

Why Banks are Not Allowed in Bankruptcy

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Abstract: Unlike most other countries, the United States uses different procedures to resolve insolvent banks and non-bank firms. When non-bank firms file for bankruptcy, the Bankruptcy Code divides control among the various claimants and a judge supervises the resolution process. By contrast, the FDIC acts as the receiver for an insolvent bank and has almost complete control. Other claimants can sue the FDIC, but they cannot obtain injunctive relief, and their damages are limited to the amount that they would have received in liquidation. The FDIC has acted as the receiver of insolvent banks since the Great Depression, and the concentration of power in the FDIC is traditionally justified by two arguments: i) the need for a timely disposition of the bank's assets to maintain the liquidity of deposits and encourage faith in the banking system, and ii) the FDIC's role as the largest creditor gives it an incentive to maximize the recovery from the assets. We revisit these arguments in light of the dramatic changes that have occurred in banking and ask whether they still (or ever did) justify FDIC control. We suggest that the first argument fails because it conflates the need for a timely satisfaction of the claims of insured depositors by the FDIC with the need to quickly dispose of the failed bank's assets. As stated, the second argument does not justify FDIC control as one must generally ask whether the largest creditor will take actions that are harmful to the other claimants on the failed firm's assets. However, if modified the second argument is much more persuasive. A detailed survey of the capital structure of failed banks reveals that the FDIC is usually the *only* major creditor and that the value of the FDIC's claim nearly always exceeds the value of a failed bank's assets. The FDIC is therefore the residual claimant and has the incentive to make the right decisions in disposing of the bank's assets. We question whether this principal can justify recent proposals to extend FDIC control over the resolution of large bank holding companies. We further note that this principle limits the circumstances in which the FDIC should retain control over the resolution of the banks themselves. Four limits are considered: i) capital structure is endogenous – the absence of claims junior to the FDIC may reflect the lack of voice given to these claimants in a bank resolution process, ii) agency costs internal to the FDIC may prevent the FDIC from maximizing the recovery from the failed bank's assets, iii) the FDIC may not be the residual claimant of extremely large banks with complex liability structures, and iv) debt conversion schemes which allow for automatic financial restructuring of a failed bank may render bank resolution procedures less necessary. The Article argues that these limits do not justify removing the FDIC from control in resolving most bank failures.

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Most nations resolve failed banks with the same procedures they apply to other insolvent firms.¹ American law is different. American banks and thrifts do not receive bankruptcy protection.² Instead, regulators seize insolvent or unsound banks or thrifts and give the Federal Deposit Insurance Corporation (FDIC) the authority to resolve them. Almost always the FDIC chooses to resolve seized institutions through a receivership.³ Very different rules govern the bankruptcy and bank receivership processes. These rules appear in different titles of the United States Code and have important substantive differences. The most important difference between the two procedures is the concentration of control over the disposition of the failed firm's assets. The traditional bankruptcy reorganization divides control among the various claimants and appoints a judge to supervise the process. The overwhelming majority of reorganizations are resolved consensually with the approval of each class of creditors and shareholders.⁴ Even when a debtor tries to "cram down" a plan over the objections of dissenting creditors, the debtor must win approval of at least some creditors, and the other creditors can ask the judge to reject the

¹ See Rosalind L. Bennett, *Failure Resolution and Asset Liquidation: Results of an International Survey of Deposit Insurers*, 14 FDIC BANKING REV. 1, 9 (2001)) ("Outside the United States, most failed banks go through a regular corporate bankruptcy process."); Apanard Angkinand & Clas Wihlborg, *Bank Insolvency Procedures as a Foundation for Market Discipline*, at 4, LEFIC Working Paper 2005-08, www.cbs.dk/C=LEFIC.

² Banks are ineligible for bankruptcy, and so neither the bank nor the bank's creditors can place the bank in bankruptcy. 11 U.S.C. § 109(b), (d) (2009). As noted below, bank holding companies can file for bankruptcy in the United States, and many of the largest bankruptcies on record have been bank holding companies. See *infra* note 29, and accompanying text.

³ The FDIC can decide to resolve the bank by a conservatorship or by a receivership. Conservatorships are very rare, however. Between 1934 and 2005 only two banks were resolved in conservatorships. See RICHARD S. CARNELL, JONATHAN R. MACEY & GEOFFREY P. MILLER, *THE LAW OF BANKING AND FINANCIAL INSTITUTIONS* 706 (4th ed. 2009). For convenience, we therefore use the term "bank receivership" to refer to any proceeding designed to resolve an insolvent bank.

⁴ For the predominance of consensual reorganizations, see Frederick Tung, *Confirmation and Claims Trading*, 90 NW. L. REV. 1684, 1693 (1996), Lynne M. LoPucki & William C. Whitford, *Bargaining Over Equity's Share in the Bankruptcy Reorganization of Large, Publically Held Companies*, 139 PA. L. REV. 125, 141 (1990).

plan because it fails to comply with tests of horizontal and vertical equity or it is not in the best interests of the creditors.⁵

Debtors sometimes bypass the traditional reorganization with a relatively quick sale of many of the failed firm's assets or at least the assets necessary for some of the business to continue operating. Although this quick sale denies the creditors the ability to vote on the sale, the debtor must still seek approval of the bankruptcy judge,⁶ and the dissenting creditors can at least ask the judge to enjoin the sale. The recent Chrysler bankruptcy provides a nice illustration of this process. Within a few weeks of Chrysler's bankruptcy filing, the debtor sold substantially all of its operating assets to a "New" Chrysler owned by the UAW, Fiat and the U.S. and Canadian governments.⁷ New Chrysler emerged from bankruptcy and continued manufacturing and selling cars.⁸ The original corporate entities and the few assets that New Chrysler did not want stayed in bankruptcy, and Old Chrysler remains there to this date.⁹ Eventually the bankruptcy process will conclude, and these remaining assets and the proceeds of the sale to New Chrysler will be distributed to the creditors of Old Chrysler. This sale occurred outside of a plan of reorganization, and the creditors did not vote on the sale. However, a bankruptcy judge did approve the sale, and the creditors had a right to, and did, argue that the approval should have

⁵ 11 U.S.C. § 1129(b) (2009).

⁶ *Id.* at § 363.

⁷ See Mark H. Anderson & Jeff Bennett, *Pension Funds Ask High Court to Delay Sale of Chrysler*, WALL ST. J., June 8, 2009, at B3.

⁸ *Id.*

⁹ See Alisa Priddle & David Shepardson, *Chrysler Sells Good Assets to Fiat, New Company Formed*, DETROIT NEWS, June 11, 2009, at B1.

been denied. Apart from its notoriety, the way in which Chrysler's principal assets were disposed of now is fairly typical in large bankruptcy reorganizations.¹⁰

A bank receivership begins when the FDIC seizes control of the bank. In the vast majority of cases, the FDIC has already identified an acquiring financial institution when it seizes the failed bank.¹¹ The acquirer will assume some or all of the failed bank's deposits and perhaps some of the failed bank's other liabilities as well. As consideration, the acquirer will receive some of the failed bank's assets and will usually receive a payment from the FDIC. The FDIC will usually retain most of the failed bank's assets¹² and take months or even years to liquidate these assets.¹³ However, the initial purchase and assumption occurs much more quickly than the initial sale of a firm's assets in bankruptcy. The automobile bankruptcies generated headlines because the sales were completed in a matter of weeks. A typical purchase and assumption of a failed bank is quicker. The FDIC nearly always identifies an acquirer before they seize the bank at the close of business on a Friday, and some of the failed bank's offices will reopen as part of the acquiring bank the following Monday.¹⁴

The FDIC enjoys a level of control that a dominant creditor could only dream of obtaining in bankruptcy. There are few checks on the FDIC's discretion in disposing of bank

¹⁰ Two features of Chrysler's sale were somewhat unusual: the sold assets remained subject to certain liabilities and interests, and the bidding was restricted to offers that assumed these liabilities and interests. See Congressional Oversight Panel, September Oversight Report: The Use of TARP Funds in the Support and Reorganization of the Domestic Automobile Industry (September 9, 2009). However, the timing and judicial approval of the sale outside a reorganization plan were typical.

¹¹ For statistics on the method of resolution chosen by the FDIC, see *infra* Figure 1. The FDIC had identified an acquirer in every "PA" or "PI" transaction.

¹² See *infra* note 81, and accompanying text.

¹³ See Division of Resolution and Receiverships, Asset Disposition Manual, Ch. 2 (at 22) (1999).

¹⁴ A typical example is the recent failure of Century Bank, FSB. According to the FDIC's press release, the eleven branches of the former Century Bank were scheduled to reopen as branches of the acquirer (IBERIABANK) with the resumption of normal business hours.

<http://www.fdic.gov/news/news/press/2009/pr09205.html>

assets. The initial purchase and assumption will be complete long before a judge can conceivably hear an objection. Even if a creditor's objection is timely, the law significantly restricts the grounds upon which a creditor can complain about the sale.¹⁵ The law also limits complaining creditors to a monetary remedy based on the amount that they would have received in a liquidation of the bank's assets.¹⁶

Articles in the legal literature discuss the initiation of the bank resolution process.¹⁷

There is surprisingly little discussion of the resolution process itself—on what happens after the process has been initiated. This Article focuses on the resolution process. The literature offers two possible reasons for giving the FDIC the extraordinary control it has. The first is speed.¹⁸ Control gives the FDIC the ability to sell assets with no interference from other creditors and little judicial oversight. This allows for quick resolutions. A swift resolution in turn can ensure liquidity for depositors, increase depositors' confidence in the banking system, and prevent runs on both failed and healthy banks. We are not persuaded by this justification. The identified benefits of speed depend on the timely reimbursement of insured depositors (a matter governed by the terms of FDIC insurance) and not on the sale of the failed bank's assets. In fact, the FDIC

¹⁵ See *Mosseri v. FDIC*, Lexis U.S. Dist. Lexis 18999 (S.D.N.Y. 2001) (failed bidder has no private right of action against the FDIC for breach of its statutory duties in connection with liquidation of a failed bank's assets); *19 Court Square Ass. v. Resolution Trust Corp.*, 190 Bankr. 933 (Bankr. S.D. NY 1996) (same with respect to the RTC's statutory duties).

¹⁶ See 12 U.S.C. § 1821(i)(2).

¹⁷ See, e.g., David F. Skeel, *The Law and Finance of Bank and Insurance Insolvency Regulation*, 76 TEX. L. REV. 723 (1998); Peter P. Swire, *Bank Insolvency Law Now That It Matters Again*, 42 DUKE L. J. 469 (1992). For discussion of the optimality of the procedure for initiating a bankruptcy, see Douglas G. Baird, *The Initiation Problem in Bankruptcy*, 11 INT'L REV. L. & ECON. 223 (1991).

¹⁸ See, e.g., Bennett, *supra* note 1, at 7.

does not typically complete the disposition of the failed bank's assets until four years after the seizure of the bank.¹⁹

The second reason for FDIC control is that it is likely the largest creditor of the failed bank and therefore has an incentive to maximize the recovery from the bank's assets.²⁰ But bankruptcy does not grant the largest creditor control over the resolution of non-bank firms. All claimants (including shareholders) are given a voice to ensure that the largest creditor does not use its control to their detriment. However, if the FDIC enjoys all the gain and suffers the loss from its decisions in disposing of assets, it is the residual claimant and has the incentive to make socially optimal decisions. The available evidence suggests that the FDIC is in fact the residual claimant in the overwhelming majority of bank failures. The FDIC typically accounts for the vast majority of the claims against the insolvent banks.²¹ Claims senior to those of the FDIC are nearly always paid in full,²² the FDIC almost always loses at least some money,²³ and claims junior to the FDIC almost never receive a distribution.²⁴ Thus, in most cases the FDIC has the financial incentive to sell the assets of the failed bank for their greatest value. Unlike corporate bankruptcy, bank resolution procedures concentrate decision-making in a single entity with the financial interest in making the right decision about how to dispose of the assets.

Although we argue in favor of the concentration of control in the FDIC, the case has four major caveats. First, a firm's capital structure depends at least in part in the mechanism used to resolve failed firms; the lack of claims junior to the FDIC may reflect the lack of voice given to

¹⁹ See *supra* note 13.

²⁰ See, e.g., Bennett, *supra* note 1, at 9.

²¹ See *infra* Table 1.

²² See *infra* note 140, and accompanying text.

²³ See *infra* Figure 2, and accompanying text.

²⁴ See *infra* note 141, and accompanying text.

these claims in a bank resolution. Second, the FDIC does not make decisions, its employees and directors do. As a government agency the FDIC may not effectively incentivize its employees to make wealth maximizing decisions. Despite this limitation, however, the FDIC may be the best available alternative given the current capital structure of most failed banks. Third, although the FDIC appears to have been the residual claimant in nearly all of the bank insolvencies, it may not have been the residual claimant for most of the assets that have passed through the bank insolvency process. The capital structure of our very largest banks makes it less likely that the FDIC serves as the residual claimant, and the largest banks are dramatically bigger than those that typically fail. A single failed bank, Washington Mutual, accounts for more than sixty percent of all of the assets of banks that have failed since 1995,²⁵ and the FDIC suffered no losses from its closure.²⁶ It is dangerous to draw conclusions for a sample of one, but there are other reasons to believe that the FDIC may not be the residual claimant if other extremely large banks failed. Although special insolvency procedures for failed “mega-banks” are possible, we argue for the advantages of a single set of generally applicable procedures. Finally, a number of scholars have suggested “automatic” debt conversion methods designed to eliminate the need for formal bank resolution procedures. We do not address these proposals at length because this Article takes the capital structure of banks as given, and an automatic debt conversion method would not complete the resolution process as it would leave the FDIC as the dominant shareholder of the failed bank.

²⁵ According to the FDIC, Washington Mutual Bank had assets of \$307 billion; the total value of assets of banks that failed between January 1, 1995 and October 19, 2009 was \$490 billion. The percentage of assets held by failed “mega-banks” rises considerably if one includes the bank subsidiaries of Citigroup. However, these banks received open-bank assistance and did not formally fail.

²⁶ See *infra* note 173, and accompanying text.

This Article is structured as follows. Part I contrasts bankruptcy and the bank resolution process. Assessments of the existing bank resolution system must take into account the capital structure of failed banks, particular their liability structure and loss to the FDIC in resolving failed banks. Accordingly, Part II uses data from past bank failures to present the best case for the existing bank resolution system. The best case, it concludes, is a strong one. Part III describes caveats that limit but do not undermine that case. Part IV applies these arguments to recent proposals to extend the FDIC's control to certain insolvent bank holding companies. Part V concludes.

I. Bankruptcy and Bank Insolvency

Most banks (and nearly all big banks) are owned by bank holding companies.²⁷ Bank holding companies can, and do, file for bankruptcy, but their bank subsidiaries are ineligible for bankruptcy relief.²⁸ For example, Washington Mutual, Inc. filed for bankruptcy,²⁹ but its subsidiary, Washington Mutual Bank, entered receivership and its resolution was governed by a very different set of laws. This is more than just a matter of the organization of statutes, administrative convenience, or discrete technical rules. A more fundamental contrast concerns control: Unlike decision-making under any of the Chapters of the Bankruptcy Code, the law of bank resolution gives decision-making power to one party, the FDIC, and the FDIC can exercise this power with almost no judicial review.

A. Dispersed Control in Bankruptcy

²⁷ Bank holding companies own over 83% of U.S. banks and almost all banks with assets of at least 1 billion dollars. See www.fedpartnership.gov/bank/bank-holdingcompanies (2007 percentages).

²⁸ 11 U.S.C. § 109.

²⁹ Washington Mutual, Inc. is the second largest bankruptcy on record, behind only Lehman Brothers Holdings, Inc. See http://lopucki.law.ucla.edu/study_results.asp.

We argue that the primary difference between bankruptcy and bank insolvency is the distribution of control. We therefore must describe the distribution of control in bankruptcy. Control begins with the initiation of the process, and the initiation decision is very different for a bank than it is for other firms. Only a bank's primary regulator,³⁰ and the FDIC in some cases,³¹ can place it in receivership. By contrast, a non-bank firm can voluntarily file for bankruptcy,³² or a coalition of its creditors can force it into bankruptcy if it is not paying its debts.³³ For this reason, creditors have some control over the initiation of a bankruptcy case; they have almost no control in the initiation of the bank resolution process.³⁴ A number of scholars have examined control over the initiation decision.³⁵ We focus instead on control in the resolution process—on control once the process has started.

Control is the power to decide what to do with the firm's assets. It is a continuous variable, not a discrete one. Accordingly, claimants can have more or less control over that decision. In bankruptcy, stakeholders have different degrees of control over asset sales, depending on the bankruptcy Chapter under which the firm seeks relief. In Chapter 7, for example, the firm's assets are liquidated by a trustee who can in turn be chosen by the firm's unsecured creditors.³⁶ The trustee decides how best to liquidate the assets, but her decision is subject to judicial approval.³⁷ Most courts require the proponent of the sale to present an

³⁰ See, e.g., 12 U.S.C. § 1464(d)(2)(A) (Office of Thrift Supervision may appoint receiver for an insured savings association). The primary regulator is the entity that has issued the bank's charter.

³¹ See 12 U.S.C. § 1821(c)(4), (10).

³² See 11 U.S.C. § 301.

³³ *Id.* at § 303.

³⁴ Even ignoring involuntary bankruptcy, creditors can partially control initiation by controlling access to credit or collateral. In theory, creditors could influence the regulator's decision as to when to seize the bank. On the other hand, we show below that non-deposit creditors play an insignificant role with most banks.

³⁵ See *supra* note 17, and accompanying text.

³⁶ See 11 U.S.C. § 702,

³⁷ Section 363(b) requires judicial approval for sales outside of the ordinary course of business.

“articulated business justification” for the sale,³⁸ and other stakeholders can appear at the hearing and ask the court to stop the sale. The presence of judicial oversight gives the trustee (and the unsecured creditors) less than full control in the matter.

