that already are within the debtor's capital stack, see Skeel, *supra* note 103.

169 *Id.*

It is worth emphasizing that the adequate protection requirement is not nearly so daunting an obstacle as bankruptcy judges seem to think. Even if a debtor's assets are fully encumbered, a priming lien could be deemed to attach to value created from operations during the bankruptcy case. This is precisely how receiver's certificates, the precursor to DIP financing, functioned in the nineteenth century.[170] Restoring that legal standard would facilitate the functionality of the DIP Discount Window Facility and would make good economic sense, too.

Bankruptcy courts could further incentivize competition through the simple expedient of deeming the adequate protection requirement to be met by an outside lender if the inside lenders have asked for a priming lien themselves. By requesting a priming lien—as inside lenders routinely do—the inside lenders are conceding that the value of the debtor's assets is greater than the original lien.

The existence of a DIP Discount Window facility would itself help further alleviate the problem of insider control. The benefits of the facility should induce many outside banks to offer alternative financing conditioned on the court granting a priming lien. This increase in opportunities to consider the parameters of adequate protection could create a virtuous loop. As courts develop clearer—and one suspects, more flexible—standards for authorizing priming liens, more outside lenders will be willing offer alternative financing, increasing the competitiveness of the DIP financing market.

III. BENEFITS AND COSTS OF A DISCOUNT WINDOW FACILITY

A resurgent discount window as a tool for credit channeling by the Fed has important benefits. It is also costly. In this Part, we present a clear-eyed accounting of both the costs and the benefits and defend the idea that it is, on balance, cost-beneficial as an alternative to both private DIP financing and Fed 13(3) emergency lending, especially in the absence of widespread fiscal stimulus to prevent the economic collapse of small- and medium-sized businesses. Discount window facilities targeted at other structural flaws in the credit markets would produce analogous benefits.

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[170] Based on this reasoning, two bankruptcy scholars have recently offered a strategy for expanding the use of priming liens, inspired by this historical practice. Under their proposal, a court would "require a temporary period at the outset of the case (perhaps 60-90 days) in which a DIP loan can prime even secured creditors." After this initial period, the court would then "consider a more expansive set of DIP loan proposals in the usual way." Ayotte & Ellias, *supra* note 104, at 54.

A. Benefits of Intervention

In this section, we discuss four key benefits of creating and deploying a DIP Discount Window facility: (1) improvements to the bankruptcy process by spurring more competition for the financing of large corporate debtors and better access to DIP financing for smaller debtors; (2) improvements to the bank regulatory and supervisory environment by pushing more DIP financing into depository institutions; (3) benefits for monetary policy and central banking functions generally; and (4) a more tailored approach to crisis response that is more than the usual Fed lending and less than the sweeping 13(3) interventions in 2008 and 2020.

1. Improvements to Bankruptcy Process

The DIP Discount Window Facility would improve the bankruptcy process in three important respects. First, it would help introduce more competition into the market for financing large corporate debtors. As we have seen, the vast majority of financing comes from inside lenders, at noncompetitive rates that increase the cost of credit and undermine the efficiency of the bankruptcy process.[171] The large debtor facility would entice more outside lenders to offer to provide DIP financing—and would only be available to outside lenders—and would enhance the competitiveness of the market and efficiency of the reorganization process. Second, the small debtor facility would make bankruptcy financing available for companies that might not otherwise have access to it. As we have discussed, smaller companies struggle to obtain DIP financing even under ordinary circumstances.[172] This gap in the market for financing is of particular concern during a crisis or other disruption of liquidity, since otherwise viable businesses are much more likely to be forced into bankruptcy if there has been a liquidity shock.

Third, the facility could expand the range of institutions that provide DIP financing. DIP financing currently is provided almost entirely by the largest banks, along with hedge funds and equity funds. As noted earlier, the top ten providers of DIP financing are all large banks (led by JP Morgan Chase and Bank of America), and only 21 banks made more than 5 DIP loans in the past several decades.[173] Although local banks would seem to be logical participants in the DIP financing market, they currently play very little role. The DIP Discount Window Facility might induce both incumbent and new lenders to

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[171] *See supra* notes 98-99 and accompanying text.

