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The Risks of Fractured Resolution – Financial Institutions and Bankruptcy

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THE RISKS OF FRACTURED RESOLUTION – FINANCIAL INSTITUTIONS AND BANKRUPTCY

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Introduction

Consistent with the general theme of the deregulatory era, the past decades have seen a growing divide between banking and bankruptcy.² The divide is consistent with the theme of deregulation, because encouraging the divide advanced the “specialness” of banking and financial institutions, and enabled their exception from the normal rules of corporate law and corporate failure. That is, finance became excused from bankruptcy.

The divide had long existed, fostered by the unique nature of a class of debtors that has large group of government insured creditors, but the past decades saw the banking community move away from the bankruptcy system, and chapter 11 in particular, with a vigor nearing revulsion.³ The only way bankers would be involved in bankruptcy was as creditors. Bear Stearns seems to confirm the special place that bankers held in the order, inasmuch as Bear Stearns and its stakeholders were not subjected to the same fate as mundane insolvent companies.

And then Lehman. Bankers faced the cold reality that the growth of “shadow banking” had moved banking out of the comfortable realm of the OCC, the FDIC and

¹ Daniel J. Moore Professor of Law, Seton Hall University School of Law. This paper was written for the 2011 Adolf A. Berle, Jr. Symposium on Corporations, Law and Society at Seattle University School of Law, and I appreciate the comments I received at the symposium, as well as the many helpful comments I received at the 2011 Seton Hall Faculty Scholarship Retreat.

² I conceive of this era as extending from at least the passage of the Staggers Act in 1980, which deregulated the railroads, through 2010, which saw both the passage of health care regulation and the passage of the recent financial reform legislation in 2010. I do not intend any pejoration by the term. For example, the deregulation of the railroads was arguably a good thing, given their financial condition under regulation. Although I trace the real growth of the divide to the deregulatory era, I agree with David Skeel that the roots of the division trace back to at least the 1930s, and the decision to exclude Wall Street from most corporate restructurings. David A. Skeel, Jr., *Bankruptcy Boundary Games*, 4 Brook. J. Corp. Fin & Comm. Law 1, 1 (2009).

³ Stephen J. Lubben, *Systemic Risk & Chapter 11*, 82 Temp. L. Rev. 433 (2009); cf. David Hahn, *The Financial Crisis of 2009 - Have Reorganization Proceedings in Emerging Markets Gone Bankrupt? Israel as a Case Study*, 12 U. Pa. J. Bus. L. 731, 760 (2010).

the Federal Reserve.⁴ The government rescue of AIG can be seen as a desperate attempt to regain control.⁵ The subsequent treatment of Citibank and Merrill Lynch, contrasted with the treatment of Lehman, reaffirms this interpretation.

The Dodd-Frank Act formalizes this attempt to restore the old order.⁶ All large bank holding companies, which now includes former investment banks such as Goldman Sachs, and many other important institutions, with more than 85% of their activities in “finance,”⁷ will be subject to a new resolution regime controlled by the FDIC and initiated by the Treasury Secretary and the Federal Reserve.

But by developing a new system for addressing financial distress, instead of integrating the new system into the existing structure of the Bankruptcy Code, the financial reform act simply recreates the prior problem in a new place. The future Lehmans and AIGs will be covered by the new procedure, but other firms that have 84% of their activities in finance will not. In short, the disconnect between bankruptcy and banking has moved to a different group of firms. And we may have done nothing but protect ourselves against an exact repeat of the financial crisis.⁸

This change will reduce the overall risks to the financial system to the extent that the size of Lehman, AIG, Bear Sterns, and others was the key problem in the recent financial crisis. But if instead the problem was the interconnected nature of these firms, the difference between 84 and 85% is unimportant. And in focusing on the biggest of the big, the recent financial reform bill has left behind the banking industry’s detritus in the bankruptcy system.⁹ For example, derivatives will now get special treatment in bankruptcy only in those cases where it is least needed to protect the banking industry.¹⁰

⁴ Cf. Arthur E. Wilmarth, Jr., *The Dark Side of Universal Banking: Financial Conglomerates and the Origins of the Subprime Financial Crisis*, 41 Conn. L. Rev. 963 (2009).

⁵ Press Release, U.S. Dep’t of Treasury, U.S. Treasury and Federal Reserve Board Announce Participation in AIG Restructuring Plan (Mar. 2, 2009), available at <http://www.ustreas.gov/press/releases/tg44.htm>.

⁶ The Dodd-Frank Wall Street Reform and Consumer Protection Act, H.R. 4173, 111th Cong. (2010).

⁷ A company is “predominantly engaged in financial activities” if (1) the annual gross revenues of the company and all of its subsidiaries from activities that are financial in nature (as defined in section 4(k) of the Bank Holding Company Act) represent 85 percent or more of the company’s consolidated annual gross revenues or (2) the consolidated assets of the company and all of its subsidiaries related to activities that are financial in nature (as defined in section 4(k) of the Bank Holding Company Act) represent 85 percent or more of the company’s consolidated assets.

⁸ Charles K. Whitehead, *Reframing Financial Regulation*, 90 B.U.L. Rev. 1 (2010) (discussing the reactive nature of most financial regulation).