Most firms with asset sizes of even the smallest banks file in Chapter 11.³⁹ In Chapter 11 the managers of the firm retain control as the “debtor in possession.” As such they exercise the powers of the trustee.⁴⁰ If the firm is to emerge from bankruptcy, the managers must win confirmation of a plan of reorganization.⁴¹ This plan will answer three fundamental questions. First, how will the assets of the firm be used? Second, what is the value of the firm’s assets? Third, how will the proceeds of the assets be divided amongst the various claimants?

There are two ways for a plan to be confirmed. One is by the consent of creditors.⁴² The other is by judicial confirmation of the plan under prescribed conditions over the objection of creditors.⁴³ Creditor consent is determined by complicated voting procedures that can grant substantial power to minority creditors. Claims and interests are divided into classes and half of the claims cast (two thirds by value) of each class must vote in favor of the plan.⁴⁴ Dissimilar claims, such as secured and unsecured claims, cannot be placed in the same class,⁴⁵ and

³⁸ See *In re Chrysler LLC*, 576 F.3d 108 (2d Cir. 2009); *In re Lionel Corp.*, 722 F.2d 1064 (2d Cir. 1983). For a critical evaluation of this standard, see Lynn M. LoPucki & Joseph W. Doherty, *Bankruptcy Fire Sales*, 106 MICH. L. REV. 1 (2007).

³⁹ In 2002 only 1.2% of all Chapter 7 cases had more than \$500,000 in assets, and the total amount distributed from the 37,518 Chapter 7 cases with some assets was \$1.45 billion. See http://www.usdoj.gov/ust/eo/public_affairs/articles/docs/abi122002.htm. The very smallest bank insolvency in our sample (Monument National Bank) had more than fourteen times this amount in assets (\$7,680,000).

⁴⁰ See 11 U.S.C. § 1107(a).

⁴¹ This assumes that the plan will be confirmed during the period in which only the debtor can propose a plan.

⁴² See 11 U.S.C. § 1129(a).

⁴³ *Id.* at § 1129(b).

⁴⁴ *Id.* at § 1126(c).

⁴⁵ *Id.* at § 1122(a).

consensual confirmations require unanimity among classes.⁴⁶ Thus, a group of creditors or even equity holders can block confirmation if they believe that they are entitled to or can demand more. Junior claimants can sometimes demand more simply because the alternative to a consensual plan is so difficult and costly. Most significantly, the court must determine that the plan achieves both horizontal equity (the plan does not unreasonably discriminate between creditors of equal priority) and vertical equity (the plan does not pay junior creditors anything if senior creditors are not paid in full).⁴⁷ Because plans will rarely pay everyone in cash, these findings require complex and time-consuming fact-finding. For this reason, most confirmed reorganization plans are consensual.⁴⁸

Both consensual and nonconsensual confirmations take time, and the Code authorizes management to make day-to-day operating decisions prior to confirmation.⁴⁹ The Code also allows management to make some decisions that are not in the ordinary course of business if the management obtains court approval.⁵⁰ Bankruptcy practitioners have found that they can use this power to determine how the assets will be used without having to seek plan approval.

The recent automobile bankruptcies provide salient examples of this trend. The Chrysler and General Motors groups filed for bankruptcy protection under Chapter 11. Rather than seek approval of their creditors to a plan of reorganization, each quickly sold their most valuable assets to a newly formed entity in exchange for cash and the assumption of some of the old firms' liabilities.⁵¹ The old corporate groups remained behind in bankruptcy with the unwanted

⁴⁶ *Id.* at § 1129(a)(8).

⁴⁷ *Id.* at § 1129(b)

⁴⁸ *See supra* note 4.

⁴⁹ *Id.* at § 363

⁵⁰ *Id.* at § 363(b)(1).

⁵¹ For example, the purchaser of Chrysler paid about \$2 billion in cash and assumed about \$2 billion in liabilities <http://www.calfee.com/Article.aspx?ContentKey=647>. For GM's sale, see Mike Specter, *GM*

assets and the disfavored creditors, but the press reported that the firms emerged from bankruptcy. As a practical matter the press was correct: the firm's critical assets and operations emerged from bankruptcy; only the disfavored creditors and assets retained by the old corporate shells remained behind.

According to the literature, Chapter 11 sales of going concerns outside a reorganization plan were unusual between 1978 and the mid-1990s. By 2000 such sales were frequent, not the exception. In 2002, for instance, a majority of large firms in Chapter 11 were sold in one form or another.⁵² By one count, about 16 percent were auctioned by means of a 363 sale.⁵³ The trend continues to be prevalent to date.⁵⁴

This description implies that management controls the process of disposing of assets. As a formal matter it does. As a practical matter, however, creditors often decide how the firm's assets will be disposed because they enjoy sufficient leverage to effectively dictate the management's decisions.⁵⁵ Once again, the automobile bankruptcies provide a good example.

Asset Sale Gets Judge's Nod, Wall Street J., July 6, 2009, at B1. A summary of the details of both Chrysler and GMs' sales appears in the Congressional Oversight Panel, September Oversight Report: The Use of TARP Funds in the Support and Reorganization of the Domestic Automobile Industry 13-31 (Sept. 9, 2009).

⁵² See Douglas G. Baird, *The New Face of Chapter 11*, 12 AM. BANKR. INST. L. REV. 69, 71 (2004); Douglas G. Baird & Robert K. Rasmussen, *Chapter 11 at Twilight*, 58 STAN. L. REV. 673, 674 (2003); *The End of Bankruptcy*, 55 STAN. L. REV. 751, 751 (2002); generally George W. Kuney, *Hijacking Chapter 11*, 21 EMORY BANKR. L. DEV. J. 19 (2004). Note that the classification of asset dispositions into reorganizations or asset sales is somewhat subjective. Nearly every bankrupt debtor in Chapter 11 reorganization will use § 363 to sell at least some assets. Section 363(b) authorizes the sale of assets in the ordinary course without court approval. The trustee, acting as the debtor in possession, often will sell assets to maintain liquidity or avoid losses on assets with declining values. We are more interested in sales of substantial portions of the firm outside of the ordinary course of business.

⁵³ See LYNN M. LOPUCKI, *COURTING JUSTICE* 170-71 (2005).

⁵⁴ See lopucki.law.ucla.edu/bankruptcy_research.asp; In re Chrysler LLC, 576 F.3d 108 (2d Cir. 2009), Lynn LoPucki & Joseph W. Doherty, *Bankruptcy Fire Sales*, 106 MICH. L. REV. 1, 12-15 (2007), both summarizing the rise of 363 sales.

⁵⁵ See Barry E. Adler et al., *Destruction of Value in the New Era of Chapter 11* (Oct. 24, 2006); Kenneth M. Ayotte & Edward R. Morrison, *Creditor Control and Conflict in Chapter 11*, Northwestern University

The continued existence of Chrysler and General Motors (and thus the fate of the senior management) largely depended on continued funding. Only the federal government was willing to lend. Management was understandably loath to make decisions that would anger the administration. Similarly, management of other bankrupt firms may be unwilling to make decisions that would anger their dominant creditors, particularly if these creditors included strong covenants in their loan agreements. Management jeopardizes its continued employment with the firm and perhaps future employment prospects by making decisions that creditors with leverage dislike.⁵⁶ However, neither management nor a dominant creditor will have complete control. By selling assets outside of the plan of reorganization, they successfully deprive other claimants of the right to vote to block the sale. But they must still seek judicial approval of the sale, and these other claimants have the right to argue that the sale is not in the best interest of the claimants as a group. Management, on the sale proponents' behalf, must provide a business reason for the sale, and it must convince the court that the sale maximizes the value of the estate. Thus, in an important sense management, dominant creditors and the bankruptcy court share control over disposal of the firm's assets. As we note below, a single creditor, the FDIC, enjoys complete control over bank resolutions. The sale of a bank's assets does not require judicial approval.

B. Bank Insolvencies and the Purchase and Assumption Agreement

Law School, Law & Econ. Research Paper Series, No. 08-16 (2008); Douglas G. Baird, *The New Face of Chapter 11*, 12 AM. BANKR. L. REV. 69, 75 (2004).

⁵⁶ See M. Todd Henderson, *Paying CEOs in Bankruptcy: Executive Compensation When Agency Costs are Low*, 101 Nw. L. Rev. 1543, 1595-96 (2007); Stuart C. Gilson & Michael R. Vetsuypons, *CEO Compensation in Financially Distress Firms: An Empirical Analysis*, 48, J. FIN. 425 (1993).

Bank receiverships and bankruptcy proceedings operate under significantly different rules.⁵⁷ The differences include the procedure for determining claims, the right to repudiate contracts, stays of litigation, and the power to avoid certain transactions. Claims against a non-bank debtor are allowed or disallowed by the bankruptcy court, and its determination can be appealed.⁵⁸ By contrast, the authority to disallow claims is given to the FDIC, as receiver; its determination is subject to limited judicial review.⁵⁹ The FDIC has the power to repudiate or perform contracts entered into by the failed bank;⁶⁰ the bankruptcy trustee can reject or assume only contracts that are executory.⁶¹ Litigation against the failed bank is not automatically stayed while the bank's failure is being resolved. The FDIC instead must timely request a court to enjoin litigation,⁶² and courts disagree as to whether they must comply with the request.⁶³ Applicable law does not otherwise prevent creditors from enforcing their property rights in the failed bank's assets.⁶⁴ Bankruptcy's automatic stay prevents the enforcement of property interests (such as security interests) in the assets of the debtor.⁶⁵ Finally, certain payments made by non-bank firms to their creditors are recoverable by the firms' trustees as preferences.⁶⁶ Depositors are creditors of their depository banks. However, withdrawals by depositors before

⁵⁷ American banks have been barred from bankruptcy courts since the inception of the first lasting bankruptcy act in 1898. Bankruptcy Act of 1898, ch. 541, 30 Stat. 544. Prior to 1933, state receivership law controlled state bank failures, and federal law governed national bank failures. Today, the Federal Deposit Insurance Act governs failures of FDIC-member banks.

⁵⁸ See 11 U.S.C. § 502.

⁵⁹ See 12 U.S.C. § 1821(d)(5)(E). Courts rarely disagree with the FDIC's disallowance of a claim; for a rare instance see *Adagio Investment Holdings Ltd. v. FDIC*, 338 F. Supp.2d 71 (D.D.C. 2004).

⁶⁰ See 12 U.S.C. § 1821(e)(1).

⁶¹ See 11 U.S.C. 365(a).

⁶² See 12 U.S.C. § 1821(d)(12)(A), (B).

⁶³ Compare *Wachovia Bank, N.A. v. Michael Taylor*, 2007 U.S. Dist. Lexis 83793 (Nov. 13, 2007) (mandatory grant) with *FDIC v. Taylor*, 727 F. Supp. 316 (S.D. Tex. 1989) (permissive grant).

⁶⁴ See FDIC Advisory Opinion: Self-Help Liquidation of Collateral by Second Claimants in Insured Depository Receiverships (Dec. 15, 1989), FDIC 89-49.

⁶⁵ See 11 U.S.C. § 362.

⁶⁶ *Id.* at § 547.

the bank fails are not recoverable by the FDIC as preferences. The FDIC's power to avoid fraudulent transfers by the failed bank is more limited than the comparable power given to the bankruptcy trustee. Unlike the bankruptcy trustee's power,⁶⁷ the FDIC avoidance power requires actual fraud;⁶⁸ constructive fraud is insufficient. These are important difference between bank and bankruptcy insolvency rules. However, we argue that the most critical differences are the allocation of control over the resolution process and the distribution of losses among claimants.

Somewhat different priority rules order claims against banks and non-banks. Regardless of whether the firm is a bank or non-bank, secured claims have first priority with respect to their collateral,⁶⁹ administrative expenses should be paid before unsecured creditors,⁷⁰ and subordinated debt and equity should receive nothing unless general unsecured creditors are paid in full. The priority rules differ, however, in the extent by which they distinguish between unsecured creditors. Bankruptcy does grant some unsecured creditors priority over others; for example, workers and customers are given limited priority over general claimants.⁷¹ However, in large corporate bankruptcies these priority claims do not typically account for a substantial portion of the total claims.⁷² By contrast, banking law grants priority to domestic deposits over

⁶⁷ *Id.* at § 548.

⁶⁸ See 12 U.S.C. § 1821(d)(17) (transfer or incurrence of liability made with “the intent to hinder, delay, or defraud”).

⁶⁹ See 12 U.S.C. § 1821(11)(A) ; 11 U.S.C. § 725.

⁷⁰ See 12 U.S.C. § 1821(d)(11)(A)(i); 11 U.S.C. § 507(a)(2).

⁷¹ See 11 U.S.C. § 507(a)(4), (7).

⁷² See Elizabeth Warren & Jay Westbrook, *Contracting Out of Bankruptcy*, 118 Harv. L. Rev. 1197, 1243 (2004) (8% of the debt of business debtors in 1994 represent employee wage claims). Bankrupt debtors do, however, sometimes repay “critical vendors” at the outset of the case even though other creditors will not be repaid in full. However, the authority to do so is unclear; see *In re Kmart Corp.*, 359 F.3d 866 (7th Cir. 2004).

foreign deposits and general claims.⁷³ The FDIC insures domestic deposits up to an amount that varies over time, currently \$250,000,⁷⁴ and becomes subrogated to the claims of these creditors.

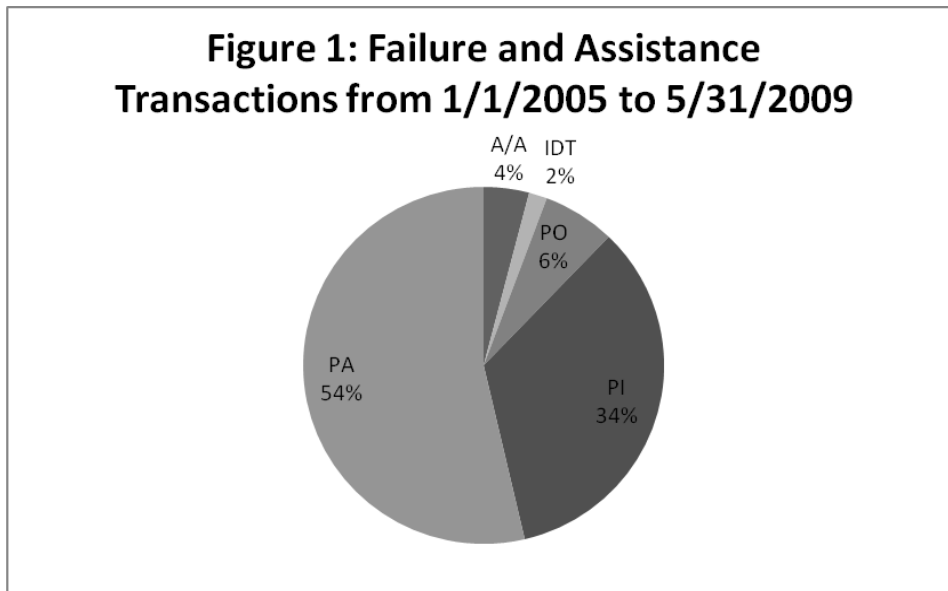


Figure 1 presents the FDIC’s categorization of how they dealt with troubled banks between 1995 and 2009. The FDIC can provide assistance without closing the bank (the FDIC calls these “Assistance Transactions” or “A/A”).⁷⁵ This includes purchasing nonvoting securities in the bank or assuming some of its liabilities.⁷⁶ Its purpose is to reinforce the capital of a troubled bank, making the bank more attractive to investors, and avoid having put the bank through the resolution process. Assistance transactions are rare, however. The only assistance transactions that occurred between 1995 and 2009 were the FDIC’s assistance to the five bank

⁷³ See 12 U.S.C. § 1821(d)(A)(ii); 12 U.S.C. § 1813(l)(5) (“deposit”).

⁷⁴ See 12 U.S.C. § 1821(a)(1)(A). The insured limit has been raised temporarily to \$250,000 . The insurance limit applies to the depositor, not the deposit. See 12 U.S.C. § 1813(m)(1).

⁷⁵ See 12 U.S.C. § 1823(c)(1), (3). Another open bank transaction is a reprivatization in which management takes over the bank and sells it with or without the assistance of the FDIC. See 12 U.S.C. § 1821(d)(16)(E). <http://www2.fdic.gov/hsob/help.asp#BFITT>. We do not discuss this transaction as it has not been used since 1989 and has been used just three times since 1934.

⁷⁶ See 12 U.S.C. § 1821(a)(3), (c)(5).

subsidiaries of Citigroup.⁷⁷ The FDIC and the U.S. Treasury guaranteed \$306 billion of loans and securities held by these banks. Under a loss sharing arrangement both agreed to bear part of the banks' losses on these assets above \$29 billion, up to stipulated amounts. The arrangement also gave the FDIC and Treasury preferred shares in Citicorp's banks.⁷⁸

If the FDIC decides to close a failed bank it has several options. It can simply pay the insured depositors what they are owed (a "pay-out" or PO) or transfer the insured deposits to another bank (an "insured deposit transfer" or IDT). In both cases the FDIC liquidates the assets of the bank, and distributes the proceeds in accordance with the priority structure. Like open-bank assistance, these choices of resolution are rare, occurring only about eight percent (6% PO and 2% IDT) of the time since 1995.

In eighty-eight percent of cases the FDIC finds a bank that is willing to assume some or all of the failed bank's liabilities and purchase some or all of the failed bank's assets. In a significant portion of the cases (34%), the acquirer assumes only the insured liabilities (a purchase and assumption of insured deposits, or "PI"). However, most of the time (54%), the acquirer assumes some of the uninsured deposits as well (a purchase and assumption agreement or "PA"). These transactions also vary in the nature of the assets acquired. The standard purchase and acquisition contract grants the acquirer the option to purchase the physical assets of the bank (the offices, furniture, etc.),⁷⁹ but on average these assets account for only about 2.3

⁷⁷ See Figure 2. In generating Figure 2 we calculate each bank as a separate transaction even if the banks are part of a related family. For example, the assistance that the FDIC provided to Citigroup and its affiliates counted as five transactions because there were five banks.

