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DYNAMIC RESOLUTION OF LARGE FINANCIAL INSTITUTIONS

THOMAS H. JACKSON & DAVID A. SKEEL, JR.*

One of the more important issues emerging out of the 2008 financial crisis concerns the proper resolution of a systemically important financial institution. In response to this, Title II of Dodd-Frank created the Orderly Liquidation Authority, or OLA, which is designed to create a resolution framework for systemically important financial institutions that is based on the resolution authority that the FDIC has held over commercial bank failures. In this Article, we consider the various alternatives for resolving systemically important institutions. Among these alternatives, we discuss OLA, a European-style bail-in process, and coerced mergers, while also extensively focusing on the bankruptcy code. We argue that implementing several discrete modifications to Dodd-Frank, as well adopting an ambitious Chapter 14 proposal written by a working group at the Hoover Institution is the best way forward for establishing a strong resolution framework.

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Introduction

As of 2008, when the financial crisis hit in earnest, there were two principal options if a large financial institution fell into distress in the United States: bankruptcy or some kind of government bailout. Specialized administrative resolution rules governed particular kinds of subsidiaries—commercial banks were and are subject to resolution by the Federal Deposit Insurance Corporation (FDIC),[1] for instance, and state regulators handle insurance company failures[2]—but bankruptcy or bailout was the choice for bank holding companies and nonbank financial institutions. After the initial wave of the crisis passed, Federal Reserve Chairman Ben Bernanke, Treasury Secretary Timothy Geithner, and other key regulators called on Congress to put an administrative resolution framework in place for these institutions as well.[3] In 2010, with the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), they got their wish.[4] Title II of the legislation (the Orderly Liquidation Authority, or OLA) gives regulators the power to take over and resolve financial institutions whose failure could cause systemic problems.[5]

The Dodd-Frank resolution rules were controversial before they were enacted and that controversy has continued. In response to some of this controversy, the FDIC claimed that it might have secured a recovery of ninety-seven cents on the dollar if it had had its current resolution powers in the months before Lehman Brothers collapsed.[6] Critics scoff at these claims and characterize the new administrative resolution framework, despite ominous-sounding statutory language, as having perpetuated bailouts.[7] Many of the critics argue for some version of the existing bankruptcy laws as the best strategy for resolving the financial distress of the largest financial institu-

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[1] *See* 12 U.S.C. § 1821(c) (2006).

[2] *See* McCarran-Ferguson Act, 15 U.S.C. §§ 1011–1015 (2006).

[3] *Oversight of the Federal Government's Intervention at American International Group: Hearing Before the H. Comm. on Fin. Services*, 111th Cong. 111-20 (2009) (statement of Ben S. Bernanke, Chairman, Federal Reserve Board), *available at* http://www.federalreserve.gov/newsevents/testimony/bernanke20090324a.htm; *Systemic Regulation, Prudential Matters, Resolution Authority and Securitization*, 111th Cong. 111-88 (2009) (statement of Timothy F. Geithner, Secretary, U.S. Dept. of Treasury), *available at* http://financialservices.house.gov/Calendar/EventSingle.aspx?EventID=231801.

[4] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

[5] *Id.* §§ 201–217.

[6] *See* Fed. Deposit Ins. Corp., *The Orderly Liquidation of Lehman Brothers Holding, Inc. Under the Dodd-Frank Act*, 5 FDIC Q. 31 (2011), *available at* http://www.fdic.gov/bank/analytical/quarterly/2011_vol52.html [hereinafter *Lehman Report*].

[7] *See, e.g.*, Kenneth Scott, A Guide to the Resolution of Failed Financial Institutions: Dodd-Frank Title II and Proposed Chapter 14, 15 (February 29, 2012) (unpublished manuscript), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2018035 (arguing that Title II precludes bailouts of shareholders but permits creditor bailouts); Vern McKinley, Financing Failure: A Century of Bailouts 283 (2011) ("Although the goal of ending taxpayer bailouts once and for all is a noble objective, the likelihood that the Dodd-Frank legislation has accomplished this is quite small.").