⁹ <http://dealbook.blogs.nytimes.com/2010/11/02/derivatives-still-special-after-overhaul/>

¹⁰ Under Dodd-Frank, banks will have to spin-off (into their broker-dealer affiliates) their trading in equity swaps, commodity swaps, energy swaps, CDS on non-investment grade reference entities, and uncleared CDS on investment grade

Expecting that the financial reform bill is not the last piece of legislation in this area, I explore the divide between banking or finance and bankruptcy.¹¹ As with any other industry, bankruptcy is of limited import to the financial industry in normal times, save for its role in general debtor-creditor law. But even here bankruptcy rules are a vital part of every financing contract, operating to make claims consistent across similarly situated creditors and discouraging runs on the assets of the firm.

In times of general financial stress, the content of these rules and their strength becomes ever more vital. And if the rules are unclear or their application uncertain, the risk to the financial system becomes acute. This is especially true in the financial industry, where the horizontal connections between firms go far beyond those found in any other industry.

I use this paper to argue that there are significant gaps in the federal system for resolving financial distress in a financial firm, even after passage of the Dodd-Frank bill. These gaps represent potential sources of systemic risk – that is, risk to the financial system as a whole. They must be fixed.

But I should make clear at the outset that I do not argue that these gaps must be filled with the Bankruptcy Code.¹² Rather, the point is that the various systems for resolving financial distress among financial firms – including the FDIC bank resolution process, the new resolution authority, state insurance resolution proceedings, and the SIPC process for broker-dealers, as well as chapter 11 of the Code – must be integrated so that the result of financial distress is clear and predictable. Integrating all under the Bankruptcy Code is an option, but not the only way to achieve such clarity.

The first part of this paper sketches the several existing systems for resolving financial distress in financial firms, including the new resolution authority created by the Dodd-Frank bill. By my count, there are at least six systems at work here, not counting state-by-state variations. In Part II, I examine the coverage of these systems, and the uncertainty created by the interaction of the same. For example, under current law, a large hedge fund would be “resolved” under chapter 11 of the Bankruptcy Code – unless the newly created systemic risk counsel, a body

reference entities. Dodd-Frank Act §716. These disfavored contracts will continue to be subject to special treatment in the bankruptcy, including the bankruptcy cases of non-financial firms, where the justifications for special treatment are implausible. Stephen J. Lubben, *Derivatives and Bankruptcy: The Flawed Case for Special Treatment*, 12 U. Pa. J. Bus. L. 61 (2009). Moreover, many of these disfavored derivatives are the types of contracts that can be used to give “normal” supply contracts special treatment under the Code. In re MBS Management Services, Inc., 2010 WL 2639822 (Bankr. E.D.La.).

¹¹ This expectation finds support in the myriad studies of bankruptcy and financial institutions that are mandated under the Dodd-Frank Act.

<http://www.creditslips.org/creditslips/2010/07/the-code-and-the-new-financial-reform-act.html>

¹² Samuel L. Bufford, *Increasing Scope of Bankruptcy Code*, 4 Am. Bankr. Inst. L. Rev. 500, 500 (1996).

dominated by people from outside the restructuring community, decides otherwise. This leaves it unclear to the fund's counterparties which set of rules is incorporated into their contracts with the hedge fund. Undoubtedly both will be priced, with a further discount for the uncertainty. That is unlikely to be the optimal solution.

Part III of the paper then considers the ways in which the divide between finance and bankruptcy could be narrowed, if not eliminated. Ultimately I doubt the plausibility of solving these issues with some grand solution, like drafting a unified bankruptcy law. The political realities involved in getting a major piece of legislation through Congress are so daunting nowadays that it is something of a wonder that even Dodd-Frank, with all its limitations, was passed. A unified system of financial distress, which would implicate both state and federal interests, seems almost more unlikely. Given this reality, I suggest incremental ways to move the myriad existing system together. These suggestions exploit the new Financial Stability Oversight Counsel's power to recommend changes in regulation to fill gaps left by the Dodd-Frank Act.¹³

It is important throughout to maintain a realistic approach: blind regulation will more often than not simply encourage new innovation, often in ways that are apt to be even more inefficient or less transparent, or both. But only by overcoming the divide between banking and bankruptcy will the systemic risks presented by the existing patchwork be ameliorated. Ultimately this is a matter that will require coordination between the alienated worlds of banking and bankruptcy.

¹³ Dodd-Frank Act § 120.

I. Resolution Regimes

Historically, the United States has taken an inconsistent approach to the division between banking and bankruptcy. For example, the 1841 Bankruptcy Act applied to bankers and those who underwrote insurance policies.¹⁴ But while the statute initially included banks -- the entity as opposed to the individual -- and all other corporations among those who could file bankruptcy, the provision was removed, allegedly on "State's rights" grounds, before the Act received final approval.¹⁵ The 1867 Bankruptcy Act split the difference -- federally chartered banks could not file under the Act, while state-chartered banks and insurance companies could and did.¹⁶

By the time of the first permanent American bankruptcy law, in 1898, it was widely accepted that banks and insurance companies were sufficiently different from other companies that they should be excluded from the normal bankruptcy process.¹⁷ Of course, most big business was excluded from the Bankruptcy Act, as the law also excluded railroads,¹⁸ so the exclusion of financial companies was also consistent with the broader tendency to specialize the law of large enterprise.¹⁹

More recently, the key bankruptcy mechanism for dealing with large corporations is chapter 11 of the Bankruptcy Code. In addition, the United States has a number of different specialized insolvency regimes, including the Federal Deposit Insurance Act of 1950 ("FDIA") provisions that apply to banking organizations, and the Securities Investor Protection Act ("SIPA") provisions that apply to broker-dealers.²⁰

Furthermore, in response to the Supreme Court's decision in *United States v. South-Eastern Underwriters Ass'n*,²¹ in 1945 Congress passed the McCarran-

¹⁴ SAMUEL OWEN, A TREATISE ON THE LAW AND PRACTICE OF BANKRUPTCY 11-12 (1842).