⁷⁸ See Press Release: Joint Statement by Treasury, Federal Reserve and FDIC on Citigroup, November 23, 2008, fdic.gov/news/news/press/2008/pro8125.html.

⁷⁹ Samples of purchase and assumption agreements can be found on the FDIC's web page, www.fdic.gov.

percent of total assets; the primary assets of the bank are its cash, loans and securities⁸⁰ In most cases (51%) the acquirer will acquire less than one-quarter of the assets of the failed bank;⁸¹ the remaining assets are then sold by the FDIC in the ensuing months or even years.⁸² Even when the acquirer acquires the majority of the assets of the failed bank, the FDIC usually enters into a loss-sharing agreement so that it retains much of the risk of a decline in value. Of the twenty-nine insolvencies in which the acquirer purchased more than three-quarters of the firm's assets, the FDIC entered loss-sharing agreements in eighteen of the transactions. This ratio rises to sixteen of nineteen transactions in the banking crisis of 2008 and 2009. The FDIC entered into just one loss-sharing transaction in the sixty-nine transactions in which the acquirer took less than three-quarters of the failed bank's assets.

Since 1991 the FDIC has been required to choose the resolution method that imposes the least cost on the insurance fund, unless it determines that doing so is necessary to avert systemic risk.⁸³ However, in order to invoke this exception to the least cost rule it must obtain the approval of the Chairman of the Federal Reserve and the Treasury Secretary, and they must consult with the President.⁸⁴ This exception has been invoked just once in the last decade in order to provide assistance to Citigroup's bank subsidiaries.⁸⁵ Prior to the adoption of the least

⁸⁰ See FREDERICK S. MISHKIN, *THE ECONOMICS OF MONEY, BANKING AND FINANCIAL MARKETS* 226 (Table 1) (9TH ed. 2010) (in 2008 9 percent of total commercial bank assets were "other assets," which include physical capital).

⁸¹ In about 51% of the Purchase and Assumption (PA, PI and P&A) transactions for which the FDIC provided data on the assets acquired the acquiring bank purchased less than 25% of the failed bank's assets. In another 12% of these transactions the acquirer purchased between 25% and 50% of the assets. The remaining transactions were between 50% and 75% (7% of transactions) and 75% and 100% (30% of transactions).

⁸² See *supra* note 13, and accompanying text.

⁸³ See 12 U.S.C. § 1823(c)(4)(A).

⁸⁴ See 12 U.S.C. § 1823(c)(4)(G).

⁸⁵ The FDIC also invoked this exception when approving financing for Citibank's bid to buy Wachovia. See Editorial, *Who's Too Big to Fail?*, *Wall St. J.*, (Sept. 13, 2009, at A14). However, this transaction was not consummated as Wells Fargo purchased Wachovia instead.

cost standard, the FDIC used standards that allowed them to consider, among other things, the impact of a bank closure on a community.⁸⁶ Congress worried that the FDIC was too willing to consider these other factors and too willing to pay an acquiring bank to assume all of the liabilities of the failed firm, not just the insured liabilities. The effect of such payments was to use the federal deposit insurance fund to subsidize payments to uninsured depositors and other creditors because the FDIC typically would have to pay an acquiring bank more to assume all of a failed bank's deposits than assume only its insured deposits. Accordingly, some observers believed that resolutions involving the assumption of all deposits would become the exception rather than the norm as they would not satisfy the least cost requirement.⁸⁷ Data on the form of resolution used by the FDIC between 1995 and 2009 clearly show that this has not been the case as PA transactions outnumber PI transactions by a factor of about two to one.⁸⁸

Some purchase and assumption transactions can be quite similar to bankruptcies that utilize section 363 to sell all or substantially all of the assets. Both processes can be used to quickly transfer the core assets or goodwill of the failed entity to an acquirer. Assets not transferred are retained for months or even years before being liquidated and creditors paid in accordance with the relevant priority rules.⁸⁹ However, the processes differ in three fundamental

⁸⁶Prior to 1991, the Federal Deposit Insurance Act required the FDIC to dispose of a failed bank's assets in such a way that the cost to the insurance fund was less than the cost to it of paying off insured deposits. See 12 U.S.C. § 1823(c)(4)(A) (1950). However, 12 U.S.C § 1823(c)(4)(A) recognized an exception allowing the FDIC to use a method of disposal not satisfying this "less cost" standard if the failed bank was deemed essential to its community. See *id.*

⁸⁷ See Peter P. Swire, Legal and Political Implications of Deposit Preference, reported in Skeel, *supra* note 17, at 771 n. 176.

⁸⁸ See *supra* Figure 1. The dominance of PA transactions is even more apparent if we expand our sample to include all transactions from 1991 through 2009. During this period there were 135 PI transactions and 513 PA or P&A transactions. See <http://www2.fdic.gov/hsob/index.asp>.

⁸⁹ Lehman Brothers Holdings, Inc.'s bankruptcy shows the same pattern. The largest bankruptcy in U.S. history, Lehman's North American investment banking unit and headquarters was sold in a 363 sale within a week of its bankruptcy filing. Other core units were sold within weeks later. Still other assets

ways. First, the initial stage of the bank resolution process is much faster than even the quickest bankruptcy. Chrysler and General Motors were notable because the sales were completed in a matter of weeks, and the fastest 363 sales take more than a week.⁹⁰ In every completed purchase and assumption transaction, the FDIC completed the sale of the failed bank simultaneously with its seizure.

Second, the standards for determining the method of resolutions are not the same. Surprisingly, the Bankruptcy Code does not provide the judge with an explicit standard for approving sales outside of the ordinary course of business.⁹¹ The standard has been left to courts, which typically require the sales proponent to articulate a “sound business reason” for the sale.⁹² Many courts and commentators believe that the judge should approve a transaction if, and only if, it increases the aggregate return of all parties with legal claims against the failed entity.⁹³ Other commentators disagree. They believe that the court should also consider the interests of other stakeholders who lack a legal claim such as workers or the local community.⁹⁴ Congress explicitly rejected this broader “stakeholder” standard in the context of bank insolvencies when its own money was on the line. It did, however, provide a possible exception in the case of systemic risk, but this exception requires an acknowledgement of those who face far more

were auctioned approximately three months after the filing. See *Lehman's Collapse: A Timeline*, THE DEAL, September 26, 2009, <http://www.thedeal.com/dealscape/2009/09>.

⁹⁰ See LYNN M. LOPUCKI, *COURTING FAILURE*, Table at 171-72 (2005); also his post-2003 data on 363 sale times.

⁹¹ See 11 U.S.C. § 363.

⁹² See *In re Lionel Corp.*, 722 F.2d 1064 (2d Cir. 1983).

⁹³ See Douglas G. Baird, *Bankruptcy's Uncontested Axioms*, 108 YALE L. J. 573 (1998); Douglas G. Baird, *Loss Distribution, Forum Shopping, and Bankruptcy: A Reply to Warren*, 54 U. CHI. L. REV. 1534 (1987).

⁹⁴ See Elizabeth Warren, *Bankruptcy Policy*, 54 U. CHI. L. REV. 775 (1987);

political accountability than a bankruptcy judge.⁹⁵ Significantly, this exception has only been invoked once to preserve a group of banks owned by Citigroup.⁹⁶

The third difference is the most significant. While control of the bankruptcy process is divided amongst all of the claimants, control over a bank receivership is concentrated in the FDIC. Bankruptcy provides all claimants with the opportunity to vote on the plan and to at least object to a sale outside of the ordinary course of business.⁹⁷ When objecting to the sale, claimants can, and do, argue that the sale of the assets would yield more if the assets had been marketed in another manner or if an alternative buyer had been chosen. If the judge believes that the dissenters have the better of the argument, she can enjoin the sale. By contrast, claimants on the assets of the failed bank have neither the right to vote on the sale of the key assets of the bank nor the ability to seek an injunction from a court.⁹⁸ They can, and sometimes do, seek damages if they believe that the FDIC made poor decisions. However, claimants are entitled only to the difference between what they received and the amount that they would have received in liquidation.⁹⁹ They have no entitlement to any going concern value of the bank.

II. The Case for FDIC Control of Bank Insolvencies

We argue that the key difference between a bank receivership and a bankruptcy proceeding is the concentration of control in a single decision maker – the FDIC. The FDIC is not a neutral arbitrator, and the concentration of control in its hands can impose costs if it acts

⁹⁵ See *supra* notes 83-84, and accompanying text.

⁹⁶ The FDIC was also prepared to invoke this rule to arrange Citibank's acquisition of Wachovia. See Joe Adler, *Wachovia Deal Forces FDIC to Use Systemic Tool*, AM. BANKER, Sept. 30, 2008, at page 4.

⁹⁷ See *supra* notes 37-38, and accompanying text.

⁹⁸ See 12 U.S.C. § 1821(d)(13)(D).

⁹⁹ See 12 U.S.C. § 1821(i)(2)

against the interests of other creditors.¹⁰⁰ The literature offers two plausible justifications for this concentration of control. First, it allows for much greater speed and secrecy, and this speed and secrecy could yield benefits in banking. Second, concentration of control is appropriate to the extent that the FDIC is the largest creditor and will wish to maximize the value of the assets of the firm. We find the first justification unconvincing. However, if we recast the second justification to say that the FDIC is the residual claimant on the assets of most failed banks, it provides a strong rationale for FDIC control.

A. The Benefits of Speed and Secrecy

Numerous commentators ask whether banking regulators act with sufficient speed when seizing failing institutions.¹⁰¹ Banks are highly leveraged, much more so than non-financial firms.¹⁰² This high leverage means that relatively small shocks can quickly render the firm insolvent. The relatively liquid nature of the bank's assets means that the moral hazard created by insolvency or near-insolvency can be severe. Banks that are insolvent or close to insolvent can easily deploy their assets quickly to increase risk and exploit the option value of equity in a nearly insolvent firm. The dispersion of depositors makes coordination difficult, and thus initiation rules that differ from those that apply in bankruptcy may be justified. This paper does not, however, address the speed with which the regulator initiates the bank resolution process as

¹⁰⁰ Writing just after the bank crises of 1930-1933, Cyril Upham and Edwin Lamke worried that the recently created FIDC would favor its own interests over those of other creditors. They concluded that "...since [the FDIC] is a quasi-governmental body, it may be expected to administer assets fairly with respect to the rights of all depositors." CYRIL B. UPHAM & EDWIN LAMKE, CLOSED AND DISTRESSED BANKS: A STUDY IN PUBLIC ADMINISTRATION 58 (1934). For doubts on this score, see *infra* Part III.A.

¹⁰¹ See, e.g., Skeel, *supra* note 17; Arnoud W.A. Boot & Anian V. Thakor, *Self-Interested Bank Regulation*, 83 AM. ECON. REV. 206 (1993); Edward J. Kane, THE S&L INSURANCE MESS: HOW DID IT HAPPEN? (1989).

¹⁰² Banks have a debt-equity ratio of about 9.1. Non-bank firms in different industries tend to have much lower leverage ratios. The following are median debt-equity ratios for select industries in 2004-5: Agriculture (dairy cattle and milk production): 2.3; manufacturing (plastics): 1.4; mining (sand and gravel): 1.4; and transportation (freight trucking): 2.6. See Annual Statement Studies, Financial Ratio Benchmarks 2008-2009 (2008).

the bank nears insolvency. Rather, it asks whether there are significant benefits from speed in resolving a failed bank once a procedure has been initiated. We are skeptical of the possible benefits of speed and conclude that speed does not justify giving the FDIC control over the resolution process.

Speed provides two closely related benefits: liquidity and confidence in the banking system. Speed gives depositors uninterrupted access to their deposit balances, preserving liquidity.¹⁰³ The assurance of continued liquidity of deposits in turn increases depositors' confidence in the banking system and prevents series of bank runs that could pose a risk to the entire financial system. Although these benefits may be substantial, they do not require FDIC control over the resolution process.

In resolving a failed bank the resolving authority must dispose of the bank's assets and distribute the proceeds to the bank's creditors. These tasks are distinct from the FDIC's duty to honor its commitment to the insured depositors. The FDI Act requires the FDIC to reimburse insured depositors from the Deposit Insurance Fund ("DIF" or "insurance fund")¹⁰⁴ to the

¹⁰³ See FDIC, *THE FIRST FIFTY YEARS: A HISTORY OF THE FDIC 1933-1983* 83 (1984) ("there were also conflicting concerns that depositors had to wait too long to recover their funds..."). One can question the importance of this liquidity. Depositors can obtain liquid short-term funds by using credit cards or investing in money market funds offered by mutual funds. They do not need the liquidity provided by demand deposits; alternative products offering it are available. See Daniel R. Fischel, Andrew M. Rosenfield & Robert S. Stillman, *The Regulation of Banks and Bank Holding Companies*, 73 VA. L. REV. 301, 318 (1987). For the rise of financial products issued by non-banks that are functionally similar to demand deposits, see Jonathan Macey & Geoffrey Miller, *Nondeposits and the Future of Banking Regulation*, 91 MICH. L. REV. 33 (1992).

¹⁰⁴ For the history of the Federal Deposit Insurance Act, see CHARLES W. CALOMIRIS & EUGENE N. WHITE, *The Origins of Deposit Insurance*, in *THE REGULATED ECONOMY* 145 (C. Goldin & G.D. Libsap eds. 1994). For the FDIC practice of allowing prompt access, see George G. Kaufman & Steven A. Seelig, *Post-Resolution Treatment of Depositors at Failed Banks: Implications for the Severity of Banking Crises, Systemic Risk and Too Big to Fail*, 2002 ECON. PERSP. 27, 32 (2002). For the FDIC's prompt payment of insured deposits when conducting a direct payoff transaction, see George G. Kaufman, *Depositor Liquidity and Loss Sharing in Bank Failure Resolutions*, 23 CONT. ECON. POL'Y 237, 245 (2004). The United States is one of the few countries that gives depositors immediate access to insured deposits; see Kaufman & Seelig, *supra* note, at 32-33, 36 (Table 1); George G. Kaufman, *Using*

insured limit.¹⁰⁵ Reimbursement of insured depositors does not therefore depend on when or whether the failed bank's assets are liquidated, or the liquidation value of those assets. Speedy payment of insured depositors is necessary to preserve the liquidity of their deposits. However, speed in liquidating the failed bank's assets is unnecessary to do so. As long as depositors have uninterrupted access to their insured deposits, they should be indifferent as to the fate of their depository bank or its assets. Insured depositors therefore have no reason to run on their failed banks. For the same reason, the failure of unhealthy banks cannot justifiably induce insured depositors of healthy banks run on their banks as long as they believe that the insurance fund is solvent and that they would be quickly reimbursed in the event of bank failure.

As insurer of the deposits, the FDIC must be subrogated to their rights so that it can be reimbursed for the expense of making depositors whole. However, the liquidation of the assets need not occur concurrently with the payment of depositors. In fact, the FDIC often retains a sizable portion of the failed bank's assets, by choice or necessity, and liquidates them over time.¹⁰⁶ The FDIC sometimes does transfer assets to the acquiring bank as partial compensation for the acquirer's assumption of insured deposits and other liabilities. However, as noted above, the acquirer usually receives less than a quarter of the failed bank's assets,¹⁰⁷ and the FDIC uses cash payments to make up the difference between the deposits assumed and the assets received. In other words, the FDIC must have a claim against the assets of a failed bank, but it need not control the disposition of these assets.

Efficient Bank Insolvency Resolution to Solve the Deposit Insurance Problem, 8 J. BANK REG. 40, 46 (2006) (FDIC usually pays insured deposits on close of business day after seizure). For the timing in which select countries with deposit insurance pay insured depositors, see GILLIAN G.H. GARCIA, DEPOSIT INSURANCE: ACTUAL AND GOOD PRACTICES 83-84 (Table A7) (2000).

¹⁰⁵ See 12 U.S.C. § 1821(a)(5).

¹⁰⁶ See Division of Resolution and Receiverships, Asset Disposition Manual, Ch. 2 (at 22) (1999).

¹⁰⁷ See *supra* note 81, and accompanying text.

FDIC control of assets might be justified if it reduced the size of the FDIC's claim against the failed bank. For instance, consumers value liquidity and the convenience provided by a bank account. Accordingly, the FDIC can usually find an acquirer willing to assume the insured deposits for less than the amount that it would cost the FDIC to repay the insured depositors in full.¹⁰⁸ The FDIC's control of the physical assets of the failed bank would be appropriate if consumer depositors were more likely to continue their banking relationship with the acquiring bank if the acquiring bank purchases some of these assets. In this case acquirers of consumer deposits would typically prefer to purchase the failed bank's physical assets. But the factual assumption is wrong: acquirers do not typically pick them up. Instead, the standard purchase and assumption agreement merely gives the acquirer an option to purchase them.¹⁰⁹ This is not hard to explain. Because acquiring banks have their own branches and other deposit facilities, they (and their depositors) do not usually need the failed bank's physical assets. Acquirers can preserve a consumer depositor's preexisting banking relationship with her failed bank, if at all, without buying the failed bank's furniture or equipment. In fact, throughout the 1980s the assets sold as a part of the basic purchase and assumption agreement were limited to cash and cash equivalents.¹¹⁰ Acquirers are unlikely to pay more for deposits merely because the FDIC offers the failed bank's physical assets as well. In any case, physical assets account for a tiny fraction (an average of 2.29%) of the assets of the failed banks.

It might be thought that uninsured depositors and subordinate creditors prefer a quick liquidation of a failed bank's assets. Their willingness to invest in banks would be jeopardized

¹⁰⁸ The acquirer typically "pays" a premium for the deposits.

¹⁰⁹ For a standard purchase option, see Purchase and Assumption Agreement between FDIC and Wilshire State Bank, June 26, 2009, sec. 4.6(a) (p. 17).