tions.[8] Unlike the new resolution rules (and the FDIC bank resolution powers on which they are based), which vest regulators with the authority to determine how much creditors are paid and how the financial distress is resolved,[9] bankruptcy leaves much of the decision making to the parties themselves, subject to statutory rules and judicial oversight. Under the corporate reorganization provisions of Chapter 11, a corporation's managers generally decide when to commence the process,[10] and either propose a sale of the firm's assets or negotiate the terms of a reorganization with its creditors.[11] In a traditional reorganization, the negotiations culminate in a vote by each class of creditors and shareholders whether to approve the proposed plan.[12]

In Europe, lawmakers are considering a third strategy for resolving the financial distress of a large financial institution, an approach generally known as bail-in.[13] Like OLA, bail-in is a form of administrative resolution, but it is designed to serve as a mid-course correction to preserve a troubled financial institution rather than as a full-blown, administrative resolution. The most prominent proposals assume that regulators will determine when to intervene, and would dictate which claims could be altered and which could not.[14] Under some models of bail-in, adjustments to creditors' entitlements would occur automatically, based on a market trigger.[15]

One important objective of this Article is to carefully assess the strengths and weaknesses of each of the principal options. In addition to OLA, bankruptcy, and bail-in, we also consider a more idiosyncratic, but undeniably important, resolution option: coerced, nonresolution sales. Coerced sales were a major feature of the 2008 crisis—Bear Stearns and Wa-

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[8] *See* Scott, *supra* note 7, at 15–17 (favorably comparing bankruptcy, as amended by a Chapter 14 proposal advocated by a Hoover Institution working group, to OLA).

[9] *See* Dodd-Frank Act § 204.

[10] 11 U.S.C. § 301 (2006) (A "voluntary case . . . is commenced by the filing . . . of a petition . . . by an entity that may be a debtor . . . ."). While, under certain circumstances, creditors can file an "involuntary petition," *see* 11 U.S.C. § 303, this is unusual for large institutions.

[11] Under 11 U.S.C. §§ 1107 and 1108, the managers of the company, as "debtor in possession," 11 U.S.C. § 1101(a), are authorized to continue running the business. They are the only ones who are permitted to propose a reorganization plan for at least the first four months of the case. 11 U.S.C. § 1121(b). Both of these provisions can be changed by judicial decision. 11 U.S.C. §§ 1107, 1108.

[12] *See, e.g.*, 11 U.S.C. § 1129(a)(8) (requirement that every class approve plan as prerequisite to confirming a consensual reorganization plan). The Chapter 11 process is described *infra* Part II.

[13] Riva Froymovich, *EU Barnier: Bail-Ins Must Be Option Included in Bank Resolutions*, WALL ST. J. (Mar. 30, 2012), http://online.wsj.com/article/BT-CO-20120330-703493.html.

[14] *See, e.g.*, Thomas F. Huertas, Vice Chairman, Comm. of European Banking Supervisors and Dir., Banking Sector, U.K. Fin. Services Auth., The Road to Better Resolution: From Bail-out to Bail-in, Speech at The Euro and the Financial Crisis Conference hosted by the Bank of Slovenia (Sept. 6, 2010), *available at* http://www.fsa.gov.uk/library/communication/speeches/2010/0906_th.shtml; CLIFFORD CHANCE, LEGAL ASPECTS OF BANK BAIL-INS 6 (2011).

[15] CLIFFORD CHANCE, *supra* note 14, at 6.

chovia were both resolved through brokered sales.[16] Even if the Dodd-Frank Act has eliminated the possibility of traditional bailouts—an issue that is subject to considerable debate—regulators still may still be in a position to midwife sales outside of the formal resolution process. Indeed, the very provisions that are designed to discourage bailouts, such as a requirement that any Federal Reserve financial intervention occur on an industry-wide basis,[17] rather than with particular firms, could facilitate the coerced merger strategy.

The second major objective of this Article is to provide a dynamic account of the existing options. The resolution options are not mutually exclusive. For instance, a large financial institution can be resolved either in bankruptcy or under the Dodd-Frank resolution rules. Although the principal bail-in proposals look very different than the Dodd-Frank resolution framework, a resolution that looks quite similar to bail-in could theoretically be achieved under Dodd-Frank. By considering how these various moving parts fit together, we can better see how the different approaches work.