¹⁵ F REGIS NOEL, A HISTORY OF THE BANKRUPTCY LAW 136-37, 140-42 (1919); CHARLES WARREN, BANKRUPTCY IN UNITED STATES HISTORY 67 (1935). Implicit in the State's Rights argument was a fear that Northern banks would be the only banks left standing if Western and Southern institutions were subject to bankruptcy petitions.

¹⁶ See also EDWIN JAMES, THE BANKRUPT LAW OF THE UNITED STATES 261-62 (1867)

¹⁷ It is often asserted that the United States is unique in this regard, but that does not appear to be true. Stephanie Ben-Ishai, *Bank Bankruptcy in Canada: A Comparative Perspective*, 25 Bank. & Fin. L. Rev. 59, 64-65 (2009).

¹⁸ Stephen J. Lubben, *Railroad Receiverships and Modern Bankruptcy Theory*, 89 Cornell L. Rev. 1420 (2004).

¹⁹ It is important to note that this was the era before FDIC insurance or the Glass-Steagall Act's separation of banking functions, so that bankers often engaged in activities that we would now ascribe to broker-dealers or investment banks. This was especially true during the Gilded Age, when the growth of large railroads led to a concomitant growth of high finance.

²⁰ And the Commodities Exchange Act provisions that apply to futures commission merchants, but I do not address these in this paper.

²¹ 322 U.S. 533 (1944) (holding Sherman Act could apply to state chartered insurance companies).

Ferguson Act,²² leaving regulation of insurance to the states. Thus insurance company insolvencies are a matter of state law by virtue of the combined effects of McCarran-Ferguson and an express exemption from the Bankruptcy Code.²³

* * *

Chapter 11 is probably the best known of these various insolvency systems. State corporate law sets the rules for how a corporation or other entity initiates a chapter 11 proceeding, but thereafter the process is entirely federal, taking place under the oversight of a federal bankruptcy court. The debtor's board retains ultimate control over the process as "debtor in possession," and the process works toward a reorganization plan.²⁴ Creditors have a right to vote on the plan, unless they are being paid in full or not paid at all, and the plan can provide for either the liquidation or recapitalization of the debtor.²⁵ While the statute itself does not express any particular Congressional aim, the main goal is understood to be the maximization of the debtor's value in a way that is not possible in either a piecemeal or quick liquidation.

Save for when the Dodd-Frank Act's new resolution authority applies, chapter 11 remains the primary instrument for resolving financial institutions. Unless a specialized regime is in place, such as those for banks or insurance companies, chapter 11 will apply. Thus, hedge funds, private equity funds, investment banks, and the parent companies of banks and insurance companies will all face resolution under chapter 11 unless the entity in question can be resolved under the new resolution authority and the Secretary of the Treasury decides to invoke the authority, as described below.

The closest procedure to chapter 11 is the resolution of broker-dealers under SIPA. SIPA specifically provides for the application of chapters 1, 3 and 5 and subchapters I and II of chapter 7 of the Bankruptcy Code to the extent such provisions are not inconsistent with SIPA.²⁶ Thus both chapter 11 and SIPA proceedings draw on the same general parts of the Bankruptcy Code to resolve claims and define the basic elements of the process.²⁷ But SIPA is strictly a

²² 15 U.S.C. §§ 1011-1015.

²³ 11 U.S.C. § 109. The exemption may be important, given that the Bankruptcy Code is enacted under express Constitutional authority, and thus might trump the McCarran-Ferguson Act. See William Goddard, *In Between the Trenches: The Jurisdictional Conflict Between a Bankruptcy Court and a State Insurance Receivership Court*, 9 Conn. Ins. L.J. 567, 574 (2002).

²⁴ 11 U.S.C. §§ 1101(1); 1107.

²⁵ 11 U.S.C. § 1126.

²⁶ 15 U.S.C. § 78fff(b)

²⁷ SIPA itself is only applicable to broker-dealers required to register under the 1934 Exchange Act, leaving small broker-dealers and certain foreign broker-dealers subject to certain specialized provisions of chapter 7 of the Bankruptcy Code. By all accounts, these exceptions are a small minority of broker-dealers.

liquidation procedure, which makes its outcome both more certain and less flexible than a chapter 11 case.

SIPA proceedings are commenced in district court and typically later removed to the local bankruptcy court.²⁸ A trustee is appointed and directed to distribute securities to customers to the greatest extent practicable in satisfaction of their claims against the debtor. Through such distributions, the customers of a broker-dealer receive a priority over other, general unsecured creditors who have to await a more bankruptcy-like distribution, if there are any assets to make such a distribution.²⁹

Bank resolution proceedings similarly involve a favored class of creditors, but take place in a completely non-judicial forum. Since the creation of deposit insurance in the New Deal, the FDIC has been the receiver for national banks, and increasingly also for state chartered institutions. The FDIC operates under an overriding mandate to reduce the cost of insolvency to the FDIC insurance fund. Moreover, the FDIC argues that the National Depositor Preference statute gives payment priority to depositors in all insolvency proceedings, and that the FDIC may assert their rights as subrogee when depositors have been paid from the insurance fund. In most cases the preference statute has the effect of eliminating any recovery for unsecured creditors and shareholders, as the largest proportion of claims against a failed institution typically are those of insured depositors.