[172] *See supra* notes 110-112 and accompanying text.

[173] Wang Email, *supra* note 34 (describing findings in a large dataset of 267 cases with DIP loans).

participate, increasing access to DIP financing, especially for smaller corporate debtors.

2. *The Mitigation of Shadow Banking in a Key Credit Sector*

The 2008 crisis was, in many important ways, a shadow banking crisis—that is, nonbank financial institutions and financial instruments lay at the heart of the crisis.[174] The extraordinary lengths the Fed has gone through with its emergency lending authority to stabilize non-bank financial markets in the past two years suggests that the 2020 crisis had important shadow banking elements, too.[175]

The introduction of a Fed facility for DIP financing limited to depository institutions would expand the banking regulatory and supervisory footprint at the expense of nonbank entities, at a time when alarming amounts of financial activity take place outside of regulatory oversight. Pushing more maturity transformation and financial intermediation back into the bank supervisory, regulatory, and insurance framework would be an important benefit of the DIP Discount Window facility.

3. *Supervisory Benefits*

Every decade or so, there is a debate about whether to strip the Fed of its bank supervisory role.[176] The Fed's primary defense is that bank supervision provides key insights that enhance the Fed's ability to conduct monetary policy. In former Fed Chair Ben Bernanke's words in 2010, "the Federal Reserve's ability to identify and address diverse and hard-to-predict threats to financial stability depends critically on the information, expertise, and powers that it has as both a bank supervisor and central bank."[177]

Facilitating greater oversight over DIP financing would provide precisely this benefit to the Fed by giving great insights into the real economy. Recognizing when bankruptcy spikes occur, how sensitive those spikes are to

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[174] *See* Gary Gorton & Andrew Metrick, *Regulating the Shadow Banking System*, 41 Brookings Papers on Economic Activity 261 (2010).

[175] Some of these interventions were discussed earlier. *See* Part II(A), *supra*.

[176] For an overview of these debates, *see* Elizabeth F. Brown, Prior Proposals to Consolidate Federal Financial Regulators, THE VOLCKER ALLIANCE (2015), available at https://www.volckeralliance.org/sites/default/files/attachments/Background%20Paper%201_Prior%20Proposals%20to%20Consolidate%20Federal%20Financial%20Regulators.pdf.

[177] Ben S. Bernanke, Former Chairman, Fed. Reserve Sys., Testimony before the House of Representatives Committee on Financial Services (Mar. 17, 2010), https://www.federalreserve.gov/newsevents/testimony/bernanke20100317a.htm.

the availability of efficiently-priced credit, and the quality of outcomes associated with different kinds of funding mechanisms would all inform and improve the quality of the Fed's monetary policies. As Kate Judge argued in criticizing the relative lack of take-up from the discount window in 2008, alternatives to traditional discount-window lending—be they through 13(3) facilities or the Federal Home Loan Banks—"lack a meaningful check on the solvency of the bank receiving the funds" and prevent the flow of supervisory information and the development of regulatory expertise to handle the systemic consequences of these credit flows.[178] Discount window lending for the purposes of credit policy can alleviate those concerns.

4. Less Fed Reliance on Emergency Lending Powers

The Fed's formerly once-in-a-century use of its emergency authority under 13(3) has become a once-in-a-decade phenomenon. This authority is deeply controversial, even as most experts regard its ongoing availability as vital to financial stability. Even so, there are essential questions about the overuse of such significant authority that some scholars have already begun to evaluate.[179] These questions will set the agenda for discussions about Fed legitimacy, independence, and accountability for years to come.