Our final objective is more explicitly normative. Based on our analysis of the principal resolution options and the relationships among them, we offer both simple and more elaborate proposals for enhancing and better integrating the resolution architecture.

We should acknowledge from the outset that we are not disinterested observers. In our own writings in this area, we have strongly defended bankruptcy as an alternative to either the bailouts of 2008 or to the new Dodd-Frank resolution rules.[18] We continue to defend bankruptcy in this Article, but we nevertheless try to provide a comparatively even-handed assessment of its limitations, as well as the strengths of the alternative approaches.

In Parts I and II of the Article, we describe and assess the new Dodd-Frank resolution rules and provide an analogous assessment of bankruptcy. In a small concession to our own views, our discussion of Dodd-Frank resolution begins with its problems, whereas we start with the virtues when we turn to bankruptcy. In Part III, we consider the bail-in proposals that have figured particularly prominently in European discussions. The benefits and shortcomings of bail-ins parallel those of the Dodd-Frank framework in many respects, but there are also key differences. In Part IV, we consider the future of coerced mergers. The issue of coerced mergers requires us to examine the Dodd-Frank provisions that are designed to prevent bailouts, and

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[16] David Zaring, *The Post-Crisis and Its Critics*, 12 U. PA. J. BUS. L. 1169, 1180 (2010).

[17] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 1101(a), 124 Stat. 1376, 2113–2116 (2010).

[18] *See, e.g.*, Thomas H. Jackson, *Chapter 11F: A Proposal for the Use of Bankruptcy to Resolve (Restructure, Sell, or Liquidate) Financial Institutions*, *in* ENDING GOVERNMENT BAILOUTS AS WE KNOW THEM (Kenneth Scott et al., eds., 2009); David A Skeel, Jr., *Give Bankruptcy a Chance*, WKLY. STANDARD, June 29, 2009, *available at* http://www.weeklystandard.com/Content/Public/Articles/000/000/016/658hmvhc.asp; Thomas H. Jackson & David A. Skeel, Jr., *Bankruptcy Reform Will Limit Bailouts*, WALL ST. J. (Apr. 21, 2010), http://online.wsj.com/article/SB10001424052748704671904575194010886218980.html.

leads to the question of the extent to which regulators with resolution authority can realistically be constrained by legal rules during a crisis.

In Part V, we shift to an explicitly normative mode. Having probed the existing options and the interactions among them, we advocate two sets of reforms. The first is a simple package of adjustments that would include a stay on derivatives in bankruptcy, as well as several amendments to Dodd-Frank. The second is a proposal for a new Chapter 14 that was drafted by a working group of the Hoover Institution.[19] The goal, we argue, should be to make bankruptcy the option of choice, with administrative resolution necessary only in rare cases.

I. Dodd-Frank's New Resolution Rules

The Dodd-Frank resolution rules are designed to extend the powers that regulators previously had when a commercial bank failed to also apply to systemically important financial institutions of all kinds. Prior to 2010, bank regulators' resolution authority was limited to commercial banking subsidiaries.[20] If a banking conglomerate fell into financial distress, its holding company and any nonbank subsidiaries were subject to the ordinary bankruptcy process.[21] Under the new resolution rules, bank regulators now have authority over the entire holding company network.[22]

In the discussion that follows, we begin by briefly describing the Dodd-Frank resolution rules. We then point out several misconceptions that lie at the heart of the framework, before turning to a more careful consideration of the strengths and weaknesses of administrative resolution of the largest financial institutions.

A. The Basic Framework

Resolution under Dodd-Frank begins when "the three keys turn"—Treasury proposes to take over a systemically important financial company that is in or near default, and the Fed and FDIC concur by a two-thirds

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[19] Thomas H. Jackson et al., Resolution of Failed Financial Institutions: Orderly Liquidation Authority and a New Chapter 14 (April 25, 2011), *available at* http://media.hoover.org/sites/default/files/documents/Resolution-Project-Booklet-4-11.pdf (unpublished manuscript) [hereinafter Chapter 14 Proposal].