¹¹⁰ See Eric Bloecher & John F. Bovenzi, *Evolution of the FDIC's Resolution Practices*, in THE FDIC AND RTC EXPERIENCE 1980-1994: MANAGING THE CRISIS 65, 67 (1998).

by delays in the recoupment of their investments. If the FDIC's control of the resolution process speeds resolution, it could increase the value of their claims.¹¹¹ This argument is unconvincing. First, most uninsured depositors and other creditors withdraw their deposits and are paid in full before a bank fails and thus do not suffer the consequences of delay.¹¹² The behavior of foreign depositors in Continental Illinois Bank and Trust's failure illustrates the behavior. Deposits in foreign offices are not "deposits" under the FDI Act, and they are therefore uninsured and junior in priority to deposits in domestic offices. Foreign depositors exited the bank in droves before it failed.¹¹³ Most uninsured depositors therefore are unconcerned about the liquidation value of their claims against a failed bank because they will not have claims when the bank fails.

Uninsured depositors and other creditors who remain and are concerned about a bank's continued solvency can and do take security interests in the bank's assets.¹¹⁴ Applicable law sometimes requires certain depositors and lenders to do so in any case.¹¹⁵ Collateral makes uninsured secured creditors generally indifferent to the speed at which the failed bank is resolved because they are almost certain to recover in full. To the extent that they are concerned, there is

¹¹¹ This assumes that the amount received in the sale remains the same. If the market for the failed bank's assets are not liquid, a quick sale could reduce the liquidation value.

¹¹² See Christine M. Bradley & Lynn Shibut, *The Liability Structure of FDIC-Insured Institutions: Changes and Implications*, 18 FDIC BANKING REV. 1, 20 (2006); James A. Marino & Rosalind Bennett, *The Consequences of National Depositor Preference*, 12 FDIC BANKING REV. 19, 28-30 (1999); John S. Jordan, *Depositor Discipline at Failing Banks*, NEW ENGLAND ECON. REV. 15 (March/April 2000) (70 percent of uninsured deposits in sample of failed banks withdrawn within two years of failure). For evidence that uninsured depositors respond to the financial health of banks, see A.M. Davenport & K.M. McDill, *The Depositor Behind the Discipline: A Micro-Level Case Study of Hamilton Bank*, 30 J. FIN. SERV. RES. 93 (2006); Lawrence G. Goldberg & Sylvia C. Hudgins, *Response of Uninsured Depositors to Impending S&L Failures: Evidence of Depositor Discipline*, 36 QUART. REV. ECON. & FIN. 311 (1996).

¹¹³ See *Continental Illinois National Bank and Trust Company*, in THE FDIC AND BTC EXPERIENCE: MANAGING THE CRISIS 1980-1989 545, 547 (1998).

¹¹⁴ See James B. Thomson, *The National Depositor Preference Law*, ECONOMIC COMMENTARY, FED. RES. BANK OF CLEVELAND, Feb. 15, 1994; Eric Hirshorn & David Zervos, *Policies to Change the Priority of Claimants: The Case of Depositor Preference Laws*, 4 J. FIN. SERV. RES. 111 (1990).

¹¹⁵ FHLB advances require collateralization, as do deposits of public funds in most jurisdictions. For a sample of the latter, see, e.g., Colo. Rev. Stat. § 11-10.5-707(5) (2009); Or. Rev. Stat. § 295.008(2)(b) (2009); Va. Code Ann. § 2.2-4402 (2009).

no reason why they must wait until all of the assets are sold. Uninsured depositors could sell their claims to those who are more patient; by definition uninsured deposits are for substantial amounts. Alternatively, the resolution process could allow partial compensation of the uninsured depositors in advance of the completion of the process. In fact, in the past the FDIC has made advance payments to uninsured depositors,¹¹⁶ although it has since discontinued the practice.¹¹⁷ There is even less reason to rush on behalf of the non-depositors. As discussed more thoroughly in Section II.B.2 below, failed banks almost always have insufficient assets to repay the FDIC and uninsured depositors in full. Because they are junior to depositors in priority, non-depositors receive nothing. They therefore should not care about the speed at which a failed bank is resolved.

Perhaps the greatest weakness with the speed of liquidation argument is that the FDIC does not, in fact, quickly liquidate the assets of the failed bank. The FDIC's own resolution manual proposes a four-year liquidation schedule,¹¹⁸ and the average time elapsed between the seizure of failed banks between 2002 and 2003 and the date of the last distribution to depositors was forty-seven months. In only one transaction was the final payment made in less than one year (ten months).

B. The FDIC as Residual Claimant

In some bankruptcies, such as most single-asset real estate cases, one creditor is owed much more than any other. While bankruptcy does apply some special rules in the single-asset

¹¹⁶ See *Treatment of Uninsured Depositors and Other Receivership Creditors*, in *THE FDIC AND RTC EXPERIENCE: MANAGING THE CRISIS 1980-1989* 245, 250 (1998).

¹¹⁷ See George G. Kaufman, *Depositor Liquidity and Loss Sharing in Bank Failure Resolutions*, 23 *CONT. ECON. POLICY* 237, 245 (2004).

¹¹⁸ See *supra* note 13.

real estate context,¹¹⁹ it does not assign total control over the process to the largest creditor. It does not do so because of the fear that the lender will sell the real estate too quickly and for too little at the expense of junior claimants.

The law can, however, entrust the largest creditor with control over the process if it is also the residual claimant: a claimant that receives all of the gains associated with a good decision and all of the losses associated with a bad decision. A creditor is the residual claimant if two conditions are satisfied: i) those who have equal priority with the creditor have negligible claims or the creditor is fully compensated for the costs it incurs in maximizing the value of assets, and ii) regardless of the decisions made by the creditor, those senior to the creditor in priority will be paid in full and those junior to the creditor will not be paid anything. In most insolvencies there is no claimant who fully meets each criteria and the law must allocate control among the parties who bear at least some of the risk associated with the decision.

Consider what happens when the decision-maker is not the residual claimant. Take the first condition. Assume that a firm has two creditors of equal priority and each are owed \$50. Assume that the firm's assets can be sold for \$80 if the decision-maker incurs a cost of \$15. If this cost is not incurred, the firm can only be sold for \$60. It is socially efficient for the decision-maker to incur this cost, because the sale nets \$5 more if the decision maker incurs the cost ($\$80 - \$15 = \$65$) than if he does not incur it ($\$60 - 0 = \60). However, she will not incur the cost unless she is reimbursed. If the decision maker does not incur the cost, she will receive \$30 (half of \$60). If she incurs it, she will receive a net of \$25 ($\$40 - \15). This problem can be eliminated by allowing the decision-maker to recoup her administrative costs before dividing the proceeds with the other creditor, but this can create its own problems. If the decision-maker

¹¹⁹ See, e.g., 11 U.S.C. § 363(d)(3).

derives some private benefit from these expenses (perhaps she can overstate her expenses), she can use this priority to divert value from the other creditor. However, her ability to do so declines as the proportion of the debt owed to the decision-maker increases.

Now consider the second assumption. Assume that a firm again has two creditors that are owed \$50, but now also assume that one is senior to the other. Suppose the decision-maker has three options. If she adopts plan A, there is a ninety percent chance that the firm's assets will be sold for a present value of \$70 and a ten percent chance that they will be sold for a present value of \$20. If she adopts Plan B, there is a fifty percent chance that the firm's assets will be sold for a present value of \$90 and a fifty percent chance that they will be sold for a present value of \$20. Plan C would be to sell the firm's assets immediately for \$60. Plan A is clearly the socially optimal choice as its expected present value of \$65 exceeds that of Plan B (\$55) and Plan C (\$60). However, if the decision-maker holds the junior claim, she will prefer Plan B as this will provide her with an expected payment of \$20 which is more than what she will expect to receive from Plan A (\$18) or Plan C (\$10). If the decision-maker holds the senior claim, she still does not have the right incentives. The senior claimant will prefer Plan C as this provides her with an expected payment of \$50 which is more than what she would receive from Plan A (\$47) or Plan B (\$35).¹²⁰ There is no true residual claimant in this hypothetical. Note that this problem is not inevitable in the presence of senior and junior claimants; it disappears if we change the value of the claims. Assume, for example, that the senior claim is owed just \$20 and the junior claim is owed \$80. The senior claim will be paid in full regardless of the plan chosen. The junior claim bears all of the risk (it is the residual claimant) and would choose the plan (Plan A) that maximizes social welfare. Similarly, if we assume that the senior claimant is owed \$90 and that

¹²⁰ These examples ignore the possibility of Coaseian bargaining. For example, the junior claimant in this scenario could simply repay the senior claim in full and thereby obtain the right to make the decisions.

the junior claimant is owed \$10, then the junior claimant will receive nothing regardless of the plan adopted. The senior claimant bears all of the risk and would make the choice that maximizes social welfare.

Allocating decision making authority to the residual claimant is generally defensible. However, to supply ex ante efficient incentives, an exception may occasionally justify giving decisions to a junior claimant. The residual claimant has an incentive to make ex post socially optimal choices, because it benefits from doing so. But it might be insufficiently motivated to make decisions at earlier stages that avoid risk financial risk later on. Additional motivation is provided by taking decisions away from the residual claimant and giving them to junior claimants when the firm is in financial distress. Because junior claimants lack the incentive to make decisions to benefit residual claimants, the shift in decision making potentially harms residual claimants' interests. For this reason, residual claimants have a further incentive to remain in control of the firm's fortunes. To remain in control, they must make decisions that avoid putting the firm into financial distress. An ex post inefficient allocation of decision making is required to give residual claimants ex ante efficient incentives.

Assume, for example, that the senior secured creditors are the residual claimants of a failed firm and that allocating decision-making rights to unsecured creditors would result in a social loss (and a loss to the senior secured claimant) of \$30. While this creates an ex post cost, it may provide ex ante incentives for the senior secured lender to curb excessive risk taking by the debtor. Assume that one year before insolvency the firm could have sold its assets for \$100 and that the only debt was \$50 owed to the senior secured creditor. Finally, assume that the debtor also had the choice of engaging in a project that, if successful, would have been worth \$200. However, the project would fail half of the time, and if it did so the firm's assets would be

worth just \$50 and the firm would incur tort claims of \$100. Society would not want the firm to undertake this project. The expected value of project is \$75 $((.5 \times \$200) + (.5 \times -\$50) = \$75)$, while liquidation of the firm would net \$50 for the unsecured creditors $(\$100 - \$50)$. However, the project would make the shareholders better off, on average, than if the firm were liquidated. If the firm were liquidated, shareholders receive nothing. For their part, the senior secured lender would have no reason to stop the shareholders from pursuing the project because its priority guarantees it payment in full (\$50) whether the project is undertaken or the firm liquidated. Note that the lender would oppose the project if either it shared control (and thus \$30 was wasted) or if it were subordinated to the tort victims. Imposing the ex post cost is a way to avoid the inefficiencies caused by the tort claimant's lack of priority and ability to control the debtor's investment decisions. The exception that separates decision making and residual claimants is inapplicable in bank failures. As we show below, there are very few fixed claimants that are junior to the FDIC; general creditors and subordinated creditors do not account for a meaningful component of the capital structure of failed banks.¹²¹

Two pieces of evidence suggest that the FDIC is truly the residual claimant in the overwhelming majority of bank insolvencies. First, in Section B.1 we show that the FDIC accounts for the vast majority of claims on the assets of both healthy and failed banks. The FDIC's status as the holder of the overwhelming majority of the debt does not ensure that it will be the residual claimant. Whether the majority creditor is a residual claimant depends on the value of the assets available for distribution to creditors. However, the greater the share of debt held by a creditor and the greater the value of the debt relative to the equity, the greater is the chance that the majority creditor will be the residual claimant too. For example, consider a bank

¹²¹ See *infra* Table 1.

with \$10 in senior secured claims, \$80 in insured deposits, and \$10 in general unsecured claims. Because the secured claims will have priority over the deposits and the deposits will have priority over the general claims, the FDIC will be the residual claimant as long as the plausible range of asset values is between \$10 and \$90. If assets have a \$90 value, the FDIC (subrogated to the rights of insured depositors) is repaid in full ($\$90 - \$10 = \$80$). The FDIC receives nothing if assets have a value of \$10 or less ($\$10 - \$10 = \0). The FDIC is repaid in part if asset values are between \$11 ($\$11 - \$10 = \1) and \$89 ($\$89 - \$10 = \79).

Second, we examine the actual payouts from failed banks in Section B.2. We show three patterns in these payouts: i) the most important secured creditors have recovered in full in every bank failure to date; ii) the FDIC suffered significant losses in the vast majority of bank failures; and iii) general creditors almost never receive any dividends. As a result, it is the FDIC that would enjoy the gains from a distribution method that yields greater proceeds.

1. The FDIC as the Largest Creditor

Most banks are part of holding company structures. However, with the possible exception of the very largest banks, discussed below, the capital structures of the actual banks are extremely simple. Domestic deposits account for the overwhelming majority of bank liabilities, and almost all of these domestic deposits are insured. These banks have comparatively little general unsecured debt, and almost no subordinated debt. This is true whether we examine failed banks or banks more generally.

Table 1: Liability Structure of Failed Banks: 1/1/1995-5/31/2009

	Less than \$100 million	\$100 million to \$500 million	\$500 million to \$1 billion	\$1 billion to \$5 billion	More than \$5 billion

Banks	44	45	10	15	5
Deposits as Percent of Liabilities (S.D.)	96.25% (4.61%)	92.85% (7.33%)	89.13% (5.38%)	87.35% (10.16%)	70.39% (7.73%)
Percent of Deposits Insured (S.D.)	89.81% (10.47%)	80.75% (18.13%)	66.03% (23.37%)	81.01% (16.93%)	84.35% (6.15%)
Foreign Deposits as Percent of Liabilities (S.D.)	0.00% (0.00%)	0.35% (1.62%)	0.00% (0.00%)	0.35% (1.35%)	0.00% (0.00%)
FHLB as Percent of Liabilities (S.D.)	1.43% (3.55%)	3.94% (5.73%)	8.82% (5.62%)	7.04% (9.95%)	26.10% (7.91%)
Repurchase obligations as % of Liabilities (S.D.)	0.35% (1.12%)	1.21% (3.26%)	0.49% (0.93%)	3.47% (6.60%)	0.12% (0.17%)
Subordinated debt as Percent of Liabilities (S.D.)	0.07% (0.30%)	0.00% (0.00%)	0.15% (0.43%)	0.18% (0.38%)	0.62% (1.22%)
General Unsecured Claims as Percent of Liabilities (S.D.)	1.73% (2.59%)	2.01% (3.48%)	1.41% (1.32%)	2.20% (2.36%)	2.77% (4.00%)

Table 1 documents key characteristics of the liability structure of failed banks as of the last reporting period before their failures. For now we will ignore the very largest banks – those with assets greater than five billion dollars. In all other banks, deposits account for the

overwhelming majority of liabilities. The proportion declines somewhat according to the size of bank, but remains high. Deposits constitute 96 percent of liabilities in failed bank with assets below \$100 million.¹²² The percentages for banks with assets between \$100 and \$500 million, \$500 million and \$1 billion, and \$1 billion and \$5 billion are 93, 89, and 87 percent, respectively. Out of the 120 banks that failed between January 1, 1995 and May 31, 2009, only ten had deposits that constituted less than eighty percent of liabilities.¹²³ Healthy banks have a similarly high percentage of deposits.¹²⁴ Banking law grants deposits in domestic branches priority over deposits in foreign branches. Except for the very largest banks, foreign deposits account for a negligible percentage of liabilities.¹²⁵

The FDIC is only subrogated to the insured deposits, but Table 1 reveals that a strong majority of deposits are insured. The percentage of insured deposits at healthy banks is a little lower.¹²⁶ Table 1 presents data from the last Call Report issued before the bank's failure, and uninsured deposits are likely to decline further as the bank nears insolvency. If the resolution process is not yet complete, the FDIC does report the claims of uninsured depositors when the acquiring bank assumes only the insured deposits. In the sixteen transactions for which we could find data, uninsured depositors averaged just 4.75 percent of total deposits. Uninsured depositors typically either exit before a bank fails or convert their uninsured amounts to insured deposits.

¹²² Asset values of banks are adjusted for inflation.

¹²³ The predominance of deposit liabilities has not changed much over time. Table 1 would not change materially if we focused only on banks that failed between 2008 and 2009.

¹²⁴ See FDIC Statistics on Depository Institutions Report (National banks), March 31, 2009 (as of December 31, 2008 deposits approximately 83 percent of liabilities for banks with assets up to \$100 million, 90 percent for banks with assets between \$100 million and \$1 billion, and 73 percent for banks with \$1 billion or more in assets). <http://www.2.fdic.gov/SDt/rpt-Financial.asp>

¹²⁵ *Id.* (showing that at the end of 2008 foreign deposits accounted for less than one quarter of one percent of the deposits of banks with assets of less than \$500 million). We could not find data for banks with assets greater than \$500 million but less than \$10 billion.

¹²⁶ *Id.* (as of March 31, 2009, approximately 78 percent of deposits are insured at banks with up to \$100 million in assets, 71 percent at banks with between \$100 million and \$500 million in assets, and 59 percent at banks with more than \$1 billion in assets).

The bank replaces the exited funds with another funding source. For instance, a study of failed New England banks found that they lost about 70 percent of their uninsured deposits within two years of failure.¹²⁷ The banks, however, replaced these deposits with insured deposits. Such replacement allows the banks to retain the same source of funding while increasing the percentage of insured deposits. In addition, failed banks tend to overstate the amount of uninsured deposits, thereby understating insured deposits.¹²⁸ By contrast, healthy banks, which do not experience a run on uninsured deposits, retain higher percentages of uninsured deposits.

Uninsured domestic deposits are equal in priority to the insured claims to which the FDIC is subrogated. Other claims are either senior or junior to the FDIC, but these claims are rarely significant. Foreign deposits are junior to the FDIC's claims,¹²⁹ but (aside from the very largest banks discussed below) nearly all banks have either no or insignificant amounts of foreign deposits. Small banks generally do not have foreign branches. Similarly, general claims rarely account for more than five percent of a bank's assets.¹³⁰

The comparative absence of subordinated debt among failed banks deserves notice.¹³¹ Subordinated debt represents only one percent of total liabilities among every category of bank,

¹²⁷ See John S. Jordan, *Depositor Discipline at Failing Banks*, NEW ENGLAND ECON. REV. 15 (March/April 2000). For a finding that banks increase their proportion of insured deposits in response to a ratings downgrade, see Matthew T. Billet et al., *The Cost of Market Versus Regulatory Discipline in Banking*, 48 J. FIN. ECON. 245 (1998).