A DIP Discount Window and other credit market interventions will encourage the Fed to develop tools that, even if used sparingly, need not await the "unusual and exigent circumstances" that open floodgates of Fed creativity in providing emergency support. An intermediate standard—perhaps "usual but exigent," or "unusual but non-exigent" circumstances—can be invoked to permit Fed liquidity to address temporary or more stubborn flaws in the credit markets without having to wait for a full-blown emergency.

B. Costs of Intervention

Although use of the discount window to correct distortions in the credit markets offers major benefits, as we have seen, it also has several real and some imagined downsides. These obviously need to be taken into account as well. The potential costs of a DIP Discount Window Facility include (1) compromising Fed independence by forcing the Fed into politically embarrassing situations when DIP-financed firms must take actions that will be unpopular, such as firing employees, closing plants, or even liquidating; (2) institutionalizing Fed interventions that distort otherwise-functioning markets; (3) manipulating the discount window beyond its traditional purposes; and (4) exploiting a legal loophole to finance firms—i.e., those in

[178] Judge, *supra* note 135, at 837-845.

[179] See Menand, *supra* note 11.

bankruptcy—that Congress has explicitly restricted from participating in the Fed's emergency lending facilities.

1. Fed Independence and Bankruptcy

The dramatic increase in Fed financing for the bankruptcy process would associate Fed lending with decisions that can be politically toxic. Firms will have to restructure, including by closing plants, restructuring debt, firing employees, etc.[180] When they do so with Fed financing, the public may come to associate the Fed with these actions. Such a public association could decrease public confidence in the Fed to perform core central banking policies that require political independence.

However valid these concerns may be, they are equally applicable to nearly every emergency intervention that the Fed has *already* undertaken. Indeed, the only difference is that permitting banks to undertake the underwriting process means that the banks, not the Fed, will be the counterparties to restructuring entities. This will present a buffer between the Fed's actions and the actions of private parties.

Furthermore, the restructuring process is a highly judicialized one. This stands in stark contrast to the Fed's other activities, which are almost completely immune to judicial oversight.[181] By adding the Fed into such a process, there would be more accountability for Fed participation, not less.

2. The Risk of Crowding Out

Some fear governmental support could "crowd out" private financing, pointing to evidence that the DIP market was robust during the recent pandemic.[182] Although this is indeed a risk whenever the Fed intervenes in a market, there are important countervailing considerations with both large and smaller corporate debtors. For large corporate debtors, the financing market is highly noncompetitive, and the new entrants would be private banks, not the government. As for small and medium-sized businesses, most do not have access to bankruptcy financing. There currently is not a significant market to crowd out. Moreover, intervention would bring a new class of lenders—smaller banks-- into the DIP financing market, another important benefit that

[180] For evidence of the detrimental effects of bankruptcy on employee wages and employment, *see* John R. Graham et al., *Employee Costs of Corporate Bankruptcy* (NBER, Working Paper No. 25922, 2019).

[181] *See* Steffi Ostrowski, *Judging the Fed*, 131 YALE L. J. 726 (2021).

[182] *See, e.g.*, Elliot Ganz & David Smith, *It's Not Time for a Government Bankruptcy Facility*, REALCLEAR MARKETS (June 15, 2020), https://www.realclearmarkets.com/articles/2020/06/15/its_not_time_for_a_government_bankruptcy_facility_496152.html.

needs to be weighed against any crowding out effect. In an important sense, then, Fed support for banks to develop their own DIP financing operations will add to market vitality, not detract from it.

3. Manipulating the Discount Window

Another concern, echoing the 1990s critique of Anna Schwartz, is that explicitly directing funds through banks to non-bank counterparties is an abuse of the discount window.[183] But as discussed above, the discount window has been a tool of credit policy, not emergency lending, since at least 2008, if not in fact in the 1980s (giving rise to Schwartz's original critique). It is also consistent with the Fed's raison-de-etre, as articulated in the original statute. While we do not disagree with idea that this represents something of an expansion to that conception, especially as it has evolved, the most novel parts of the DIP Discount Window facility reflect an evolution that has already occurred.