[20] The Treasury Department White Paper that served as the original foundation for the legislation that became the Dodd-Frank Act heavily emphasized the limitations on regulators' reach. According to the report, "[t]he federal government's responses to the impending bankruptcy of Bear Stearns, Lehman Brothers, and AIG were complicated by the lack of a statutory framework for avoiding the disorderly failure of nonbank financial firms, including affiliates of banks or other insured depository institutions." U.S. Dept. of Treasury, Financial Reform: A New Foundation 76 (June 2009) [hereinafter Treasury White Paper].

[21] *See id.*

[22] *See* Dodd-Frank Act § 201(a)(11) (definition of "financial company"), § 202 (commencement of orderly liquidation for a covered financial company).

vote.[23] If the company does not agree to the intervention, resolution is commenced by the filing of a petition in the federal district court in Washington, DC.[24] The court has twenty-four hours to consider the petition.[25] Unless the court invalidates the petition as "arbitrary and capricious," the FDIC takes over the company as its receiver, and the managers are kicked out.[26] The FDIC has nearly unfettered discretion to sell the company or any of its parts, either directly or after transferring the assets to a bridge financial company.[27]

The resolution rules include a variety of provisions that are designed to counter complaints that the new framework would institutionalize bailouts. One provision explicitly requires that the financial institution's managers be removed if they were responsible for the financial distress, shareholders be wiped out, and creditors take losses.[28] The framework also instructs regulators to liquidate the institution rather than reorganize it.[29] Although these provisions sound like harsh medicine, the FDIC also is also given ample discretion to sidestep them, as we shall see.

B. The Rhetorical Context and its Implications

The rhetorical justification for the new resolution rules was a misleading analogy promoted by bank regulators during the financial reform debates of 2009 and 2010. According to the Treasury and FDIC, the FDIC had been highly effective in handling the failures of ordinary commercial banks, but these powers did not extend to bank holding companies or nonbank financial institutions.[30] The obvious response to the 2008 crisis, they successfully argued, would be to expand the government's powers, modeled on those held by the FDIC, to include systemically important financial institutions.[31]

Regulators did encounter serious headwinds in one respect. Although their original blueprint for reform would have given regulators broad rescue powers, popular opinion was extremely hostile to bailouts.[32] In the face of repeated criticism, Dodd-Frank's drafters added a variety of provisions that are designed to make resolution look less like a bailout. Whereas regulators can use a liquidation-like receivership process or a more reorganization-oriented conservatorship process for ordinary banks, Dodd-Frank limits them to the receivership option for covered financial companies.[33] The resolution

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[23] *See id.* § 203.
[24] *See id.* § 202.
[25] *Id.*
[26] *See id.*
[27] *See id.* § 210.
[28] *Id.* § 206.
[29] *See id.* § 208.
[30] *See* TREASURY WHITE PAPER, *supra* note 20, at 76.
[31] *See id.*
[32] *See Poll: Frustration Growing Over Bailouts*, CBS NEWS (Apr. 30, 2009, 10:00 AM), http://www.cbsnews.com/2100-500160_162-4870196.html.
[33] *See* DAVID A. SKEEL, JR., THE NEW FINANCIAL DEAL: UNDERSTANDING THE DODD-FRANK ACT AND ITS (UNINTENDED) CONSEQUENCES 137 (2010).

rules also instruct regulators to oust any managers that are responsible for the institution's failure, and to ensure that shareholders and creditors take losses. The coup de grâce is a provision that was proposed by Senator Barbara Boxer late in the legislative process, which explicitly states that rehabilitation is not permitted; if regulators take over a troubled financial institution, they must liquidate it.[34]

If systemically important financial institutions were indeed like the small and medium sized banks that the FDIC ordinarily handles, these marching orders (at least apart from the liquidation "mandate") would be less problematic. But there are vast differences. With ordinary banks, the FDIC negotiates with one or more healthy banks, and arranges for one to acquire either the troubled bank's deposits or the deposits together with some or all of the troubled bank's assets and other liabilities.[35] Regulators ideally descend on the troubled bank on a Friday afternoon, and then effect the transfer over the weekend so that the transfer will be complete before the start of business on Monday.[36] This strategy generally will not work with a systemically important financial institution. There often will be very few logical buyers, and the resolution cannot realistically be achieved over a weekend. If these large institutions truly were liquidated, the results would be disastrous.