¹²⁸ See FDIC Staff Study, *An Evaluation of the Denominator of the Reserve Ratio 16* (February 12, 2007) (examination of some of failed banks show understatement in final Call Reports). Banks can underestimate their insured deposits when depositors hold multiple deposit accounts with them or depositors hold these accounts in different legal capacities.

¹²⁹ See 12 U.S.C. § 1821(d)(11)(A); 12 U.S.C. § 1813(l).

¹³⁰ We estimate general claims as the sum of "Trading Liabilities," "Other borrowed liabilities" and "Other Liabilities" less "FHLB Advances".

¹³¹ As discussed in Part IV, subordinated debt is more common at the holding company level. About eighty percent of U.S. banks and almost all banks with assets of at least 1 billion dollars are owned by holding companies. See Study Group on Subordinated Notes and Debentures, *Staff Study 172: Using Subordinated Debt as an Instrument of Market Discipline* 26 (Table 4) (Federal Reserve System, December 1999). About ten percent of these holding companies issue subordinated debt with the issuers

and is literally non-existent in failed banks with less than \$500 million in assets. The pattern is consistent with the issuance of subordinated debt by U.S. commercial banks generally. In the 1990s the percent of banks issuing subordinated debt declined for banks of all sizes except for very largest banks.¹³² Subordinated debt was present on the balance sheets of almost all of the largest banks in 1998.¹³³ This trend continues. Only nine percent of banks sampled between 1996 and 2005 issued any subordinated debt, and nearly two-thirds of these banks were large banks with assets exceeding 1 billion dollars.¹³⁴ Thus, subordinated debt is as relatively rare in healthy banks as it is in failed banks.¹³⁵ The liability structure of healthy banks is similar in these respects to that of failed banks.¹³⁶ Failed banks in all asset size categories show little debt owed to general creditors and almost no subordinated debt.

Secured claims are senior to the FDIC, and some domestic deposits are secured by the bank's securities or mortgages.¹³⁷ Federal Home Loan Bank advances are the most important type of secured liability for many banks.¹³⁸ These advances must be at least fully collateralized

concentrated among the very largest holding companies. See *id.* at 26 (Table 4). The percentage of bank holding companies issuing such debt has declined for every size bank holding company other than large companies (although the amounts have increased). *Id.* In any case, our story is about the capital structure of the bank, not the bank holding company. The FDIC resolves failed banks through receivership; bank holding companies file for bankruptcy.

¹³² *See Id.*

¹³³ *Id.*

¹³⁴ See A. Sinan Cebenoyan & Fatma Cebenoyan, Subordinated Debt, Uninsured Deposits, and Market Discipline: Evidence from U.S. Bank Holding Companies 1, 17 (Hunter College, July 2007).

¹³⁵ See Douglas D. Evanoff & Larry D. Wall, *Subordinated Debt and Bank Capital Reform* 13, 39, Fed. Res. Bank of Chicago (WP 2000-07, 2000).

¹³⁶ *Id.*

¹³⁷ State statutes often require deposits by state and political subdivisions to be collateralized. See *supra* note 118. A random sample of failed banks by asset size reveals that these "preferred deposits" range between 0 and 3 percent of a bank's deposit liabilities. Such collateralization therefore represent a relatively unimportant sort of security interest.

¹³⁸ Telephone conversation with Timothy Critchfield, Division of Insurance and Research, Federal Deposit Insurance Corporation.

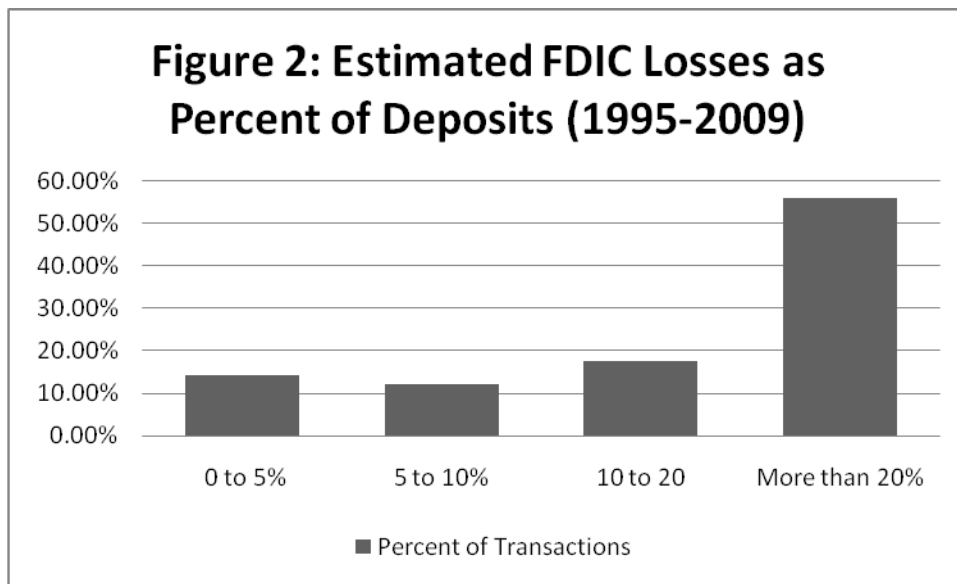
by securities.¹³⁹ Although many failed banks have not taken such advances, Federal Home Loan Bank advances are significant liabilities for banks which have taken them. Table 1 shows that Federal Home Loan liabilities rise with bank size from about 1.4 percent for the smallest banks to almost ten percent for banks between one and five billion and over twenty-six percent for banks over five billion. We note that the importance of FHLB loans may be due in part to the real estate boom of the first decade of the twenty-first century. In sum, Table 1 shows that failed banks other than mega-banks have a comparatively simple liability structure. As banks near failure, most of their liabilities are domestic deposits, and the overwhelming majority of failed banks have no significant foreign deposits, general unsecured claims or subordinated debt. A few banks do have some Federal Home Loan Bank advances or other secured debt, but these secured claims rarely account for more than twenty-five percent of all liabilities. Some banks do have significant amounts of uninsured deposits (at least at the time of the last call report before failure), and these depositors will have a claim on the assets separate from the FDIC. However, the FDIC will share proceeds on a pari-passu basis with these creditors, and so they can generally trust the FDIC to maximize recovery as long as the FDIC is appropriately compensated for its expenses and is trying to minimize the loss to the insurance fund.

2. FDIC Losses on Failure

Section B.1 demonstrates that insured deposits account for the overwhelming majority of the liabilities of insolvent banks. It also demonstrates that most of the remaining liabilities will be senior to the FDIC's claim on the failed firm's assets (FHLB loans) or will share in the proceeds on a pari-passu basis (uninsured deposits). The senior secured liabilities should not disturb the FDIC's status as residual claimant because they are *always* paid in full; there has

¹³⁹ See 12 U.S.C. § 1430(a)(3). Federal funds and repurchase agreements are also important type of secured liabilities.

never been a default on an FHLB loan.¹⁴⁰ The uninsured deposits should not disturb the FDIC's status as residual claimant because most uninsured deposits will flee as the bank nears insolvency and the remaining will share in the proceeds on a pari-passu basis. The presence of a large amount of claims junior to the FDIC could distort the FDIC's incentives, but these claims (foreign deposits, general unsecured claims and subordinated debt) are practically non-existent in nearly all bank failures. Moreover, these claims rarely receive any payment. Of the fifty-one receiverships begun between 1995 and 2008 for which the FDIC reports the percentage distribution to general claimants, general claimants have received nothing in forty-nine.¹⁴¹



Even if the FDIC were the sole creditor of the bank, it still would not be the residual creditor if the value of the assets exceeded the value of the bank's liabilities. In theory, a bank with a solvent balance sheet could fail if its regulator mistakenly declared the bank insolvent

¹⁴⁰ See Mark J. Flannery & W. Scott Frame, *The Federal Home Loan Bank System: The "Other" Housing GSE*, 91 FED. RES. BANK OF ATLANTA, ECON. REV., 33, 39 (2006).

¹⁴¹ General claimants received twenty-eight percent of their claims in the failure of Net First National Bank and one hundred percent of their claim in the failure of Dollar Savings Bank. The distribution to general creditors is only available for receiverships that are incomplete. It is therefore possible that general creditors could receive distributions in more of these receiverships.

and seized it or if a liquidity shock rendered the bank unable to meet short term obligations and unable to issue new shares to raise new funds. In practice, however, a failed bank's assets almost never exceed its liabilities: the FDIC almost always loses significant amounts of money. As long as the FDIC is losing money, it has the proper incentive to maximize the amount recovered as the FDIC will receive each additional dollar raised.¹⁴² Figure 2 shows the frequency with which FDIC losses (expressed as a percentage of deposits)¹⁴³ fall into various categories. Note that the FDIC's loss rate is typically very high – more than half (56%) of bank failures resulted in FDIC losses exceeding twenty-percent of total deposits. The loss rate is less than five percent in just fourteen percent of transactions.

The FDIC's status as a residual claimant justifies its control over the resolution process. We do not claim that Congress gave the FDIC control over the resolution process because the FDIC is the residual claimant on most failed banks' assets. This historical claim is false. Instead, the FDIC's status as a residual claimant in control of bank resolutions likely was an unintended consequence of Congress' grant of liquidation powers to the FDIC. Congress created a federal receiver with powers to liquidate failed banks and gave the FDIC these powers. Federal deposit insurance, along with the right of subrogation to insured depositors, in turn made the FDIC the residual claimant in most banks being liquidated. But Congress did not give the

¹⁴² Strictly, the FDIC has an incentive to maximize amounts recovered when its distribution of amounts recovered exceeds the cost to it of the recovery. The FDIC's distribution is limited because the amounts recovered must be shared with uninsured domestic depositors; see 12 U.S.C. § 1821(d)(11)(A)(ii). Because it incurs costs in recovering assets, the FDIC's incentive therefore is to maximize net returns to it, not total returns. The qualification usually is unimportant. There are relatively few uninsured depositors of failed banks. See *supra* Table 1. Applicable rules give priority to the expenses the FDIC incurs in disposing of assets over depositor claims. As a result, it retains the incentive to maximize the value of the assets.

¹⁴³ The literature often presents FDIC losses as a percentage of bank assets. We choose instead to present them as a percentage of deposits because the FDIC does not insure the bank's assets directly. Thus, losses divided by deposits (or insured deposits) give a more accurate sense of the rate of loss. We use deposits instead of insured deposits because it is hard to estimate insured deposits reliably

FDIC liquidation powers because it was the residual claimant. The drafting history of the legislation creating the FDIC and federal deposit insurance supports this conclusion.

The Banking Act of 1933 established both the FDIC and deposit insurance. The year before the Act was enacted, Senator Carter Glass, one of its architects, introduced in the Senate Banking and Currency Committee a proposed banking bill. The bill created a “Federal Liquidating Corporation.”¹⁴⁴ Carter’s bill gave the Corporation the power to liquidate failed banks by purchasing their assets for the purpose of speeding up payments to depositors.¹⁴⁵ The corporation in turn would sell the assets and remit the sale proceeds to the bank’s receiver. The receiver in turn would distribute them to depositors. As proposed, the liquidation corporation would control the failed bank’s assets; depositors would be repaid from the sum the corporation received for the assets. Carter’s bill did not propose to insure deposits. Depositors therefore would retain the risk of the bank’s failure. They suffered loss for amounts above their proportionate share of the failed bank’s assets. The federal liquidating corporation’s role simply was to quicken receipt of available distributions to depositors. Because the corporation did not insure deposits, it had no claim (derivative or original) on the failed bank’s assets.

Carter’s bill failed over objections principally to the capitalization of the proposed liquidating corporation.¹⁴⁶ However, it became the template the Roosevelt administration and

¹⁴⁴ See U.S. Senate, Banking and Currency Committee, 71st Cong., section 10 (1932), reproduced in *Federal Reserve Board’s Comments and Recommendations on the Glass Bill (S. 4115)*, 18 Fed. Res. Bull. 211 (1932); cf. Draft of S.3315, section 9, Carter Glass Papers, Alderman Library, Special Collections, University of Virginia, Box 284;.

¹⁴⁵ See Rixey Smith & Norman Beasley, *CARTER GLASS: A BIOGRAPHY* 305-6 (1st ed. 1937); H. Parker Willis & John M. Chapman, *THE BANKING SITUATION* 65-66 (1934).

¹⁴⁶ See Walker F. Todd, *The Federal Reserve Board Before Marriner Eccles (1931-1934)*, Cleveland Federal Reserve Bank 1, 31-33 (Working Paper 9405, 1994); 18 Fed. Res. Bull. 211-225 (1932) (evaluations of Federal Reserve Board and Federal Advisory Council).

Congress used in drafting the Banking Act of 1933.¹⁴⁷ This meant that the Banking Act in its initial draft form gave the power to liquidate failed national banks to a single resolution authority. Prior law gave the Comptroller of the Currency the authority to appoint a receiver for failed national banks. By 1932 most states had given their bank superintendents the same powers.¹⁴⁸ The 1933 Act created a resolution authority with the power to liquidate assets of member banks of the Federal Reserve. This gave it powers lacking in a few states and enabled the accumulation of expertise in liquidation through more concentrated control of the resolution process. More significant was the status of the receiver in the Act's initial draft form.¹⁴⁹ Because Carter's bill did not provide for deposit insurance, the receivership authority under the Act also would have no interest in the assets of banks it was liquidating. This changed in the bill Carter reintroduced in Congress.¹⁵⁰ As part of the compromise needed to pass the Banking Act, the Act created federal deposit insurance and the FDIC established federal deposit insurance. It also gave to the FDIC the power already described in the Act to a liquidating corporation to dispose of assets of any failed FDIC-member bank.¹⁵¹ The Banking Act required the FDIC to pay off insured depositors by creating a temporary national bank, to which insured deposits were

¹⁴⁷ See HELEN M. BURNS, *THE AMERICAN BANKING COMMUNITY AND NEW DEAL BANKING REFORMS: 1933-1935* 80 (1974). Roosevelt found Carter's proposed Federal Liquidating Corporation attractive. Although Roosevelt initially wanted the Corporation to resolve failed banks by recapitalizing them, he apparently agreed that the Corporation's role in resolution should be limited to liquidation. H. Parker Willis, who helped Glass produce the 1932 bill, reported to Glass his meeting with Roosevelt: "I explained to him the liquidating provision of the Glass bill and contrasted it with those of the bill proposed by the Comptroller of the Currency and he said that he preferred greatly the Glass provisions because they eliminated the costly, long-drawn receiverships, to which he said he had always felt a strong opposition." Letter of H. Parker Willis to Carter Glass, Nov. 19, 1932, Carter Glass Papers, Alderman Library, Special Collections, University of Virginia, Box 274.

¹⁴⁸ See Cyril B. Upham & Edwin Lamke, *Closed and Distressed Banks* 35-38 (1934).

¹⁴⁹ See 77 Cong. Rec. 196 (1933); S.245, 73rd Cong. § 7 (1933).

¹⁵⁰ See 77 Cong. Rec. 3109 (1933) (bank bill "reintroduced," as it contains "very major modifications to the bank bill introduced previously"); S.163, 73rd Cong. § 7 (1933).

¹⁵¹ See Public Law 73-66, 48 Statutes at Large 174 (1933).

transferred.¹⁵² Subrogated to the rights of insured depositors, the FDIC now had an interest in the assets it was liquidating. In the draft bill that developed into the Banking Act, the receivership authority was defined first. Only later was the FDIC created and given that authority. There is no evidence that the FDIC was given the authority because it had an interest in the assets it would be liquidating.

III. Limits of the Case for FDIC Control

Part II argues that the FDIC is likely the residual claim in nearly all bank failures. It concludes that the FDIC therefore should have the control of the resolution process bank insolvency law currently gives it. Part II's case for FDIC control depends on at least four assumptions that might not always hold. One assumption is that the capital structure of the failed banks is not a direct result of the fact that the FDIC controls the resolution of failed banks. However, the resolution process should, in theory affect the capital structure firms adopt.¹⁵³ If, for example, investors expect the FDIC to exercise its resolution powers in a way that harms subordinated debt or general claims (perhaps selling the bank's assets too quickly and too cheaply), investors will be reluctant to purchase this debt and the firm will rely more heavily on deposits or equity financing. Because a firm's capital structure is endogenous, we cannot claim that the current resolution system is truly optimal because we cannot directly assess the alternatives. We claim only that our current resolution system appears well-suited to the capital structure that firms have, in fact, chosen.

A second assumption is the absence of agency costs within the FDIC. If the interests of the FDIC and its employees diverge systematically, the FDIC's control of the resolution process

¹⁵² *See id.* at 173-174.

¹⁵³ This is a standard application of the Modigliani-Miller Irrelevance Theorem. See Franco Modigliani & Merton H. Miller, *The Cost of Capital, Corporation Finance and the Theory of Investment*. 48 AM. ECON. REV. 261 (1958).

does not guarantee resolutions that maximize asset values. The third assumption concerns liability structure. If the liability structure of a bank differs from that of the vast majority of failed banks, the FDIC might not be the residual claimant of the bank. A fourth assumption concerns the need for control of the resolution process. Control is needed only if a distressed bank cannot feasibly recapitalize itself in advance, either through debt contracts or mandatory rules that alter the bank's capital structure on failure. If the bank can recapitalize itself, resolution of the bank's distress does not require the sale of its assets to a healthy bank or other action. In this case the FDIC's role can be limited to closing the bank. This Part describes these assumptions and the impact on the case for FDIC control when they do not hold. It concludes that FDIC control is justified in the overwhelming majority of bank failures. However, we reserve judgment as to whether the FDIC should control the resolutions of the very largest failed banks.