Indeed, as discussed above, we see this evolution as superior to another evolution already underway, namely, the conception of the Fed as economic policymaker par excellence. With a robust, expansive, but still limited discount window, perhaps the Fed will not feel the pressure to resort so quickly to dramatic non-financial interventions via emergency lending.

4. Exploiting a Legal Loophole

Finally, there is a concern that using Section 10B—not Section 13(3)—for lending to bankrupt entities exploits a legal loophole, since Congress clearly limited emergency lending under Section 13(3) to non-bankrupt entities.

Such a critique would be a political one, not a legal one. Legally, it is important that the Fed's authority for discount window lending exist separately from its emergency lending authority, since the purposes and functions of these different programs will be different. It is therefore natural that Congress would tailor the programs differently. Section 10B lending has greater flexibility to lend through banks to bankrupt entities, but much less discretion in selecting counterparties, since it is available only for depository institutions. Section 13(3) represents the reciprocal determination, as reflected in the dizzying array of counterparties that have been the recipients of emergency funding in the last two crises. Creating facilities that are sensitive to Congress's differentiated tailoring shows more legal sensitivity to Congress's requirements, not less.

Indeed, it is important to note that banks *already* use the discount window while also lending to bankrupt entities. Given the fungibility of money, large

183 *See* Schwartz, *supra* note 121.

banks that engage in DIP financing while also borrowing from the discount window are creating the DIP Discount Window Facility in fact, if not in form. Our proposal would give added liquidity, rigor, regulatory clarity, and opportunity for more of what has already occurred.

C. Alternative approaches

We have advocated Fed intervention to correct the structural flaws in the DIP financing market under the Fed's discount window authority, but one can easily imagine other possible strategies for achieving this objective. In this part we consider three—Treasury oversight, use by the Fed of its emergency lending powers in section 13(3), and a National Investment Authority. None, we argue, is an adequate alternative to a DIP Discount Window facility or to other credit market interventions that follow this template.

1. Would Treasury Be Preferable?

Two of the signature interventions of the 2008-2009 crisis—the Troubled Asset Relief Program (TARP)[184] and the new resolution framework for systemically important financial institutions in Title II of the Dodd-Frank Act of 2010[185]—each provided for Treasury oversight of bankruptcy or bankruptcy-like funding by the U.S. government. Under TARP, Treasury was the sole overseer, and with Title II it shares responsibility with the Federal Reserve and Federal Deposit Insurance Corporation.[186] These interventions provide a helpful perspective on the question how a Treasury program might compare with our proposed discount window facility.

Start with TARP. Enacted in October 2008, TARP gave Treasury the authority to provide up to $800 billion of assistance to "financial institutions" during the last crisis.[187] Of particular relevance for our purposes, Treasury

[184] Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, § 101(a)(1), 122 Stat. 3767 (2008) (codified at 12 U.S.C. § 5211)[hereinafter, "TARP"].

[185] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 210(a)(11)(a)–(b), 124 Stat. 1376, 1470–71 (2010) (codified at 12 U.S.C. § 5390). Title II is also referred to as the "Orderly Liquidation Authority" or "OLA".

[186] The details of this sharing of authority are discussed below. *See infra* notes 143-44 and accompanying text.

[187] Under section 101(a)(1) of TARP, the Treasury Secretary was "authorized to establish the Troubled Asset Relief Program (or "TARP") to purchase, and to make and fund commitments to purchase, troubled assets from any financial institution, on such terms and conditions as are determined by the Secretary, and in accordance with this Act and the policies and procedures developed and published by the Secretary."

used this program to provide financing to Chrysler and General Motors both before and during their bankruptcy cases.