Fortunately, if there ever were a resolution, it is unlikely that regulators would take the command to liquidate seriously. The FDIC's powers in Dodd Frank resolution can easily be turned to more flexible ends. The FDIC can set up a bridge financial company, for instance, and transfer some or all of the bank's assets and liabilities to it.[37] The bridge financial company could easily serve as the platform for a restructuring. The FDIC itself has increasingly trumpeted its bridge financial company powers as a signal advantage of OLA as compared to other resolution options. In its report on Lehman, the FDIC wrote, "The Dodd-Frank Act provides an efficient mechanism—the bridge financial company—to quickly preserve the going-concern value of the firm's assets and business lines. There are no specific parallel provisions in the Bankruptcy Code."[38]

As this rather blatant trumpeting of the ability to preserve going-concern value indicates, Dodd-Frank's liquidation-only rule is unlikely to function the way lawmakers perhaps envisioned. As a result, the rule will have two serious costs. First, it will inject uncertainty into the resolution process. The FDIC's use of a bridge financial institution may be challenged as violat-

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[34] Dodd-Frank Act § 214.

[35] FDIC resolution of distressed commercial banks is described in SKEEL, *supra* note 33, at 125–26. Moreover, because of the prevalence of government-guaranteed deposits, in most cases the FDIC is the logical "residual owner" of an insolvent bank, with appropriate financial incentives.

[36] CLIFFORD CHANCE, *supra* note 14, at 6.

[37] *See* Dodd-Frank Act § 210(h).

[38] *Lehman Report*, *supra* note 6, at 36–37.

ing the "thou shalt liquidate" requirement. The second cost is moral and cultural. Many Americans were cynical about claims that the financial reforms would genuinely curb bailouts. Insisting that large financial institutions will not be bailed out when regulators know they will be could exacerbate the cynicism.[39]

C. Key Problems with the Dodd-Frank Resolution Rules

The key shortcomings of administrative resolution are well known and are handled with varying degrees of effectiveness by the new resolution rules. In the discussion that follows, we focus on four of the most important shortcomings.

The first difficulty is initiation. Because regulators do not have a financial stake in the institutions they oversee, they do not have an incentive to initiate insolvency proceedings in a timely fashion.[40] Their personal interests are more likely to be served by erring on the side of delay, rather than through prompt intervention. After the Savings and Loan (S&L) crisis of the 1980s, Congress addressed this concern in commercial bank resolution by enacting prompt corrective action rules that require regulators to intervene as a bank's financial condition deteriorates.[41] Dodd-Frank, by contrast, gives regulators complete discretion whether and when to intervene.[42] It focuses more on assuring that an intervention is difficult to challenge once regulators decide to take a large institution over. Dodd-Frank's principal strategy for forcing regulators' hand is to make bailouts more difficult outside of resolution by limiting the Fed's 13(3) powers. Under the new framework, the Fed is prohibited from using its emergency lending powers to support an individual financial institution; any intervention must be pursuant to a "program or facility with broad-based eligibility."[43] The new restrictions are unlikely to thwart bailouts altogether, however. The Fed could sidestep the restriction by creating an ostensibly broad-based program that actually is aimed at one or a small group of institutions, which suggests that delayed initiation will continue to be the norm.

The second problem is that administrative resolution is nontransparent and violates rule of law principles, including basic priority rules. In ordinary bank resolution, for instance, the FDIC has almost complete discretion over which assets and liabilities to transfer to a purchaser and which to leave

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[39] For further discussion, see David A. Skeel, Jr., *Making Sense of the New Financial Deal*, 5 LIBERTY U. L. REV. 181 (2011).

[40] *See, e.g.*, Jonathan R. Macey & Geoffrey P. Miller, *Kaye, Scholer, Firrea, and the Desirability of Early Closure: A View of the Kaye, Scholer Case From the Perspective of Bank Regulatory Policy*, 66 S. CALIF. L. REV. 1115, 1133 (1993).

[41] *See, e.g.*, *id.* at 1134.

[42] *See* SKEEL, *supra* note 33, at 131.