Under the FDIA, the FDIC acting as receiver, or, less often, conservator, succeeds to the rights of the institution for which it is acting as conservator or receiver. Shareholders and managers cease to have operational control of the bank. As receiver, the FDIC can liquidate the institution, organize a new bank or a temporary bridge bank, take over some or all of the assets and liabilities of the failed institution, or arrange a merger or purchase of assets and assumption of liabilities.

The bridge bank process is not unlike the 363 sale process used in the recent automotive chapter 11 cases, but importantly all FDIC receivership proceedings are under the sole control of the FDIC, with the role of the courts strictly constrained.³⁰ Moreover, the bank receivership process is initiated by a regulator or chartering authority – either state or federal – and the concept of a “voluntary” receivership is little more than a theoretical possibility. In short, a bank receivership is a much more “internal” process as compared with a chapter 11 case, which must play out in the public form of a federal bankruptcy court.

In this respect, insurance company resolution is more like the other non-bank systems that have been discussed to this point. Although there are state by state variations, in general a distressed insurance company is placed in receivership after a petition from the home state insurance regulator. The presiding judge will typically issue injunctions or stays to prevent the dismemberment of the company during its resolution, although the enforcement of these stays are sometimes

²⁸ 15 U.S.C. § 78eee(b)(4). *See also* *Peloro v. United States*, 488 F.3d 163, 172 (3d Cir. 2007).

²⁹ 15 U.S.C. § 78fff-3(a).

³⁰ 12 U.S.C. § 1821(j).

complicated by the more limited jurisdiction of a state court as compared with a federal district or bankruptcy court.

As with banks, appointment of a receiver suspends the powers of management and places the control of the company in the hands of the receiver. Claims are fixed as of the date of the appointment. An insurer's policies are typically deemed cancelled on appointment of a receiver. The estate is not liable for future losses, but policyholders have valid claims for losses incurred to that point. In many cases the policyholders will also have claims for breach of contract against the estate. The receiver may be responsible for either conducting the insurer's business with an eye towards rehabilitation or for conserving and protecting insurer's assets for the ultimate end of liquidation. Ultimately the state insurance regulator, as receiver, has a good deal of discretion, not unlike the FDIC acting in bank insolvency proceedings.

* * *

Until relatively recently, this fragmentation of insolvency law typically meant that a large financial institution would be subjected to chapter 11 plus one specialized regime when it failed.³¹ For example, a large banking institution would have its insured subsidiaries resolved under an FDIC process, while the holding company filed a chapter 11 petition.³² The Washington Mutual holding company filed under chapter 11 in September 2008, one day after the bank subsidiary was taken over by the FDIC.

³¹ See *In re New Times Sec., Inc.*, 371 F.3d 68 (2d Cir. 2004); Laura S. McAlister, *The Inefficiencies of Exclusion: The Importance of Including Insurance Companies in the Bankruptcy Code*, 24 Bank. Dev. J. 129 (2008). See also *In re Home Holdings, Inc.*, No. 98 Civ. 5690, 2001 WL 262750, at *1 (S.D.N.Y. Mar. 16, 2001) (chapter 11 case of holding company for "its wholly owned subsidiary, Home Insurance, a New Hampshire property and casualty insurance company."). The author represented the foregoing debtor while in practice.

³² Until passage of the Dodd-Frank Act, a Bank Holding Company was subject to regulation by the Federal Reserve, but there was no specialized insolvency system for these entities. The Bank Holding Company Act defines "bank holding company" as any company that has control over any bank or over any company that is or becomes a bank holding company by virtue of the Act. Any company has control over a bank or over any company if: (1) the company directly or indirectly or acting through one or more other persons owns, controls, or has power to vote

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per cent or more of any class of voting securities of the bank or company; (2) the company controls in any manner the election of a majority of the directors or trustees of the bank or company; or (3) the board determines, after notice and opportunity for hearing, that the company directly or indirectly exercises a controlling influence over the management or policies of the bank or company. 12 USC §1841(a).

It seems likely this arrangement is often suboptimal, since the FDIC has little incentive to maximize the value of the chapter 11 debtor's key asset – the bank subsidiary – once there was enough value to clear the costs of administration and the claims of depositors. Similarly, since most insurance regulators can avoid the insurance company's future claims by simply canceling them, there is little need to preserve the going concern value of what may be the holding company debtor's key asset. A simple liquidation will often suffice. In short, the specialized procedures favor speed and a protected class of creditor while chapter 11 favors maximizing overall value. The specialized procedures undoubtedly benefit the protected creditors, but perhaps at the expense of overall welfare.

Any inefficiency that existed in the system in the 20th Century was undoubtedly amplified by the effective repeal of Glass-Steagall in 1999 and the subsequent creation of a kind of “universal banking” model in the United States.³³ Where once a financial institution might implicate two insolvency systems, new entities like Citibank, Bank of America, and JPMorgan-Chase would have triggered three or four insolvency procedures within the United States alone.