Use of TARP money to assist the carmakers began at the end of the Bush administration. Under then Treasury Secretary Henry Paulson, Treasury provided initial rescue funding to General Motors in Fall 2008. After President Obama assumed office, he created an Auto Task Force which designed a bankruptcy solution for the two carmakers. In each case, a new entity was created and the carmaker sold its assets to the new entity shortly after filing for bankruptcy. Treasury made large DIP loans to Chrysler and General Motors to fund their bankruptcies, and it also lent money to the new, non-bankrupt entities the purchased the carmaker's assets in each case.[188] The bankruptcies were highly controversial at the time.[189] Some of the criticism reflected a general hostility to bailouts. Other critics complained about how the bankruptcies were handled, and still others complained that political objectives such as promoting the production of environmentally friendly cars were incorporated into the terms of the transactions.[190]

For our purposes, the carmaker bailouts have two especially salient features. First, they were ad hoc—since only two companies were involved—which made the decision whether and how to intervene inevitably political. Second, they did not involve financial institutions overseen by bank regulators, subject to bank supervision. Together, these factors weigh strongly in favor of Treasury rather than Federal Reserve oversight. As an executive branch agency whose head is removable by the president, Treasury is much more politically accountable than the Federal Reserve. Nor do the Federal Reserve or other bank regulators have any special oversight expertise

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[188] For details on the government lending to the two carmakers before and after their bankruptcy filings—totaling $81.8 billion in all-- see STEVEN RATTNER, OVERHAUL: AN INSIDER'S ACCOUNT OF THE OBAMA ADMINISTRATION'S EMERGENCY RESCUE OF THE AUTO INDUSTRY 297 (2010).

[189] The auto bailouts were more popular in retrospect, as Republican presidential nominee Mitt Romney learned to his great chagrin during the 2012 presidential campaign. An op-ed he had written arguing against bailouts was used against him during the campaign. *See, e.g.*, Jon Healey, *Romney Swings at Obama's Auto Bailout, Hits Himself*, L.A. TIMES (Oct. 30, 2012), https://www.latimes.com/opinion/la-xpm-2012-oct-30-la-ol-mitt-romney-auto-bankruptcy-commercial-20121029-story.html (discussing Mitt Romney, *Let Detroit Go Bankrupt*, N.Y. TIMES, Nov. 18, 2008).

[190] For scholarly criticism of the auto bankruptcies, *see, e.g.*, Mark Roe & David Skeel, *Assessing the Chrysler Bankruptcy*, 108 MICH. L. REV. 727 (2010); Ralph Brubaker & Charles Jordan Tabb, *Bankruptcy Reorganizations and the Troubling Legacy of Chrysler and General Motors*, 2010 U. ILL. L. REV. 1375. For defenses, *see* Stephen J. Lubben, *No Big Deal: The GM and Chrysler Cases in Context*, 83 AM. BANKR. L.J. 531 (2009); Douglas G. Baird, *Lessons from the Automobile Reorganizations*, 4 J. LEG. ANALYSIS 271 (2012).

with carmakers that would give them unique insight into the resolution of their financial distress.

The other legislation involving bankruptcy-like funding is Title II of the Dodd-Frank Act of 2010. Title II gives Treasury, the Fed, and the FDIC joint authority whether to initiate a receivership for a systemically important financial institution that has fallen into financial distress.[191] If the three regulators agree the institution is in default or danger of default—the "three keys turn," in lingo that arose at the time of Dodd-Frank's passage—a Title II proceeding is commenced and the FDIC becomes the receiver.[192] Title II gives the FDIC access to substantial amounts of funding—very similar to a DIP loan from the government—if Treasury agrees to its use.[193] Treasury approval is thus required both at the outset of the Title II case, and as a prerequisite to receiving funding.

In our view, this power sharing arrangement among Treasury, the Fed and the FDIC generally makes sense. Unlike with the carmaker bankruptcies, exclusive Treasury oversight would not be optimal, given that the Fed and FDIC have special expertise in regulating financial institutions. The benefits of this expertise would be sacrificed, at least to some extent, if Treasury had complete control.[194] Treasury also brings important attributes to the oversight framework, however. Because the decision to take over (or not to take over) a systemically important financial institution is likely to be politically charged—much more than with an ordinary, non-systemically important financial institution—Treasury involvement is appropriate. Treasury's role ensures the presence of a democratically accountable decision maker.