[43] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 1101(a), 124 Stat. 1376, 2113–2116 (2010).

behind.[44] In theory, creditors can challenge the FDIC's determination,[45] but judicial review is severely limited in practice. With most commercial banks, the consequences are not severe, because the vast majority of the bank's liabilities are insured deposits. Nearly 93% of the liabilities of banks with between $100 million and $500 million in assets are deposits.[46] In essence, for these banks, the FDIC is not just the decision-maker, but also the major creditor.[47] Systemically important financial institutions, by contrast, have a far greater range of liabilities, and a much smaller role for government-guarantees (and hence for the symmetry between the decision-maker and the residual owner). Regulatory discretion is therefore a much more serious concern.

The resolution rules try to address this concern in three ways. First, regulators are not permitted to pick and choose which derivatives and other qualifying financial contracts with a particular party to keep and which to terminate.[48] They must either assume all of the contracts (which ordinarily will mean transferring them to a bridge bank) with a particular counterparty, or terminate all of them.[49] Second, regulators are required to give each creditor at least as much as the creditor would have received if the financial institution had been liquidated and its proceeds distributed in accordance with the absolute priority rule.[50] Finally, if creditors receive more than this amount, regulators are instructed to claw back the excess except for "payments or amounts necessary to initiate and continue operations essential to implementation of the receivership or any bridge financial company."[51]

Because regulators have only one day to make their decision,[52] they will likely assume all of the institution's derivatives. They can preempt other creditors' complaints about this favored treatment by giving them a small recovery and arguing that the creditors would have received little or nothing in a true liquidation. Because of the absence of a proceeding, or readily available information, challenging the FDIC's moment-in-time liquidation valuation after-the-fact may be practically impossible. The clawback provision theoretically could offset the effect of this differential treatment to some extent, by requiring derivatives creditors to give back the portion of their recovery that exceeds liquidation value. But the FDIC can (and one suspects, would) sidestep the clawback by characterizing protection of the institution's derivatives as essential to the operations of the bridge financial company.

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[44] *See* SKEEL, *supra* note 33, at 147.

[45] *See id.* at 131.

[46] *See id.* at 123.

[47] A 1993 law enshrines a priority for depositors behind secured claims and administrative expenses only. *See* 12 U.S.C. § 1821(d)(11)(A) (2006).

[48] *See* Dodd-Frank Act § 210(c)(11).

[49] *Id.* § 210(c)(11). This may be the consequence of most master agreements anyway.

[50] *Id.* §§ 210(a)(7)(B), 210(d)(2).

[51] *Id.* § 210(o)(1)(D)(i).

[52] *Id.* § 203(c)(2).

The FDIC already has suggested that it will indeed protect short-term creditors rather than expose them to losses.[53] The cost of this protection will be continued creditor moral hazard, in that the creditors with the best opportunity to discover—and act upon—an institution's growing financial difficulties will have little, if any incentive, to act. The failure to adequately address creditor moral hazard is the third problem with Dodd-Frank resolution.

The fourth problem is expertise. With ordinary banks, the FDIC has both the experience and expertise necessary to handle bank failures reasonably well. If our predictions about Dodd-Frank resolution are even close to correct, the FDIC would essentially be running a systemically important financial institution for at least a year or two if the resolution rules were invoked.[54] The FDIC does not have the staff or expertise necessary to run a major financial institution. Since the Dodd-Frank Act was enacted, the FDIC has been scrambling to scale up its capacity, but it is nowhere near well positioned to manage a financial institution like Citigroup or Bank of America. Questions about the FDIC's competence could undermine its ability to preserve confidence in the bridge financial institution during the transition period.

To be sure, several factors may mitigate the expertise deficit to some extent. The first is that the FDIC does not need to have all of the relevant experts in house. Much as restructuring experts are brought on to help in ordinary corporate bankruptcies, the FDIC could hire managers to run a financial institution in resolution.[55] In addition, if the living wills that are now required by Dodd-Frank are implemented effectively, regulators will not be starting from scratch at the outset of the resolution process. Nevertheless, the FDIC's expertise deficit raises very serious questions about its ability to handle the failure of a systemically important financial institution. The deficit is exacerbated by the fact that the FDIC is not a systemically important institution's primary regulator; in the absence of financial distress, the Federal Reserve plays that role. Even if the FDIC succeeds in closing some of the expertise deficit in the near term, it is far from clear that it can retain the highly-qualified experts it needs over the long haul, particularly if there is little for them to do between crises—which we hope will be the norm! The FDIC is likely to be better prepared now than it will be if resolution is first invoked five years from now, or ten.