A. Agency Costs in Bank Resolutions

Section II claims that the FDIC is the residual claimant and thus would maximize social value if it followed the law's command that it exercise its authority in a way that results in the least cost to the deposit insurance fund.¹⁵⁴ However, the FDIC does not (and cannot) actually exercise any authority. Its employees must act on its behalf, and these employees will have interests that diverge from those of the primary stakeholders in the FDIC - the member banks and the taxpayers. The employees' interests likely include a desire for income, leisure and career

¹⁵⁴ See 12 U.S.C. § 1823 (c)(4)(A). "Public interest" here is understood broadly. The deposit insurance fund is funded by assessment against participating banks, not by tax revenues. However, bank resolutions that minimize costs to the deposit insurance fund make it unlikely that tax revenues will be used to subsidize failed banks. More generally, resolving failed banks maintains the integrity of the banking system. Both matters are concerns of "public interest."

advancement, in some combination.¹⁵⁵ Because FDIC employees' salaries are fixed, the outcome of a bank resolution has no effect on their income. It might also not affect any of their other interests. Accordingly, FDIC employees might act to serve their interests even at the expense of the FDIC's interest in resolving a failed bank. The divergence of the FDIC and its employees' interests creates agency costs.¹⁵⁶ Agency costs may prevent the FDIC's employees from making decisions that minimize the cost to the insurance fund and maximize social welfare. They might, for example, engage in too little marketing efforts and thereby sell the assets for less than they are worth. Alternatively, they might incur excessive costs in managing the disposition of assets.

Intra-organizational agency costs are not unique to the FDIC; large private organizations face these same costs. We might, however, expect private organizations to be better able to control these agency costs. The FDIC may be less able to design its employment contracts to align its employees' interests with its own,¹⁵⁷ and the FDIC may be subject to political pressure¹⁵⁸ or lobbying efforts on behalf of special interest groups. A number of scholars who have examined banking regulation prior to insolvency suggest that agency costs have resulted in lax supervision of the soundness of banks or thrifts.¹⁵⁹ As a remedy, they propose reforms that would shift more risk to the private sector and thereby induce private sector actors to monitor the

¹⁵⁵ Cf. Arnoud W.A. Boot & Anian V. Thakor, *Self-Interested Bank Regulation*, 83 AMER. ECON. REV. 208 (1993) (model assumes that bank regulators maximize a combination of good supervisory reputation and social welfare).

¹⁵⁶ Agency costs are the sum of monitoring and bonding costs, and residual loss to the FDIC when its employees act on its behalf. Cf. Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

¹⁵⁷ See Christopher James, *The Losses Realized in Bank Failures*, 46 J. FIN. 1223, 1224 (1991).

¹⁵⁸ See, e.g. Edward J. Kane, *Principal-Agent Problems in S&L Salvage*, 45 J. FIN. 755 (1990).

¹⁵⁹ See Edward J. Kane, *The Incentive Incompatibility of Government-Sponsored Deposit-Insurance Funds*, in THE REFORM OF FEDERAL DEPOSIT INSURANCE 144 (J.R. Barth & R.D. Brumbaugh, Jr. eds. 1992); THE S&L INSURANCE MESS: HOW DID IT HAPPEN? (1989); Asli Demirguc-Kunt, *Deposit-Insurance Failures: A Review of the Empirical Literature*, 25 ECON. REV. 2 (1989).

debtor or provide more accurate measures of risk.¹⁶⁰ These arguments presume that the private organizations that assume this risk would be better able to solve the agency problems and therefore better able to monitor the debtor. If private sector actors are better able to monitor a bank's activity before insolvency, they may be better able to dispose of a bank's assets after it becomes insolvent. If public regulators are better monitors than dispersed creditors holding limited debt, they may have an advantage at disposing of these assets. We do not engage the debate over the relative merits of public versus private decision-making.¹⁶¹

The presence of agency costs does not doom the argument for FDIC control. Most significantly, the arguments take the existing capital structure of banks as given. The structure is one in which insured deposits predominate, some secured debt, and seldom much subordinated or general debt. Given this structure, it is hard to find other actors with better incentives, even if the FDIC's incentives are imperfect. Insured depositors have no incentive to see that the sale of the bank's assets gets top dollar: their deposits are protected however the assets are liquidated. As noted above, the senior claimants (FHLB loans and other secured loans) and junior claimants (general creditors, subordinated debt holders and equity holders) obviously do not have the right incentives, as the former are always paid in full and the latter will almost always receive nothing. One could grant some decision-making power to the few uninsured depositors who have failed to get out before failure and perhaps have a judge adjudicate disputes among them. However, this supervision imposes its own costs.

Decisions about the timing and terms of asset dispositions are complex. They require discretion, whether the decision maker is the FDIC or another authority. Oversight of these

¹⁶⁰ See generally Claudio Borio et al., *Market Discipline Across Countries and Industries* (2004); Mark J. Flannery, *The Face of "Market Discipline,"* 20 J. FIN. SERV. RES. 107 (2001).

¹⁶¹ See Mathias Dewatripont, *THE PRUDENTIAL REGULATION OF BANKS* 29-45 (1994).

decisions can eliminate some self-interested choices by the FDIC's employees, but perhaps at the expense of depositors' interests. After all, the depositors cannot effectively dispose of the assets themselves. For this reason, over a range of decisions there is a tradeoff between the authority to decide how to dispose of assets and agency costs. At the margin the optimal amount of agency costs in resolution therefore is positive. Courts and commentators in other contexts reach a similar conclusion. In corporate governance the business judgment rule protects the board of directors from liability for corporate decisions not infected by illegality or conflict of interest. The rule prevents a court from vetting a board's decision even when the decision harmed shareholders' interests. By limiting judicial oversight, the rule enables directors sometimes to act carelessly. The rule's policy justification is that the quality of directorial decisions in the range of cases is worth the price.¹⁶² The justification implicitly recognizes that defensible legal rules can create or allow agency costs. The observation applies equally to the FDIC's decisions about asset dispositions the resolution process. Thus, the FDIC's control of the resolution process is not suspect simply because it creates agency costs in asset dispositions.

Although we lack direct measures of these agency costs, the literature offers some related evidence. A study by Christopher James shows that (1) the FDIC's losses tend to increase with the percentage of the bank's assets that it retains, and (2) the direct costs of bank insolvencies average around ten percent of assets, far higher than the averages found in other studies of bankruptcy reorganizations.¹⁶³ Neither result clearly establishes the presence of substantial

¹⁶² See, e.g., Stephen B. Bainbridge, *The Business Judgment Rule as Abstention Doctrine*, 57 VAND. L. REV. 83, 109 (2004).

¹⁶³ See Christopher James, *The Losses Realized in Bank Failures*, 46 J. FIN. 1223 (1991) (1985-86 loss 9.9%); FDIC 1991 Annual Report (8.3 %). For estimates of resolution costs incurred by the Resolution Trust Corporation in disposing of failed savings and loan banks between 1989 and 1995, see *Evolution of the RTC's Resolution Practices*, in THE FDIC AND RTC EXPERIENCE: MANAGING THE CRISIS 1980-1994 113, 138-39 (1998). Other estimates which count opportunity costs and declining asset values due to

agency costs. The first result is consistent with the FDIC not being as adept as private banks at selling or managing bank assets. It is also, however, consistent with the possibility that acquirers are more willing to purchase low-risk assets or performing loans due to adverse selection. James tries to distinguish between these theories and finds no evidence that acquirers are less likely to purchase risky assets, though he does not disprove this theory either. The second result is harder to interpret because it is unclear if one should expect similar direct bankruptcy costs in bankruptcy and bank insolvency. When calculating direct costs of bankruptcy reorganizations scholars typically include the cost of hiring attorneys and business consultants but do not include the salaries of the managers of the firm. By contrast, once the initial purchase and assumption transaction is complete, the failed bank has no management left, and the FDIC must incur the full costs of managing the estate. In addition, some assets may simply be more expensive to administer than others.

Further evidence of the FDIC's performance comes from studies of the return to holding the stocks of banks that acquire failed banks. If the FDIC does a poor job of auctioning the failed firm and routinely offers too good of a deal to acquirers, the share price of publicly traded acquirers should rise on the announcement of the P&A agreement. Of course, the acquirers stock may rise as long as the assets (or customer base) of the failed bank are somewhat unique so that potential buyers assign different valuations and the acquirer captures some of the gains from

regulatory forbearance as resolution costs are higher; William P. Osterberg & James J. Thomson, *Underlying Determinants of Closed-Bank Resolution Costs*, in THE CAUSES AND COSTS OF DEPOSITORY INSTITUTION FAILURES 75 (A.F. Cottrell et al. eds. 1995) (21%). By comparison, the direct costs of traditional Chapter 11 reorganizations are much lower. Estimates of median direct costs vary between 1.4 percent and 1.69 percent of prebankruptcy assets; see Arturo Bris et al., *The Costs of Bankruptcy: Chapter 7 Versus Chapter 11 Reorganization*, 61 J. FIN. 1253 (2006) (1.69%); Lynn M LoPucki & Joseph W. Doherty, *The Determinants of Professional Fees in Large Bankruptcy Reorganization Cases*, 1 J. EMP. LEGAL STUD. 111 (2004) (1.4%); Brian L. Betker, *The Administrative Costs of Debt Restructurings: Some Recent Evidence*, 26 FIN. MANAG. 56 (1996) (3.37%); Lawrence A. Weiss, *Bankruptcy Resolution*, 27 J. FIN. ECON. 285 (1990) (2.5%).

trade. However, a very substantial rise in price would provide some cause for concern. The literature does not, however, conclusively show that the FDIC is selling failed banks for far less than they are worth. Some early studies do find abnormal returns to acquiring banks¹⁶⁴ while others do not.¹⁶⁵ Part of the divergence in findings may be due to changes in the process of resolving failed banks; many of the studies finding no abnormal return focus on thrifts resolved through public option. Unfortunately, no study looks at transactions since the least cost resolution standard was adopted in 1992. We will remedy this omission in a related paper.

B. The Liability Structure of Large Banks

Section 2 shows that the overwhelming majority of failed banks have a similar liability structure. The majority of their debts are deposits, most of which are insured. They also have no or very little foreign deposits, general unsecured debt or subordinated debt. Some banks do have secured liabilities, but these liabilities are always paid in full. This makes the FDIC the likely residual claimant in nearly all bank failures. However, a properly designed bank insolvency law must take into account the likely residual claimant on most of the assets of failed banks. It must consider the size of assets of failed banks, not just the frequency with which banks fail. Showing that the FDIC is the residual claimant in ninety-nine percent of bank failures means little if the remaining one percent of banks own almost all the assets of failed banks. Asset size matters

¹⁶⁴ See Sheldon G. Balbirer, *et al*, *Regulation, Competition and Abnormal Returns in the Market for Failed Thrifts*, 31 J. FIN. ECON. 107 (1992) ; Rebel A. Cole *et al*, *Asymmetric Information and Principal-Agent Problems as Sources of Value in FSLIC-Assisted Acquisitions of Troubled Thrifts*, 8 J. FIN. SERV. RES. (1994); William J. Bertin *et al.*, *Failed Bank Acquisitions and Successful Bidders' Returns*, 18 FIN.L MANAG. 93 (1989); Christopher James & Peggy Weir, *An Analysis of FDIC Failed Bank Auctions*, 20 J. MON. ECON. 141(1987).

¹⁶⁵ See Thomas F. Gosnell, *et al*, *The Acquisition of Failing Thrifts: Returns to Acquirers*, 97 FIN.L MANAG. (1993) (finding no abnormal returns); R. H. Pettway & J. W. Thrifts, *Do Banks Overbid When Acquiring Failed Banks*, FIN. MANAG. 5 (1985) (finding negative abnormal returns); Paul M. Horvitz & Insup Lee, *Abnormal Returns in Post-FIRREA Acquisitions of Failed Thrifts*, 8 FIN. SERV. RES. 269 (1994)

because the liability structure of the very largest banks differs from that of banks with fewer assets.

In the United States, banking assets are, in fact, concentrated in the largest banks. This remains true whether one examines banks generally or failed banks in particular. In 2008 about 1.4 percent of insured financial institutions (commercial and savings and loan banks) had assets greater than \$10 billion. These “mega-banks” owned about 78 percent of all assets of insured financial institutions,¹⁶⁶ and the asset share of mega-banks has increased consistently over time.¹⁶⁷ Measured by their assets, mega-banks also predominate in bank failures. Insured bank institutions with assets greater than \$10 billion account for about three percent of the banks that have failed since 1995. However, these banks held 87 percent of the assets of banks in failure since that date.

The capital structures of most banks with assets greater than five or ten billion dollars do, in fact, look like those of most other banks. Since 1995 the FDIC has resolved five banks with real assets greater than \$5 billion (adjusted for inflation). The four smallest of these had deposits that ranged between 64 percent and 82 percent of liabilities and insured deposits that ranged between 76 and 91 percent of total deposits; none of these four banks had any foreign deposits.¹⁶⁸ Secured loans (FHLB plus repurchase agreements) accounted for most of the remaining liabilities; these loans ranged from 18 to 35 percent of total liabilities. None of these

¹⁶⁶ See <http://www.census.gov/compendia/statab/>

¹⁶⁷ See Kenneth D. Jones & Tim Critchfield, *Consolidation in the U.S. Banking Industry: Is the ‘Long, Strange Trip’ About to End?*, 17 FDIC BANKING REV. 31, 35 (2005).

¹⁶⁸ In the aggregate, banks with more than \$10 billion in assets do have significant foreign deposits. Deposits in foreign offices account for about one-quarter of all deposits at these banks. See FDIC Statistics on Depository Institutions Report (National banks), March 31, 2009. However, these foreign deposits are concentrated in the very largest banks. For example, over sixty-eight percent of Citigroup’s deposits are deposits in foreign offices.

four banks had appreciable amounts of subordinated debt or general claims; the sum of these two categories ranged from 0.9% to 1.9% of total liabilities.

However, the fifth bank, Washington Mutual, had a capital structure that was appreciably different than the rest, and Washington Mutual was far larger than all of the other banks put together. In fact, Washington Mutual Bank, alone accounts for more than sixty percent of the assets of the failed banks in our sample.¹⁶⁹ Washington Mutual had significant debts that were junior to the claims of the FDIC. Washington Mutual's subordinated debt accounted for 2.8 percent and its general claims 9.9 percent of liabilities.¹⁷⁰ It is dangerous to draw conclusions from a sample of one, but seemingly healthy banks of similar size also have significant claims that are junior to the FDIC. For example, Wells Fargo has subordinated debt that accounts for 3.2 percent of its liabilities and general claims that account for about 11.6 percent. Other banks have significant debt that is junior to the FDIC in the form of foreign deposits. Foreign deposits represent about 13 percent of Bank of America's liabilities and 68 percent of Citigroup's liabilities.¹⁷¹

The presence of significant debt junior to the FDIC's claim makes it less likely that the FDIC would be the residual claimant should insolvency necessitate a resolution. The least-cost resolution standard requires the FDIC ordinarily to resolve a failed bank in a way that imposes

¹⁶⁹ See *supra* note 25. Large non-bank firms represent a fraction of Chapter 11 bankruptcies. In 2008 less than one percent of all bankruptcy cases were initiated by Chapter 11 filings, and only about three one thousands of a percent (0.0003) were filed by large public corporations.

<http://www.uscourts.gov/bnkrptstatistics.htm#calendar>. According to Lynn Lopucki, of the 1,117,771 bankruptcy filings in 2008, there were 39 large public bankruptcies among 10,160 Chapter 11 filings; <http://lopucki.law.ucla.edu/study.results.asn>.

¹⁷⁰ These figures are taken from Washington Mutual's final Thrift Supervision report filed before it closed. In the 10 weeks before closing, depositors withdrew about 9 percent of deposits made by the bank, and this would have changed its liability structure. See Robin Sidel et al., *WaMu is Seized, Sold Off to J.P. Morgan, In Largest Failure in U.S. Banking History*, Wall Street Journal, September 26, 2008, page A1.

¹⁷¹ See 2009 Call Reports for Bank of America and Citigroup.

the least cost on the insurance fund.¹⁷² The FDIC is not explicitly required to do so in a way that maximizes the return to the junior claims as well. Subrogated to the rights of insured depositors, the FDIC therefore has the incentive only to receive an amount equal to the insured depositors' claims. For this reason, the FDIC's control over the resolution process in large bank failures is unlikely to maximize the value of the failed bank's assets.

Washington Mutual Bank's resolution illustrates this concern. At its closing, the bank's assets had a book value of \$307 billion. The FDIC transferred most of the assets to J.P. Morgan Chase Bank as part of a purchase and assumption transaction. In return J.P. Morgan paid \$1.9 billion and acquired certain of Washington Mutual's contracts, and all of its deposits and liability to general creditors. J.P. Morgan did not assume Washington Mutual's subordinated debt or equity.¹⁷³ Subordinated debt and equity will receive nothing while the depositors and general creditors will be paid in full by J.P. Morgan. Because J.P. Morgan acquired all of Washington Mutual's deposits, there was no loss to the FDIC. If J.P. Morgan's paid top dollar for Washington Mutual's assets, subordinated debt has no complaint. It has a complaint if another bidder would have paid more: a higher bid price might have allowed distributions to subordinated debt. Because J.P. Morgan's bid resulted in no loss to the insurance fund, the FDIC had no incentive to seek or accept a higher-valued bid. Washington Mutual's holding company, the holder of subordinated debt, has sued the FDIC, presumably on the theory that the liquidation value of Washington Mutual's assets is sufficiently higher than the sum J.P. Morgan

¹⁷² See supra note 83 and accompanying text.

¹⁷³ See Purchase and Assumption Agreement Between the Federal Deposit Insurance Corporation and J.P. Morgan Chase Bank, September 25, 2008, Article 2.1, Schedule 2.1 (pp. 8, 34), <http://www.fdic.gov/about/freedom/Washington-Mutual>.

paid to partly or wholly satisfy its claims.¹⁷⁴ Its suit might fail on the merits. However, Washington Mutual’s liability structure does not justify a presumption in favor of the FDIC: Because the FDIC is not the residual claimant, its control of the resolution process cannot be assumed to maximize asset values.