What implications do these two funding programs from the 2008-2009 crisis have for addressing structural flaws in the DIP financing market? The first thing to note is that a Treasury-run program does not seem optimal for addressing such a crisis. Unlike TARP, which was used for targeted

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[191] For an overview of the basic details of Title II, *see, e.g.,* SKEEL, *supra* note __, at 129-42.

[192] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub L No 111-203, § 203 124 Stat 1376, 1450-54, 12 U.S.C. § 5383 (2010).

[193] The FDIC is authorized to borrow up to 10% of the book value of the institution as of the time it is taken over, and 90% of its value in resolution, if the Treasury approves. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub L No 111-203, § 210(n) 124 Stat 1376, 1506-09, 12 U.S.C. § 5390(n) (2010).

[194] Treasury might consult informally with the Fed and FDIC even if it had exclusive authority, but this would not make nearly as much use of the bank regulators' regulatory expertise as giving them a formal role.

interventions with particular firms, regulatory intervention in the DIP financing market would be broader—it could be used by any qualifying bank for any business in bankruptcy. As a result, the DIP Discount Window facility would not be as politically charged as loans to systemically important financial institutions and General Motors and Chrysler. Nor would Treasury have particular expertise in administering the loans. Not only is the Fed a more logical overseer, but a Treasury-led program would sacrifice the additional benefits promised by our DIP Discount Window facility, such as the synergy between the lending program and the Fed's oversight of the banking system.

To be sure, one can imagine a program that provided both for Treasury and Fed oversight, as with the CARES Act during the recent pandemic. But the credit channeling function advocated in this article is more targeted than the sweeping CARES Act funding programs. Indeed, CARES Act lending appears to have been highly inefficient, providing funding for businesses that could survive without it and failing to provide funding for firms that did need help.[195] Moreover, such a program would be far less nimble than the Fed's ordinary discount window authority, requiring legislation from Congress.[196] And, as noted above, Treasury does not have any particular comparative advantage in this context.

Our conclusion that unilateral Fed oversight is preferable to a Treasury program assumes that the facility is in fact non-political— that the rules for inclusion are standardized and applied consistently. If this were not the case, the Fed would find itself making unavoidably political decisions. In our view, this argues for minimizing the range of discretion in the facility, and for avoiding features that are inevitably political where possible.

This removal from politics—procedurally and substantively—also supports the DIP Discount Window facility's purpose to provide an alternative to the fiscal-monetary consensus of 2020, should that consensus not be available. This does not mean that the work of banking and bank-intermediated finance is somehow apolitical—it means simply that it is political in the ways that it has always been.

[195] According to the lead author of one study of the Paycheck Protection Program under the CARES Act, "[a] very large chunk of the benefit went to a very small share of the firms, and those were probably the firms least in need." Ben Casselman & Jim Tankersley, *$500 Billion in Aid to Small Businesses: How Much Did it Help?*, N.Y. TIMES (Feb. 1, 2021), https://www.nytimes.com/2021/02/01/business/economy/ppp-jobs-small-business.html (quoting M.I.T. economist David Autor).

[196] Congress's frequent inability to respond quickly in a crisis is one of the themes of Posner and Vermeule's work on executive power. *See* ERIC POSNER & ADRIAN VERMEULE, THE EXECUTIVE UNBOUND: AFTER THE MADISONIAN REPUBLIC (2010).