Given the competing goals of these procedures, creating a single forum for resolving a financial institution seemed like a natural goal of the Dodd-Frank legislation. But it was only partially achieved.

The resolution authority established by the Dodd-Frank Act is meant to address two goals for the financial regulatory overhaul: the elimination of taxpayer bailouts and the end of “too big to fail.” Both are said to come from the inadequacies of current insolvency law, particular chapter 11 and its inability to deal with systemic crisis.

The new law partially supersedes chapter 11 as applied to financial companies, granting the Treasury Secretary the authority to appoint the FDIC as receiver of a systemically important financial company, with certain important limitations that will be discussed in the next part of this paper.

To understand Dodd-Frank, one has to abandon any hopes that the Act will show internal consistency. In particular, the categories of firms that are subjected to heightened regulation because of their perceived systemic importance have but a loose relationship to the categories of firms that are subject to the new resolution authority. For example, only bank holding companies with more than \$50 billion of assets can be regulated as systemically important, while any bank holding company can be placed into resolution authority.

In general, a financial institution is subject to the new resolution authority in two instances. First, bank holding companies, as defined in section 2(a) of the BHCA³⁴ are automatically subject to the new resolution authority.³⁵ In addition, if

³³ Section 101 of Gramm-Leach-Bliley Act of 1999 amended the Banking Act of 1933, commonly known as the Glass-Steagall Act, by repealing section 20 of Glass-Steagall, which prohibited any Federal Reserve member bank from affiliating with an entity engaged in securities activities, and section 32, which prohibited interlocking management between a member bank and any securities firm.

³⁴ 12 U.S.C. § 1841(a).

the new systemic risk oversight panel determines that a company is primarily engaged in financial activities, it can be subjected to the new resolution authority.³⁶ Companies previously deemed “systemically important non-bank financial institutions,” and subject to heightened regulation, are automatically included in this second category – no additional determination is required.³⁷

Also included are subsidiaries of the two foregoing categories of financial companies, other than subsidiaries that are insured depository institutions or insurance companies. In addition, the Act purports to include broker-dealers that are members of SIPC, but as discussed in Part II, the significance of this inclusion is unclear, given other provisions of the Act. And insurance companies cannot be placed into receivership under the Act.

For purposes of determining whether a company is predominantly engaged in financial activities, the Act establishes an 85% test. Under the test, 85% of the total consolidated revenues of the company must come from activities the oversight panel deems financial in nature or more than 85% of the firm’s consolidated assets must be financial in nature.³⁸ This same 85% requirement applies to a determination that a non-bank financial institution is systemically important and thus subject to heightened regulation, and automatic eligibility for the resolution authority.³⁹

Upon a determination by the appropriate federal regulators that the financial company is in default or in danger of default, a financial company may become subject to FDIC receivership, modeled on the FDIC’s traditional bank receiverships.⁴⁰ Chapter 11, or another relevant insolvency procedure, remains the default,⁴¹ but the new resolution authority largely trumps when activated.

Ultimately the power to invoke the process will rest in the hands of the Treasury Secretary, who will decide to invoke the resolution procedure upon a 2/3 vote of both the Federal Reserve Board and the FDIC Board or the SEC, and in consultation with the President.⁴² The Secretary’s decision is subject to but limited, confidential review by the D.C. District Court, a tribunal not known for its extensive experience with insolvency law.⁴³ And even this review will not happen if the firm’s

³⁵ Dodd-Frank Act § 201(a)(11). The “Hotel California” provision in Dodd-Frank requires any bank holding company with \$50 billion or more in assets as of January 1, 2010 that received assistance or participated in the capital purchase program under the Troubled Asset Relief Program to be treated as a systemically important non-bank financial institution, and thus subject to the resolution authority, even if it subsequently ceases to be a bank holding company.

³⁶ *Id.*

³⁷ This heightened regulation includes risk-based capital and liquidity requirements, leverage limits, concentration limits and resolution plan requirements. § 165.

³⁸ *Id.* at § 201(b).

³⁹ § 102(a)(6).

⁴⁰ § 203.

⁴¹ § 203(a)(2)(F).

⁴² Dodd-Frank Act § 203(a).

⁴³ § 202(a)(1)(A)(iii).

board consents to the resolution process – one can expect that future boards will be subject to extreme pressure in this regard.⁴⁴

The FDIC's resolution powers allow it to transfer all or any portion of the assets or liabilities of the financial company to a third party.⁴⁵ If a third-party buyer cannot be found, the FDIC has the authority to establish a temporary bridge financial company to hold any part of the business worth preserving until it could be sold to a third party at fair value or otherwise liquidated in an orderly fashion.⁴⁶

The FDIC is given near unilateral authority to review claims and allow or disallow them.⁴⁷ Any challenge to the claims resolution process must be filed in the district court where the financial company is located, a court that is not likely to have any knowledge or special interest in the resolution process.

The Act provides that the FDIC can incur interim debt obligations to fund a liquidation, which can later be recovered through assessments on the financial sector. The Act prevents the use of taxpayer funds to pay for the receivership process, although the Treasury clearly faces some risks that it will ultimately bear the cost if financial institutions are unable to pay the FDIC's *ex post* assessments.⁴⁸ That is, the statute can say taxpayers shall incur no losses, but that does not necessarily make it so.