The particular liability structure of large banks does not necessarily undermine the case for FDIC control of the bank resolution process. This exception applies only to the very largest banks, and these failures are very rare – these are the firms that are “too big to fail.” The FDIC is the residual claimant in almost all bank failures. At most, the liability structure of large banks justifies special resolution rules for infrequent large bank failures. Broadly, two different sorts of rules are possible. One is the creation of a separate resolution procedure for large banks that removes the FDIC from control in large bank resolutions and gives control over resolution decisions to the residual claimant. This arguably requires overly complex and administratively infeasible rules. Accurately valuing a failed bank’s assets at the beginning of the resolution process is difficult enough. Determining its liability structure to establish the amount of junior debt necessary to identify the residual claimant at that point is at least as hard. A less extreme alternative is to constrain FDIC control of the resolution decision in large bank failures. There is some precedent for doing so. The Bankruptcy Code includes separate provisions for small business debtors in Chapter 11 by way of separate reporting requirements and deadlines.¹⁷⁵ Their underlying rationale apparently is that small businesses seeking to be reorganized differ enough from larger businesses to be warrant some special rules. In large bank insolvencies, special rules might better align the interests of the FDIC and residual claimants without

¹⁷⁴ See *Washington Mutual Inc. v. Federal Deposit Insurance Corp.*, 09-533, U.S. District Court, District of Columbia.

¹⁷⁵ See, e.g., 11 U.S.C. §§ 101(51D), 308(b), 586(a)(7), 1121(c), 1125(f).

removing the FDIC from control over the resolution process. These could include enhanced bid procedures, input by junior debt, or increase the potential liability of the FDIC to junior debt in connection with the disposal of assets.¹⁷⁶ Our point is not to advocate such rules. It is simply to note that they do not undermine the case for FDIC control of the resolution process even in large bank failures.

We close by noting that any ex post inefficiency caused by the FDIC's control of an insolvent mega-bank may enhance ex ante efficiency if it increases the losses suffered by shareholders and junior creditors. Today many reasonably argue that the prospect of government bailouts creates a moral hazard for investors in the largest banks because they can reasonably believe that the government may determine that the bank is too big to fail. If the government does allow the largest firms to fail with some probability, it can counter this moral hazard by increasing the losses suffered by investors when failure actually does occur. We do not, however, argue that the current structure is optimal, as it is unlikely that the ex post inefficiency is anywhere near large enough to counter the effect of the moral hazard.

C. Self-Financed Restructuring: Debt Conversion

The earliest bankruptcy systems resolved failed firms by selling their assets in the market and distributing the proceeds to their creditors.¹⁷⁷ This is still the predominant method used today; most bankrupt firms are liquidated in Chapter 7.¹⁷⁸ The FDIC's favored resolution method, a purchase and assumption, in effect is a liquidation coupled with the assumption of

¹⁷⁶ Recent legislative proposals move in the opposite direction. As we discuss in the next section, these proposals would place the FDIC in charge of resolving large bank holding companies even when it has no claim on the assets of these firms.

¹⁷⁷ See, e.g., Bankruptcy Act of 1800, § 7, Ch. 18, 2 Stat. 19, 23; Bankruptcy Act of 1841, § 4, Ch. 9, 5 Stat. 440, 442-443.

¹⁷⁸ In the twelve months ended June 30, 2009 there were 37,337 business filings in Chapter 7 and 12,863 business filings in Chapter 11. See <http://www.uscourts.gov/bkrpctystats/statistics.htm#june>

some of the failed bank's liabilities by another firm. By contrast, a traditional Chapter 11 reorganization can resolve a failed firm without an actual sale of its assets. The assets are instead effectively transferred among the existing claimants in a hypothetical sale. Junior claims are cancelled if the assets are insufficient to pay the more senior claimants in full, and some of the remaining debt is typically converted into equity to return the firm to solvency. The value of the firm's assets is determined by the agreement of the parties in a consensual reorganization or by the bankruptcy judge in a cramdown.

A number of scholars have proposed mechanisms that convert a troubled bank's capital structure without a sale of its assets.¹⁷⁹ Like Chapter 11, debt is converted into equity in the reverse order of priority, from the lowest to highest priority liabilities. These proposals are intended to be unlike Chapter 11 in that the conversion occurs "automatically".

¹⁷⁹ A number of proposals for debt conversion have been made, with some differences among them; see, e.g., Heather Landy, *Experts: No Pain Means No Gain*, *American Banker*, July 6, 2009, page 1; Luigi Zingales, *Yes We Can*, *Secretary Geithner*, 6 THE ECONOMIST'S VOICE 1 (February 2009), *Plan B*, October 8, 2008, <http://faculty.chicago.booth.edu>; Squam Lake Working Group on Financial Regulation, *An Expedited Resolution Mechanism for Distressed Financial Firms: Regulatory Hybrid Securities* (Council on Foreign Relations Working Paper, April 2009); David G. Mayes, et al., *The Proposed Approach to Bank Insolvency Legislation*, in WHO PAY FOR BANK INSOLVENCY? 331 (D.G. Mayes & A. Liuksila eds. 2004); Mark J. Flannery, *No Pain, No Gain? Effecting Market Discipline via "Reverse Convertible Debentures,"* in CAPITAL ADEQUACY BEYOND BASIL: BANKING, SECURITIES, AND INSURANCE 171 (Hal S. Scott ed. 2005); Augustin Landier & Kenichi Edua, *The Economics of Bank Restructuring: Understanding the Options* 1, 12-13 (International Monetary Fund, June 4, 2009). For earlier proposals that apply to all firms, not just banks, see Barry E. Adler, *Financial and Political Theories of American Corporate Bankruptcy*, 45 Stan. L. Rev. 311, 324-25 (1993); Note, *Distress-Contingent Convertible Bonds: A Proposed Solution to the Excess Debt Problem*, 104 Harv. L. Rev. 1857, 1869-77 (1991). Many of the proposals call for debt conversion by contract; the description in the text provides for mandatory conversion under the prescribed conditions.

For instance, assume that banks must meet a required minimum capital ratio of 8%.

Suppose a bank that has issued 10 shares of common stock becomes insolvent as the value of its assets fall from \$1,000 to just \$800. Before resolution, its balance sheet reveals:¹⁸⁰

Assets	Liabilities
\$800	\$870 Deposits
	\$50 General claims
	(\$120) Equity (10 shares)

The bank's assets are sufficient to satisfy only \$800 of the \$920 in outstanding claims against it. Thus, to return to solvency, the 10 shares and \$120 in debt must be cancelled. To meet the minimum capital requirements an additional \$64 of debt must be converted into equity. Because general claims have lower priority than deposits, the general claims totaling \$50 are extinguished. Similarly, \$70 of the deposits must be extinguished and \$64 of the deposits must be converted into equity,¹⁸¹ leaving \$736 in deposit liabilities. This does not deprive insured depositors of access to the insured balances in their deposit accounts. Insured depositors are reimbursed by the FDIC from the bank insurance fund in the amount of their insured deposits. Their interests therefore are unaffected by the conversion of their debt into equity.¹⁸² The FDIC in turn is subrogated to the rights of depositors it reimburses, to the extent of the

¹⁸⁰ The example is based loosely on Mark J. Flannery, *No Pain, No Gain? Effecting Market Discipline via "Reverse Convertible Debentures,"* in CAPITAL ADEQUACY BEYOND BASEL: BANKING, SECURITIES, AND INSURANCE 171, 178 (H.S. Scott ed. 2005) but is used for different purposes.

¹⁸¹ The mechanism need not formally cancel any debt that is equal in priority to the residual claim. If, for example, the mechanism "converted" \$13.40 in deposits to equity and cancelled no deposits, the market would quickly cancel \$7 by revealing that the equity is worth just \$6.40.

¹⁸² Zingales' proposed debt conversion scheme for systemically important banks exempts individual depositor liability; see Zingales *supra* note 179, at 5. Because conversion does not affect the liquidity of insured individual deposits, the exemption is unnecessary.

reimbursement.¹⁸³ Applicable priority rules give insured and uninsured depositors equal priority in a bank resolution.¹⁸⁴ Thus, the FDIC and the bank's uninsured depositors (if any) are issued shares in proportion to their share of the \$64 in deposits converted to equity. The FDIC can sell its shares, as it can sell almost any asset in a bank's resolution.

Automatic debt conversion purports to have three advantages: it reduces the risk that taxpayers will be asked to recapitalize failed institutions, it is fast and it does not result in substantial administrative costs for the FDIC.¹⁸⁵ However, even a truly automatic debt conversion mechanism would likely fail to accomplish any of these goals unless the capital structures of existing banks are changed so that there are sufficient claims junior to the FDIC to ensure that the FDIC's claims are neither extinguished nor converted into equity. If the process grants the FDIC most of the shares of the bank, it will have to sell them. Financial constraints force it to do so. The costs of such sales might equal or exceed the costs the FDIC currently incurs in selling the assets of failed bank.

To see this, note that a debt exchange in almost every past bank failure would have left the FDIC as the majority shareholder. This is because almost all failed banks have no or little debt subordinate to deposits and little uninsured deposits at the time of failure.¹⁸⁶ At the same

¹⁸³ See 12 U.S.C. § 1821(g).

¹⁸⁴ See 12 U.S.C. § 1821(d)(11)(A)(ii).

¹⁸⁵ Estimates of the direct costs to the FDIC, although imprecise, are as high as 21 percent of asset values; see note supra 165.. By comparison, the direct costs of traditional Chapter 11 reorganizations are much lower. Estimates of median direct costs vary between 1.4 percent and 1.69 percent of prebankruptcy assets; see Arturo Bris et al., *The Costs of Bankruptcy: Chapter 7 versus Chapter 11 Reorganization*, 61 J. FIN. 1253 (2006) (1.69%); Lynn M LoPucki & Joseph W. Doherty, *The Determinants of Professional Fees in Large Bankruptcy Reorganization Cases*, 1 J. EMP. LEGAL STUD. 111 (2004) (1.4%); Brian L. Betker, *The Administrative Costs of Debt Restructurings: Some Recent Evidence*, 26 FIN. MANAG. 56 (1996) (3.37%); Lawrence A. Weiss, *Bankruptcy Resolution*, 27 J. FIN. ECON. 285 (1990) (2.5%).

¹⁸⁶ Required increases in the amount of unsecured claims or subordinated debt would increase the amount of debt junior to deposit liabilities that could be converted into equity. Alternatively, required increases in the amount of equity would avoid the risk of insolvency altogether. The relative merits of these proposed

time, insured deposits are the major liabilities of most banks.¹⁸⁷ Because the FDIC is subrogated to the claims of insured depositors, it ultimately shares loss with uninsured depositors when a bank fails. The consistent pattern of FDIC loss shows that depositors lose money in most bank failures.¹⁸⁸ Thus, a debt exchange will give depositors equity in the typical failed bank. The FDIC will receive the largest share of equity, because insured deposits represent most deposit liabilities of typical failed banks. However, the FDIC is unlike holders of swapped debt in non-bank firms. Creditors in non-bank firms whose debt has been converted to equity might want to retain it. The conversion can give them a control premium in the firm stock. Alternatively, the equity can give a creditor a strategic advantage in the relevant industry. More generally, financial constraints do not generally restrict their ability to hold firm stock. The FDIC is different. It cannot retain large equity positions that come from debt conversions of failed banks. To avoid exhausting the balance of the deposit insurance fund, the FDIC must sell bank assets, and FDIC policy requires as much.¹⁸⁹ For the same reason, it would have to sell its equity in failed banks obtained under a debt conversion scheme. Thus, debt conversion schemes do not

requirements are beyond the scope of this paper. For assessments of the proposals, see Douglas D. Evanoff & Larry D. Wall, *Subordinated Debt and Bank Capital Reform*, Fed. Res. Bank of Chicago (WP 2000-07, August 2000); Study Group on Subordinated Notes and Debentures, *Staff Study 172: Using Subordinated Debt as an Instrument of Market Discipline*, Fed. Res. Sys. (December 1999).

¹⁸⁷ See *supra* II.B.1

¹⁸⁸ See *supra* II.B.2.

¹⁸⁹ See *supra* note 13 (FDIC Asset Disposition Manual suggested timelines for sales). The Federal Deposit Insurance Act requires the balance of deposit insurance fund to satisfy a statutorily mandated minimum “designated reserve ratio”: the ratio of the balance of the deposit insurance fund to insured deposits. See 12 U.S.C. § 1817(b)(3). Paying losses to insured deposits reduces the balance in the fund, thereby also reducing the effective reserve ratio. The designated reserve ratio therefore limits the amount available to the FDIC to pay insured depositors. By increasing the fund balance, the FDIC in principle can pay insured deposits while staying within the designated reserve ratio. The fund balance can be increased by either increasing assessments against member banks, special assessments, or borrowing from the Treasury. See 12 U.S.C. § 1817(b)(5); 12 U.S.C. § 1824(a). Political resistance makes these options infeasible on an ongoing basis. In practice the balance in the deposit insurance fund is fixed. Thus, to maintain the designated reserve ratio, the FDIC generally must sell bank assets in order to pay insured deposits.

avoid the cost of asset sales in the case of failed banks. They merely postpone those costs so that they are incurred later, outside of the formal resolution process. Again, a plausible accounting must count these costs as resolution costs. These costs might equal the administrative costs the FDIC currently incurs in disposing of failed bank assets.

Automatic debt conversion would increase the speed and reduce the cost of the final resolution only if the FDIC could more easily dispose of the stock of a failed bank than it could dispose of the assets of a failed bank through a receivership. We see little reason why this would be true. Shares of the firm are just a claim against all of the assets of that firm. Acquirers of failed banks have demonstrated that they do not want to buy the troubled assets of the failed bank: most purchase less than one quarter of the failed bank's assets.¹⁹⁰ True, acquirers may be more willing to purchase shares than troubled assets because of the option inherent in a highly leveraged firm. The acquirer would risk only the amount that they paid for the equity. Any further decline in the value of the assets of the firm would be borne by the holders of the debt (mainly the FDIC). However, the FDIC can, and does, effectively replicate this structure in some current transactions. The FDIC frequently sells all or substantially all of the assets of the failed bank to the bank that assumes the deposits. In these sales the FDIC simultaneously assumes some of the risk of a decline in the value of these assets through a loss sharing agreement.¹⁹¹ A quick sale of substantially all of the failed bank's assets certainly increases the speed of resolution and reduces the FDIC's administrative costs. On the other hand, a quick sale may not yield the highest price for the firm's assets.

¹⁹⁰ See *supra* notes 81, and accompanying text.

¹⁹¹ *Id.*

As noted in Section III.B, the capital structure of the very largest banks differ markedly from those of nearly all banks that have actually failed, and it is more plausible that an automatic debt conversion mechanism would not leave the FDIC as the dominant shareholder. Because this Article uses data from banks that have actually failed, it has little to say about the very largest banks. Only one truly “mega-bank” has failed in the last fifteen years. However, we question whether an “automatic” conversion mechanism would really be so automatic and costless. There are less and more serious problems of design. The less serious problem is the authority to trigger the conversion of debt to equity and cancellation of existing equity. Stakeholders do not have complete information about the value of the assets and therefore are likely to have different opinions about the bank’s assets values. They therefore are unlikely to all agree on the need for recapitalization. The bank’s balance sheet cannot be used as a reliable basis of information, because it computes assets and equity at book value. Book values tend to lag behind the market value of assets at troubled banks.¹⁹² Because stakeholders are unlikely to trigger the debt conversion, the FDIC (or some other entity) must have the authority to trigger it. A plausible and observable trigger is the FDIC’s seizure of a bank. This authority does not give the FDIC control in resolving the bank: its seizure of the bank simply triggers the conversion of debt to equity. The FDIC’s role is limited to initiating the process by which debt is restructured automatically.

The more serious problem is the design of the financial trigger the FDIC is to use to initiate the resolution process. Debt is to be converted to equity when the bank is economically insolvent: when all claims due against the bank cannot be satisfied from its earnings. The conversion mechanism requires some estimate of the market value of the firm’s assets.

¹⁹² See Joe Peek & Eric S. Rosengren, *The Use of Capital Ratios to Trigger Intervention in Problem Banks: Too Little, Too Late*, NEW ENGLAND ECON. REV.49, 51 (Sept/Oct. 1996).

However, these estimates are sometimes difficult to gauge, indeterminate, and manipulable. Loans are important assets of banks, and nonstandard terms in commercial or installment loans and unobservable risk characteristics of borrowers make many loans difficult to value when not traded in active markets. Something similar might be true of securitized assets on a bank's books. Market value in both cases is hard to determine. Financial triggers based on share price cannot be used at all for banks in which equity is privately held. Although the market price of traded shares can be used, variance in daily trading prices can be random. Averaging traded prices over a longer period avoids this trouble but brings another: strategic manipulation of share prices. For instance, debt holders expecting FDIC intervention might short shares of the bank in an effort to drive the price down. A lower share price allows them more shares if their debt is converted to equity.¹⁹³ Although this manipulation is unlikely to be successful with large banks whose stock is actively traded, it might work with smaller banks whose shares are less actively traded. A financial trigger geared to share value also might entice management to try to lower share price by bringing FDIC intervention, for the purpose of having conversion result in more shares issued.

These problems in design do not in advance make a debt conversion scheme unworkable. However, they make implementing it infeasible for bank resolutions. Methods of estimating the bank's value that use market mechanisms likely cannot be applied. They rely on time and liquidity that may not be available in the case of many failed banks. Take Bebchuk's proposal to give stakeholders an option to purchase senior claims for their face amount.¹⁹⁴ Assume that

¹⁹³ See Flannery, *supra* note 180, at 186; Squam Lake Working Group on Financial Regulation, *supra* note 179, at 4.