2. *Statutory Amendments to Section 13(3)*

Some commentators have proposed structuring fiscal responses to crisis—such as the CARES Act of 2020—so that lending under that authority need not comply with Section 13(3)'s prohibitions on lending to bankrupt firms.[197] Alternatively, Section 13(3) might be amended to remove the bankruptcy prohibition. After all, this proviso was only added in 2010, as part of the Dodd-Frank Act; the Fed's previous authority was untrammeled and key to interventions that many still regard as vital to the crisis response in 2008 (for example, in lending to the abundantly insolvent AIG). Would the latter approach—returning to the pre-2010 structure, and relying on the Fed's use of its emergency lending authority—be superior to a DIP Discount Window Facility?

The ostensible benefits of reverting to the pre-2010 model of emergency lending are twofold. First, as just stated, Treasury participation offers some kinds of political legitimacy for thorny issues of distribution that the Fed would rather avoid. Second, the Fed itself—not the depository institutions—would act as counterparties to bankrupt entities. This would give the Fed the ability to control underwriting, loan portfolio management, and other factors that would otherwise have to be intermediated through the banks.

These two concerns are related, but we think they counsel strongly in favor of keeping 13(3) as amended in Dodd-Frank and not reverting to the broader, pre-2010 authority. A bank-intermediated discount window facility sidesteps the potential politicization of the Fed's role caused by its direct involvement in 13(3) as a counterparty to the recipient of the loans. Because banks would be the ones making the DIP loans, the Fed would be insulated from decisions about whether a particular debtor qualifies for a DIP loan. This is one of the reasons why our discussion of eligibility, above, is limited to the eligibility of banks, not bankrupt firms: the latter decision is for the banks to decide. Were the Fed to stand in the place of banks to direct loans according to its own underwriting standards, the line-drawing problems it would face would necessarily invite political scrutiny.

[197] David Skeel, *Bankruptcy and the Coronavirus*, ECONOMIC STUDIES AT BROOKINGS, at 10 (2020), https://www.brookings.edu/wp-content/uploads/2020/04/ES-4.21.2020-DSkeel-2.pdf; David Skeel, *Bankruptcy and the Coronavirus: Part II*, ECONOMIC STUDIES AT BROOKINGS, at 9 (2020), https://www.brookings.edu/wp-content/uploads/2020/07/ES-6.6.20-Skeel-1.pdf. For a similar proposal, see George Selgin, *Catch-11*, ALT-M (May 13, 2020), https://www.alt-m.org/2020/05/13/catch-11/.

3. *National Investment Authority*

Crises such as Covid-19 have prompted some scholars, such as Robert Hockett and Saule Omarova, to propose an alternative structure to Fed interventions: a National Investment Authority.[198] The NIA is patterned in part after the Reconstruction Finance Corporation, the U.S. government agency proposed by the Eugene Meyer at the Federal Reserve in 1932 and adopted by Herbert Hoover as the cornerstone of his response to the Great Depression. The RFC was in turn modeled after the War Finance Corporation.[199] The RFC far outlasted the Great Depression and New Deal and was only shuttered in 1957, after making $2 billion in loans (for reference, GDP in 1932 was $60 billion).[200]

The general idea for an NIA is the same: a permanent investment authority with a "long-term national view in charge of managing investments" in assets and projects primarily anchored in infrastructure.[201] Other similar proposals for "greening" the economy have also been offered.[202]

Although we are not familiar with proposals for using National Investment Authority to provide DIP financing, the idea is not difficult to grasp. A permanent, public (or public-private) investment facility would be deployed explicitly for credit policy. Given the importance of DIP financing in an exogenous crisis with minimal moral hazard, deploying the balance sheet of such an entity looks similar to using the central bank for the same purpose.

Indeed, Omarova envisions using a "New Discount Window" in a world where the Fed also accepts deposits from the general public as a mechanism to "efficiently and effectively replace deposit funding for banks and enable a broad range of nonbank credit institutions to access this reliably 'patient,'

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[198] Robert C. Hockett & Saule T. Omarova, *Private Wealth and Public Goods: A Case for a National Investment Authority*, 43 J. CORP. L. 437 (2018). Adam Levitin, Lindsay Owens, and Ganesh Sitaraman have suggested another approach, which also would use a standing facility. Adam J. Levitin, Lindsay Owens & Ganesh Sitaraman, *No More Bailouts: A Blueprint for a Standing Emergency Economic Resilience and Stabilization Program*, GREAT DEMOCRACY INITIATIVE (2020), https://greatdemocracyinitiative.org/wp-content/uploads/2020/06/No-More-Bailouts-Final-Copy-.pdf.