And remember this new system only applies with certainty to bank holding companies. For other financial companies, the resolution authority is an alternative to the joint implementation of chapter 11 and the various specialized insolvency systems. The implications of this, and other potential gaps in the overall insolvency system, are explored in the next Part of this paper.

⁴⁴ § 202(a)(1)(A)(i).

⁴⁵ § 210(a)(1)(G).

⁴⁶ § 210(h).

⁴⁷ §§ 210(a)(2); 210(a)(7); 210(b).

⁴⁸ § 214.

II. The Scope of the New Order

Following Dodd-Frank, a distressed bank holding company and its bank subsidiary will now be addressed in a single forum. Maybe.

Maybe, because the new resolution authority is a process that must be invoked by regulators, and thus might be subject to delay or even neglect if the regulators disdain the new procedures. Delay presents perhaps the bigger problem in this context, inasmuch as Dodd-Frank expressly provides that a subsequently commenced FDIC resolution proceeding can displace the bankruptcy court already hearing a chapter 11 case regarding the same company.⁴⁹ Not only will this create uncertainty for the players in the chapter 11 case, but there is some risk of forum shopping. The government may find it convenient to bring a quick end to a chapter 11 case that has not gone in its favor.

And the FDIC's many roles, even in a simple case of a single bank and its holding company, present some problems. While in bank resolution the FDIC is sometimes considered the "residual claimant," and thus property in charge of the proceedings, they are really better analogized to a senior lender, who has little incentive to maximize the bank's asset value once that value clears the claims of priority deposit holders.⁵⁰ More realistically, if we assume that a failed bank resolution carries some risk for the FDIC, the agency will have incentives to simply get the process over as soon as possible. This may result in the sale of bank assets at below value, to subsidize and thus encourage a prospective purchaser. All of which has serious consequences for the resolution of the holding company, where its equity stake in the bank may be sacrificed to promote FDIC's other interests.

More broadly, there is a problem with the coverage of the new resolution authority. As noted, the resolution authority automatically applies to bank holding companies – a group which now includes the major investment banks. But after that, coverage becomes vague.

The other big area of firms subject to the resolution authority are those who get more than 85% of their revenues from finance activities. For some companies, namely those who are purely financial firms, it will be obvious that resolution authority might apply. But whether it will still remains uncertain.

For a small to mid-size hedge fund, the question of whether the resolution authority will apply might be context sensitive. In normal times regulators might be willing to let the fund enter chapter 11, but in an economy like that experienced in late 2008 and early 2009, the answer might be quite different.⁵¹ Presumably the fund's stakeholders will have to price this uncertainty when dealing with the fund.

For other firms, the question of whether they are above or below the 85% mark may be uncertain. Indeed, the answer to the question might vary depending

⁴⁹ § 208.

⁵⁰ Richard M. Hynes & Steven D. Walt, *Why Banks Are Not Allowed in Bankruptcy*, -- Wash. & Lee L. Rev. – (2010).

⁵¹ See Nicole M. Boyson, et. al, *Hedge Fund Contagion and Liquidity Shocks*, 65 J. Fin. 1789 (2010).

on when the question is asked. For a firm near the margin, the answer could vary with each new accounting statement.

For other firms, it may make sense to acquire a somewhat related non-financial business. Whatever inefficiencies this may present might be offset by lowering cost of funding, if creditors do indeed value certainty about how financial distress in the firm will be addressed. Committing to the transparency of a chapter 11 process, compared with the closed FDIC liquidation system, might have real value. For all the complaints about the automotive chapter 11 cases, the bankruptcy court hearings in those cases provide a degree of transparency totally lacking in AIG, Bearn Sterns, or Washington Mutual.

The foregoing raises the important connection between firm structure manipulation and the new resolution authority, especially for non-bank financial firms.. As drafted, the Dodd-Frank Act appears to allow regulators to move down a firm's organizational charge, but not up. In particular, the new resolution authority is applicable if the firm in question and all of its subsidiaries derive either 85% of their annual gross revenues or 85% of their consolidated assets from activities that are "financial in nature" or incidental to a financial activity, or from the ownership or control of one or more insured depository institutions.⁵² The Act also allows for the inclusion of subsidiaries of such financial companies in a resolution proceeding, apparently whether or not the subsidiary is itself engaged in finance related activities.⁵³ Thus there are some temptations to fragment the financial activities of a firm and place them under non-financial activities in a company's organizational chart, making it difficult for regulators to find any connected group of companies that are 85% engaged in finance.

Regulators would seem to have only indirect ways of addressing this kind of manipulation. Namely, the systemic risk regulation provision of Dodd-Frank allows regulators to vote to regulate a company that it believes is attempting to evade regulation.⁵⁴ Arguably this designation could be used to then get the firm in question into the resolution authority, which itself has no anti-evasion rules. Obviously this would take some dexterity on the part of the regulators if this approach were to be invoked on the eve of a financial collapse at the financial institution.

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These big picture issues will work in conjunction with some intentional gaps embedded in the new resolution authority. For example, when a SIPC member qualifies for the new resolution authority, the Dodd-Frank Act explicitly provides for the continued application of SIPA resolution proceedings, with some notable and sometimes puzzling modifications.

⁵² Dodd-Frank Act § 102(a)(6).

⁵³ Dodd-Frank Act § 201(a)(11)(iv).

⁵⁴ § 113(c)(1).