¹⁹⁴ See Lucian Arye Bebchuk, *A New Approach to Corporate Reorganizations*, 101 HARV. L. REV. 775 (1988).

the bank has two creditors, each with \$100 claims having equal priority. Suppose the market price of the bank is \$200. Debt conversion cancels the shareholder's stock and transforms the creditors' \$200 claims to equity. Under Bebchuck's proposal, the shareholders are entitled to regain their stock for the face amount of claims. If shareholders believe that the bank is worth more than \$200, they will repurchase their stock. If they believe the bank is worth less than \$200, they will not. In this way the repurchase option avoids the need to rely on market price in converting debt to equity.

Bebchuck's proposal requires liquidity and time that often is missing in bank failures.¹⁹⁵ The proposal sets a stipulated short period in which stakeholders can exercise their options. In the case of failed banks, this period must be very short. Otherwise, uncertainty about the bank's capital structure risks disrupting its operations. To exercise their options within the period, stakeholders need funds quickly. This usually is not a problem where the price of exercising their options is small relative to their wealth. But liquidity is a problem when the required exercise price is proportionately large even for institutional shareholders. Stakeholders with large illiquid holdings can borrow funds in amounts needed to exercise their options. However, the ability to borrow quickly is not guaranteed. A lender will not make an unsecured loan for \$200 if the market price of the shares in a bank is less than \$200. Although it might lend \$200 on a secured basis, the lender needs time to value collateral and obtain the required security interest. The time needed can exceed the period in which the stakeholder can exercise its option. Because the stipulated period must be very short in bank failures, liquidity problems likely

¹⁹⁵ We note that if capital markets are highly liquid, a liquidation of the bank would yield the same benefits as Bebchuck's proposal, as stakeholders could bid to buy the firm as a going concern. At most his proposal might produce lower administrative costs than liquidation.

prevent stakeholders from exercising their purchase options.¹⁹⁶ In these cases the market price of the bank effectively is final: it determines the division of value among the bank's stakeholders according to their priority. By comparison, the pricing mechanism used in FDIC-led bank resolutions works quickly. The FDIC solicits bids prior to closing the bank; the winning bid usually determines the value of the bank.

IV. Bank Holding Companies

So far this paper has focused on the control of the resolution of failed banks. We turn now to the holding companies that own the stock of these banks. Most banks are affiliates of bank holding companies.¹⁹⁷ While their bank subsidiaries are resolved by the FDIC, the bank holding companies and their non-bank subsidiaries can, and do, file for protection under the Bankruptcy Code.¹⁹⁸ Part II argued that the FDIC should control the disposition of a failed bank's assets because it is the residual claimant on those assets. This Part asks whether this justification supports proposals to alter the resolution procedure for certain bank holding companies. We conclude that it does not.

A bill recently introduced in Congress proposes to change this allocation of resolution authority for the largest bank holding companies. The "Resolution Authority for Large, Interconnected Financial Companies Act of 2009" ("the Resolution Act") subjects bank holding companies and their non-bank and broker dealer subsidiaries to a special resolution procedure if

¹⁹⁶ See Zingales, *Plan "B,"* supra note 179, at 5 (ten days). Aghion et al.'s proposed alternative to a Chapter 11 reorganization also gives stakeholders purchase options on equity; Philippe Aghion, Oliver Hart & John Moore, *The Economics of Bankruptcy Reform*, 8 J. L. ECON. & ORG. 523, 540 n.40 (1992). Their stipulated period of one month in which these options are exercisable enhances the ability of stakeholders to obtain needed funds. However, a month is far longer than the time in which bank failures plausibly must be resolved.

¹⁹⁷ See supra note 27, and accompanying text.

¹⁹⁸ Some of their non-bank subsidiaries may also be ineligible for bankruptcy protection. For example, insurance companies cannot file for bankruptcy. See 11 U.S.C. § 109(b)(2).

their activities present a risk of “serious adverse effects on the financial stability or economic conditions of the United States.”¹⁹⁹ Although undefined, these effects presumably include systemic risk to the U.S. financial market created by default. The procedure is triggered by a voting among designated authorities according to a voting rule adapted from the FDIC voting rule required for a finding of systemic risk.²⁰⁰ Once triggered, the Secretary of Treasury may appoint either the Securities and Exchange Commission or the FDIC to resolve the bank holding company and covered affiliates.²⁰¹ The Secretary must appoint the FDIC when the company’s broker or dealers are not the predominant subsidiary.²⁰² Initiation of the Resolution Act’s resolution procedure displaces the Bankruptcy Code and ends an ongoing bankruptcy case of the holding company or its covered subsidiaries.²⁰³ Under the Resolution Act, the appointed resolution authority must dispose of assets in a manner which inter alia “minimizes the potential for serious adverse effects” on U.S. financial markets and economy.²⁰⁴

The Resolution Act’s special resolution procedure gives the FDIC the authority to provide direct assistance to these systematically important bank holding companies.²⁰⁵ The assistance comes from a fund established for this purpose and supplied by assessments on certain bank holding companies.²⁰⁶ Commentators debate whether failing bank holding companies

¹⁹⁹ See Resolution Act sec. 1202(b)(2). Other proposals give the FDIC similar authority to resolve failed bank holding companies. See Sheila C. Bair, Statement: FDIC on Systemic Regulation, Prudential Measures, Resolution Authority and Securitization before the Financial Services Committee, United States House of Representatives, October 29, 2009.

www.fdic.gov/news/speeches/chairman/spoct2090.html.

²⁰⁰ See 12 U.S.C. § 1823(c)(G).

²⁰¹ See Resolution Act, sec. 1204(b); 1202(1)(A).

²⁰² See *id.*, sec. 1204(b).

²⁰³ See *id.*, sec 1207.

²⁰⁴ See *id.*, sec 1209(a)(10)(E)(iv).

²⁰⁵ See *id.*, sec. 1204(a).

²⁰⁶ See *id.* secs. 1204(a), 1209(n)(1).

should receive government assistance.²⁰⁷ One point of dispute is systemic risk. Systemic risk, although often invoked, is hard to define and arguably regulate effectively. The failure of financial institutions can produce significant loss in financial institutions or nonfinancial markets. However, the distinction between cascading losses resulting from a bank holding company's failure and large macroeconomic effects produced by its failure is elusive. Significantly, the Resolution Act employs but does not define the operative notion of systemic risk.²⁰⁸ Another dispute is over the consequences of financial assistance. Assistance may dampen the effects of financial breakdowns and thus avert major losses to the real economy. On the other hand, assistance represents a cross-subsidy from contributing holding companies which do not create systemic risk. The cross-subsidy makes financial institutions more willing to engage in risky behavior and may make financial breakdowns more likely.

This paper takes no position on systemic risk or how effectively the Resolution Act regulates it.²⁰⁹ It focuses instead on control of the resolution process itself. To begin, notice that FDIC-provided financial assistance does not by itself require or justify FDIC control over a bank holding company's resolution. Such assistance gives the FDIC a claim against the bank holding company in its resolution. But this says nothing about whether the FDIC must or should

²⁰⁷ See, e.g., Ken Ayotte & David A. Skeel, Jr., *Bankruptcy or Bailouts*, (Working Paper, 2009), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1362639.

²⁰⁸ See Resolution Act, sec. 1203(2)(A), (b). For description of different notions of systemic risk, see George G. Kaufman & Kenneth E. Scott, *What is Systemic Risk, and Do Bank Regulators Retard or Contribute to It?*, 7 INDEPENDENT REV. 371, 372-375 (2003).

²⁰⁹ We also do not address two subsidiary questions. If the government should provide assistance, we must then decide which government agency should provide the assistance and how the necessary money should be raised. In the recent crisis treasury provided money to bank holding companies pursuant to the Troubled Asset Relief Program. See TARP Capital Purchase Program Summary of Senior Preferred Terms Sheet, <http://www.Treas.gov/press/releases/reports/termsheet.pdf>. Some of the motivation for the Resolution Act is a desire to shift the funding of this assistance from general tax revenue to a special fund administered by the FDIC and raised by assessments on large bank holding companies. This shift may make direct government assistance more politically palatable by blunting populist anger over the use of taxpayer dollars to rescue large banks. This shift may also have desirable tax incidence implications, though we know of no study that has conducted the necessary analysis.

control the company's resolution process. For example, the federal government provided substantial loans and other assistance to General Motors both before and after it filed for bankruptcy and thus had a claim on General Motors' assets.²¹⁰ Although the government may have played a major role in the General Motors bankruptcy, the other claimants were at least entitled to notice and a hearing before General Motors sold most of its assets.²¹¹ Similarly, if the Treasury or Federal Reserve²¹² provides assistance to a bank holding company it will have a claim against the company. Under present law, in the holding company's bankruptcy, the government shares control with all other claimants against the holding company's estate. It does not completely control the holding company's resolution. In short, current law adopts a rule of "claim without total control." Of course, a change in law could give the FDIC or other government agency total control over the resolution process, even if it had no claim against the holding company. "Total control without a claim" has a historical precedent. A predecessor bill to the 1933 Bank Act proposed a federal agency to dispose of failed banks.²¹³ The proposal was based on perceived inefficiencies in state bank receiverships. Similarly, inefficiencies in the Bankruptcy Code might justify a government controlled receivership process for bank holding companies. Our point is simply that a claim against a holding company does not by itself require or justify control of the company's resolution.

The residual claimant principle defended in Part II does not justify the FDIC's control of the resolution of bank holding companies. The FDIC could have a significant claim against the failed bank holding company, either because it provided direct assistance to the holding

²¹⁰ See *supra* note 51, and accompanying text.

²¹¹ *Id.*

²¹² See 12 U.S.C. § 343 (limited authority of Federal Reserve Bank to lend to nonbanks).

²¹³ See text *supra* notes 144-145, and accompanying text.

company²¹⁴ or if the bank holding company issued a source-of-strength guarantee in connection with a previous capital restoration plan.²¹⁵ However, we doubt that this claim would often make the FDIC the residual claimant of systematically important failed bank holding company. The Resolution Act gives the FDIC priority over general claims and subordinated debt²¹⁶ just as current law grants the FDIC priority over the general claims and subordinated debt of banks.²¹⁷ Unlike most banks, however, the largest bank holding companies have substantial amounts of general claims and subordinated debt.²¹⁸ Thus, the FDIC would be the residual claimant only if

²¹⁴ The Resolution Act permits the FDIC to fund companies being resolved within it from a fund established for this purpose. See Resolution Act, secs. 1204(a), 1209(n)(1).

²¹⁵ See 12 U.S.C. § 1831o(e)(2)(E) (FDIC approval of capital restoration plan requires controlling company to guarantee the lesser of 5 percent of undercapitalized bank’s assets or the amount needed to adequately capitalize bank). The Federal Reserve Board has its own broader source-of-strength authority; see 12 C.F.R. § 225.4(a)(1). While exercise of that authority can give the Board a claim against the parent, it does not give the FDIC a claim.

²¹⁶ See Resolution Act, sec. 1209(b)(1); cf. Statement of Sheila C. Bair, Establishing a Framework for Systemic Risk Regulation, Before Comm. On Banking, Housing and Urban Affairs, United States House of Representatives, July 23, 2009, at 7.

²¹⁷ See 12 U.S.C. § 1821(d)(A)(ii); 12 U.S.C. § 1813(l)(5) (“deposit”).

²¹⁸ Most of the assets of the five largest U.S. bank holding companies are in the form of stock or debt held in their bank and non-bank subsidiaries, as following chart shows.

Holding Company: March 31, 2009 Unconsolidated Balance Sheet (Selected Items)

	J.P. Morgan	Citigroup	Bank of America	Wells Fargo	Goldman Sachs
Total Assets	444.5	361.5	446.8	257.5	293
Stock in Subs	184.2 (41.4%)	192.6 (53.2%)	241.3 (54%)	133.1 (51.6%)	66.4 (22.6%)
Loans to Subs	148.6 (33.4%)	134.1 (37%)	53.2 (11.9%)	78.2 (30.3%)	177.5
(60.5%)					
Total Liabilities	274.3	217.5	207.3	157.2	229.1
Short Term Debt					
Commercial Paper	28.5 (10.3%)	0 (0%)	9.1 (4.3%)	5.3 (3.3%)	34.6
(15.1%)					
Other	25.3 (9.2%)	10.2 (4.6%)	13.0 (6.2%)	22.3 (14.1%)	155.3
(67.7%)					
Long Term Debt					
Subordinated Debt	27.6 (10%)	26.5 (12.1%)	29.5 (14.2%)	13.4 (8.5%)	5.3 (2.3%)
Other Debt	144.5 (52.6%)	127.6 (58.6%)	114.3 (55.1%)	79.5 (50.5%)	17.6
(7.6%)					
Other Liabilities	6.1 (2.2%)	7.7 (3.5%)	7.9 (3.8%)	5.6 (3.5%)	16.1 (7%)

Amounts in billions

Source: <http://www.ffec.gov/nicpubweb/nicweb>

the value of the bank holding company's assets fell by an amount sufficient to extinguish this debt. This is unlikely. At a minimum, ongoing regulatory supervision of bank holding companies are likely to make such significant declines in assets values infrequent in the range of cases. In fact, the FDIC is also unlikely to be the residual claimant when the very largest banks fail. These mega-banks are the subsidiaries of the systematically important bank holding companies. As a result, the residual claimant principle suggests that the FDIC should have less control over the failure of large banks and their parent corporations, not more.²¹⁹

Proponents of the reforms might argue that the FDIC's relative lack of a financial interest makes it an impartial agent, much like a bankruptcy trustee in Chapter 7 or a state receiver.²²⁰ A crucial difference, however, is that bankruptcy and state receivership law subjects the trustee or receiver's control to judicial oversight and grants interested parties the right to be heard. The FDIC is not subject to similar oversight.²²¹ Judicial scrutiny helps mitigate the risk that the agent will slacken her efforts or serve her own interest. On the other hand, this oversight delays resolution and may increase administrative costs. It is at least theoretically possible that the benefits provided by speed would outweigh the costs of a loss of judicial oversight.

In Section II we rejected speed and secrecy as a justification for the FDIC's control of bank resolutions, and we are skeptical about its use to justify FDIC control of very large bank holding companies. The first reason we rejected speed and secrecy in the bank context does not apply to bank holding companies. Bank resolutions promptly reimburse insured depositors; they do not promptly dispose of the failed bank's assets. Bank holding companies and their affiliates

²¹⁹ This is subject to the same caveats that we expressed above. For example, the assignment of control to the FDIC might still be efficient even if it is not the residual claimant if this gives subordinated claims an incentive to ensure that the firm does not become insolvent and the FDIC does not seize control.

²²⁰ This assumes that the FDIC has no stake in the failed firm or that there is sufficient debt junior to the FDIC to insulate the FDIC from loss.

²²¹ See *supra* note 98, and accompanying text.

do not take in deposits. However, they do have short-terms obligations that make that may make them vulnerable if their counter-parties get nervous and try to quickly withdraw their funds. A prompt resolution could perhaps ease counter-party fears if it could somehow solve the liquidity crisis by quickly disposing of the assets and reimbursing creditors.

The FDIC's experience in quickly resolving failed banks is not encouraging. It gives no reason to believe that the FDIC would resolve a bank holding company much more quickly than would bankruptcy, unless the FDIC were willing to provide substantial assistance that shifts much of the risk of loss to the FDIC itself. Recall that in most bank failures the FDIC retains at least seventy-five percent of the failed bank's assets after the initial assignment and assumption²²² and liquidates them over a period of about four years.²²³ By contrast, bankruptcy courts required a little less than one and half years, on average, to dispose of the filings of large publicly traded corporations between 1995 and 2008.²²⁴ It is reasonable to expect an even slower pace in disposing of assets at the holding company level that affiliate banks do not typically maintain. Granted, the FDIC sometimes sells all or substantially all of the assets of the failed bank immediately upon seizing the failed bank. These resolutions are marginally quicker than the fasted bankruptcies resolved by use of section 363. However, in conducting these immediate sales the FDIC usually agrees to bear much of the risk of a fall in the value of these assets through a loss-sharing agreement.²²⁵ It is the FDIC's willingness to retain troubled assets or assume the risk of a decline in their value that provides liquidity and prevents the assets from being sold at "fire sale" prices. In a bank failure the FDIC's willingness to assume this risk is

²²² See *supra* notes 81 and accompanying text.

²²³ See *supra* notes 13, and accompanying text.

²²⁴ We used Lynn Lopucki's Bankruptcy Research Database to calculate this figure. See http://lopucki.law.ucla.edu/study_results.asp

²²⁵ See *supra* notes 81 and accompanying text.

unobjectionable; the FDIC already accepts this risk when it insures the major liability of the bank – the domestic deposits. The FDIC has not, however, guaranteed the short-term obligations of bank holding companies. Although bank failures cannot be directly compared to bankruptcy filings, the burden of proof is on the proponents of change in the resolution of bank holding companies.

V. Conclusion

It is not obvious why the FDIC should have the central role it has in resolving failed banks. The bankruptcy law of most other countries does not give bank regulators this role. Two arguments sometimes are given to justify the FDIC's control over the bank resolution process: speed in asset disposal and the FDIC's status as the largest creditor of the failed bank. The argument from speed wrongly conflates the quickness with which assets are disposed with the quickness with which deposits can convert their deposits into cash. Speed in disposing of assets has nothing to do with preserving the liquidity of deposits. This Article, however, takes seriously the FDIC's status as the largest creditor of the typical failed bank and the implications of this status. Data suggest that the likely asset values of most failed banks makes the FDIC is the residual claimant on those assets. It therefore has the proper incentives to act to maximize these asset values. Other stakeholders in those assets do not the same incentives. This is distinctive of most bank insolvencies, and justifies giving the FDIC control of the resolution process. Things could be different and sometimes are. The capital structures of mega-banks often differ from those of the typical failed bank. Bank holding companies too exhibit more complicated capital structures, with significant general and subordinated debt. With large banks the allocation of control to the FDIC is presumptively unjustified. Non-regulatory claimants likely are the residual claimants on the assets of bank holding companies. In both

cases the residual claimant principle allocates control to claimants other than the FDIC or other regulator.