[199] *See* DAVID KENNEDY, FREEDOM FROM FEAR: THE AMERICAN PEOPLE IN DEPRESSION AND WAR, 1929-1945 84-86 (1999).

[200] *Id.*

[201] Hockett and Omarova, *supra* note 148.

[202] *E.g.*, Lisa Friedman, *What is the Green New Deal? A Climate Proposal, Explained*, N.Y. TIMES (Feb. 21, 2019), https://www.nytimes.com/2019/02/21/climate/green-new-deal-questions-answers.html.

stable, and affordably priced capital."[203] In Omarova's proposal, then, the discount window becomes a dramatic expansion of the Fed's balance sheet, to replace funding for banks that would have occurred through their deposit-taking.

We envision no such expansion. We see instead the DIP Financing Discount Window facility as narrowly tailored to a specific purpose consistent with the Fed's existing statutory mandates. Even if it became a model for other credit intermediation efforts, that model is not to displace banks but to encourage them.

Importantly, the DIP Financing Discount Window facility would not be a permanent expansion of the discount window, but seasonal. The entire point of the exercise is to provide an intervention between open-market operations and conventional regulatory and supervisory tools on the one hand and break-the-glass emergency lending on the other. That means some twilight mechanism after which private markets are restored, after which banks can continue to make these loans and even use the permanent discount window for appropriate support, under that permanent framework. As with a Treasury program, bank intermediation is key: private entities bear at least some of the risk and responsibility such that they make decisions about capital allocation, rather than having the government perform that role.

CONCLUSION

This Article has joined a growing conversation about the government's role in correcting structural flaws in the credit markets. The Fed has edged in this direction during the last two crises of 2008 and 2020, often by construing broadly its lender-of-last-resort authority to make emergency loans in ways that have drawn to it sincere and partisan questions about the appropriateness of the institution to its tasks.

The Fed, to date, has conceptualized its actions as fitting within one of its two traditional roles, conventual monetary policy and lender-of-last resort intervention in crises. We have argued instead that the Fed is uniquely well-positioned to take on a new role that is intermediate between its two traditional tasks: channeling credit policy in the event of a temporary or more entrenched disruption in the proper functioning of the credit markets.

To show how the credit channeling function might work, we have identified and focused the market for credit in bankruptcy. This market is

[203] Saul Omarova, *The People's Ledger: How to Democratize Money and Finance the Economy*,74 VAND. L. REV. 1231 (2021).

undermined by structural problems that manifest differently in different parts of the market. For the largest corporate debtors, DIP financing is available but it is extremely costly, due to the near monopoly held by debtors' inside lenders. Smaller debtors, by contrast, have very little access to bankruptcy financing. To address these issues, we have proposed that the Fed create a DIP Discount Window facility with eligibility requirements tailored to the specific flaws in the DIP financing market. With large corporate debtors, the facility would only be available to outside lenders, so that the facility could inject more competition into the market. With small debtors, the debtor's current lender would be eligible; indeed, the program would be designed to draw these lenders into the DIP financing market. In each context, the facility would be limited to banks.

In addition to improving the DIP financing market, the DIP Discount Window facility would bring a variety of other benefits as well. It would shift more lending from the shadow banking to the formal banking sector, for instance, and would enhance the Fed's visibility into the participating banks.

The DIP financing market is only one area in the credit markets that would benefit from Fed intervention. We have used it to make the benefits of the novel credit channeling role we advocate in this Article concrete. In future work we intend to identify and explore other structural flaws in the credit markets that would benefit from this approach.