First, the FDIC, as receiver of a covered broker or dealer, is to appoint SIPC as trustee for the liquidation of the covered broker or dealer.⁵⁵ This contrasts with the normal practice of SIPC appointing a private attorney as trustee – apparently in cases under the new resolution authority, SIPC itself will have to act as trustee. In addition, SIPC, as trustee, shall have all powers and duties provided under SIPA and shall conduct the liquidation of the covered broker or dealer in accordance with the terms of SIPA, except that SIPC shall have no powers or duties with respect to assets and liabilities transferred by the FDIC from the covered broker or dealer to a bridge company. SIPA is in charge, except when it isn't.

The Dodd-Frank Act requires that customer net equity claims be discharged and satisfied as if the FDIC had never been appointed receiver of the broker or dealer.⁵⁶ Moreover, the Dodd-Frank Act provides that the FDIC shall satisfy customer claims to the extent that a customer would have received more securities or cash had the covered financial company been subject to a SIPA proceeding without the appointment of the FDIC as receiver. SIPC, as trustee, is to allocate customer property and distribute customer name securities in accordance with section 78fff-2(c) of SIPA, but all other claims are to be paid in accordance with the priorities under section 210(b) of the Dodd-Frank Act.

In short, broker-dealers will be half in and half out of the new resolution procedure, an awkward status that will leave part of the financial institution in the district court while the remainder is totally outside court oversight. Moreover, SIPA's incorporation of Bankruptcy Code principles raises the potential for problematic interactions with the resolution authority that was expressly designed to supplant the Bankruptcy Code.

Similar problems arise with regard to insurance companies, which are largely excluded from the new resolution authority.⁵⁷ The only power the FDIC obtains under Dodd-Frank is the ability to initiate a state court receivership if the state regulator fails to act.

Thus the insurance company piece of a large financial company will be largely unaffected by the enactment of Dodd-Frank, while the parent company will be subject to the new resolution procedure. Given the realities of the McCarran-Ferguson Act⁵⁸ this aspect of Dodd-Frank will be especially difficult to address, as explained in the next Part of this paper.

* * *

Overall, this analysis has shown two broad types of gaps in the overall insolvency structure. First, there is the uncertainty element created by overlaying a new procedure, without having it entirely displace the prior structure. The Dodd-Frank FDIC structure might apply, but debtor firms have no ability to invoke the process themselves. Thus the question of whether the new procedure will apply is

⁵⁵ § 205(a)(1).

⁵⁶ § 205(f).

⁵⁷ § 203(e).

⁵⁸ *See, supra* note 22 and text.

left in the hands of regulators, leading to the possibility that one procedure will commence (chapter 11) only to be supplanted by another (resolution authority) in an ad hoc manner.

Uncertainty is also created by the use of a bright-line 85% rule for what constitutes a covered financial company. The use of such a rule recognizes the reality of “shadow banking” – namely, the expansion of banking from traditional banks to other, related areas like money market funds, securitization, and private investment funds. Simply creating a resolution procedure for “banks” and bank holding companies would clearly fall short. But if the new resolution authority is designed to address perceived inadequacies with chapter 11, why is chapter 11 adequate for a firm that derives 84% of its revenue from finance?

This rule creates uncertainty in that the application of the rule will be unclear *ex ante* for some number of firms that are in finance related areas, but which receive somewhat less than all of their revenues from finance.

In short, there is uncertainty across two plains: will the regulators invoke the procedure, an issue that might be especially acute for small or mid sized firms, and does the procedure even apply to the firm in question?

Consider a large money market mutual fund. If a run on the assets of the fund began, would the new resolution procedure be invoked? The fund likely meets the 85% test – more than 85% of its assets will be finance related. But is this fund important enough for the Secretary and the Systemic Risk Counsel to invoke resolution authority? Individually, maybe not, but if the run on this fund might prompt runs on other funds? This uncertainty over how the government will respond to a crisis was allegedly solved by the new resolution authority, but in this case it seems quite unclear.

The second area in which gaps have been identified turns on the coverage of the new procedure. If the goal was to resolve a large financial firm in a single procedure, Dodd-Frank clearly failed. Given the international component of finance, it was unlikely to be fully successful. But as noted, even domestically large financial firms will continue to be subject to a variety of procedures, especially with regard to broker-dealers and insurance companies.

There is also the question of whether the 85% rule can be manipulated to create gaps in the coverage of the new resolution authority. What if Apple decided to run what amounted to a technology focused hedge fund out of a non-incorporated division of the parent company? Enron reminds us that the example might not be totally implausible.

III. Going Forward

Given that the new structure is subject to manipulation and creates uncertainty, both in terms of how the new system will work and which system will apply, there is obviously some room for improvement. But it seems unlikely that any such improvements will take the form of major legislative enactments. Thus, this part of the paper focuses on the changes that can be made under existing law.

First, since the 85% rule in the resolution authority context is clearly subject to some manipulation, regulators will have to use their authority to combat such manipulation in the systemic risk context to also address manipulation in the resolution context. Namely, extra vigilance will be required on the systemic risk side to ensure that the new resolution authority remains available to regulators when and as appropriate. Only if a company has been made subject to systemic oversight will a firm with less than 85% of its activities in finance qualify for resolution.

Even if manipulation is put to one side, the uncertainty surrounding which resolution procedure will apply remains. Some of this is exacerbated by the fact that while the FDIC will be in charge of the resolution process once initiated, they have no authority over the commencement of the process. The key player in initiation is the Treasury Secretary, an inherently political actor who is unlikely to be able to make commitments that will last beyond any particular Secretary's term in office. Thus, while a Secretary might commit to only using the resolution authority in times of systemic financial crisis – thus leaving chapter 11 and the other specialized regimes dominant in most instances – this commitment is of limited value.

The Federal Reserve Board might make such a commitment, using its power to authorize the Treasury Secretary's action to commit to block a resolution proceeding, save in specified instances. Ultimately, however, the amusingly complex mechanism for instituting a resolution proceeding – requiring the consent of the FDIC, the Federal Reserve, and the Treasury Secretary simultaneously – suggests that resolution proceedings will only be instituted when the entire financial-regulatory community is in agreement. In such instances, a prior commitment might be of little value.

Nonetheless, there could be some value in all of these regulators defining when they believe it would be appropriate to invoke the resolution authority. Creditors will still have to price two insolvency systems for most financial firms, but at least such a statement will provide some insight into the relative probabilities of each system's use.

The Federal Reserve can bolster a credible commitment to use of chapter 11 and the other specialized insolvency systems through its power to require systemically important institutions to file resolution plans.⁵⁹ If these plans set forth a convincing scheme for resolving the company under chapter 11, other indications that the Dodd-Frank resolution authority will be used only as a last resort will be more credible. The prepackaged CIT bankruptcy case offers one model for how such a plan might work, although it should be conceded that CIT, although large, was

⁵⁹ § 165(d)(1).

substantially smaller than many of the systemically important institutions in this country.⁶⁰ The key will be to require a good deal of specificity in such plans, along with the input of reorganization professionals. In short, the banking lawyers will have to talk to the bankruptcy lawyers.

Moreover, the plans must be continually updated to ensure their relevance. A plan done once and filed away in a drawer obviously ignores the dynamic nature of the financial industry.

The uncertainty over which insolvency system will be invoked can also be reduced by minimizing the differences between the Dodd-Frank resolution process and the other insolvency systems. Thus, rather than creating new rules for the resolution process, the comparable rules should be incorporated from the Bankruptcy Code or other relevant insolvency process. The consequences of rejecting a contract, for example, should be the same regardless of the procedure used, unless there is a good reason for some deviation.

Similarly, the FDIC could use its rule making authority⁶¹ to commit to following a financial institution's resolution plan, even if that plan contemplated resolution under chapter 11. For example, if the plan calls for a quick sale of key assets under section 363 of the Bankruptcy Code, the FDIC could also commit to move the same assets into a bridge institution upon commencement of the resolution process. Thus the basic outcome would be harmonized across the various possible resolution procedures.

* * *

All of this is feasible, and can narrow the gap between resolution processes. But is it likely? And what risks remain?

On the question of the probability of these changes happening, one has to be somewhat skeptical. Up to this point the FDIC has shown little interest in engaging with the restructuring community, and has moved to implement the new resolution authority with little input from those who understand chapter 11 in particular.⁶²

The risks that remain, even if existing procedures are used to narrow the gap among resolution procedures, stem from the simple fact that there still remains differences among systems, and the degree of those differences is often hard to evaluate *ex ante*.

For example, the new resolution process provides for a kind of "best interest of creditors" test like that found in chapter 11, which requires that creditors receive at least as much as they would have in a chapter 7 liquidation.⁶³ But the Dodd-Frank version of the test provides no right to test the valuation of the debtor in court, and no apparent right to appeal the FDIC's determination in any respect.⁶⁴ Thus, in

⁶⁰ <http://business-finance-restructuring.weil.com/case-overviews/cit-%E2%80%93-one-year-on/>

⁶¹ § 209.

⁶² <http://www.fdic.gov/regulations/laws/federal/2010/10c04Orderliq.PDF>.

⁶³ 11 U.S.C. §1129(a)(7).

⁶⁴ §§210(a)(7)(B), (d)(2)(B).

chapter 11 the test will be founded on the testimony of the debtor's valuation expert, subject to cross-examination and competing valuation evidence. In the resolution authority, the FDIC will conduct the analysis without any obligation to disclose its methods or subject them to examination. From an *ex ante* perspective, an unsecured creditor can have no faith that these two procedures will result in the same recovery for creditors.

And one drawback of reducing the use of Dodd-Frank's resolution authority is that it will increase the uncertainty of how that system will play out when finally invoked. And there is no way to prevent use of resolution authority in some number of extreme cases. In short, the limited number of Dodd-Frank resolution cases will make it harder to price the effects of the resolution authority.

In short, the differences between the various insolvency systems, and creditors' rights thereunder, will continue to be a source of uncertainty and thus systemic risk. And while the FDIC and other regulatory authorities can attempt to minimize the gaps between the two systems, the inherent difference between a FDIC receivership, where the FDIC acts as both liquidator and bankruptcy court, and the more typical, court-centered bankruptcy process, with much greater rights of due process, means that the financial markets will have to come to grips with the new, flawed reality of the post-Dodd-Frank world.

On the other hand, I should be clear that the problems I identify do not inevitably point to the need to have chapter 11 dominate this entire field. Instead, I ultimately conclude that the missed opportunity of Dodd-Frank was the failure to come up with a single forum for resolving financial distress in financial institutions. That forum might be chapter 11, but it might also be resolution authority. Each has its drawbacks, but Congress should have had the courage to pick one.