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[53] *See The Ruling Ad-Hocracy,* WALL ST. J., Jan. 21, 2011, at A12.

[54] Recall that one of the consequences of administrative resolution under Title II of Dodd-Frank is the likely termination of management of the financial institution, giving real punch to the notion of the FDIC "running" the institution.

[55] How easily a complete team of such managers—with relevant experience—could be assembled remains to be seen; we tend to believe it may be a serious practical problem given that there will be little, if any time, for a new management team to come "up to speed."

D. Potential Benefits

As we turn from the problems with Dodd-Frank resolution to its potential benefits, we are reminded of Barack Obama's grudging allowance, during a 2008 debate, that Hillary Clinton was "likeable enough."[56] Although we are not a great deal more enthusiastic about Dodd-Frank resolution than Obama was about his then-opponent, it does offer several possible benefits.

The first benefit is that the resolution rules give the FDIC the capacity to intervene quickly and with ample funding to support ongoing business operations. This is of course the flipside of the propensity for regulators to bail out troubled institutions. The FDIC is authorized to borrow up to 10% of the book value of the institution as of the time it is taken over, and 90% of its value in resolution.[57] For the largest of banks, this would make over $200 billion available as of the time of the take-over, and far more under an aggressive interpretation of the 90% standard the moment the resolution was underway.[58] A bridge financial company might even have access to the Federal Reserve's discount window. Although the discount window is only available to solvent financial institutions, nothing bars a bridge financial institution from qualifying so long as enough liabilities are left behind to leave it solvent.[59] Given these financing options, the FDIC should be fully capable of keeping any essential functions operating and paying any counterparties as needed.

A second benefit is the possibility of regulatory coordination. The Dodd-Frank Act itself does not contribute a great deal to the international dimensions of a default of a systemically important financial institution. Its major innovation in this regard is the new requirement that systemically important financial institutions prepare a rapid resolution plan—or "living will."[60] As a result, any coordination on an international level will have to take place on an *ad hoc* basis. To some extent, regulators already interact through international conferences and periodic meetings. Although this is not a robust solution to the international problems that attended the Lehman default, it may be that networks of regulators will be better able to coordinate an international proceeding than bankruptcy judges are. Truth be told,

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[56] *See, e.g.*, Amy Bingham, *"Likeable Enough" Hillary Clinton Now More Well-Liked Than Obama*, ABC News, (Mar. 30, 2011), http://abcnews.go.com/blogs/politics/2011/03/likeable-enough-hillary-clinton-now-more-well-liked-than-obama/.

[57] Dodd-Frank Act § 210(n).

[58] Bank of America, for instance, has $2.1 trillion in assets, which would give the FDIC access to over $210 billion. *See, e.g.*, *Total Assets Rankings*, Y-Charts, http://ycharts.com/rankings/assets (last visited Apr. 3, 2012) (ranking of bank assets).

[59] Note that this may be a procedural way around the supposed restrictions on the Fed under 13(3). 12 U.S.C. § 343. That is, if the regulators want to use a coerced merger, and guarantee obligations, they run the troubled institution through OLA for an instant, issue the guarantee, and then consummate the merger (and close down the OLA)—pointing, proudly, to the fact that the troubled institution has indeed "disappeared," thus complying with the strictures of Dodd-Frank.

[60] *See* Dodd-Frank Act § 165(d).

however, all of these *ad hoc* interventions are patches in the absence of agreements among the major nations (the United States and Great Britain in particular) about sorting out complex international financial institutions. Moreover, regulators may prove even more territorial, and more protective of assets within their jurisdiction in the event of a crisis, than judges are.

II. The Bankruptcy Alternative

Even the most fervent advocates of the new resolution approach have stated that bankruptcy is the presumptive mechanism for resolving the financial distress of all but the most systemically important financial institutions.[61] The question, in a sense, is how big is the set of institutions that require resolution? Although we identify several important limitations of bankruptcy in the discussion that follows, we conclude that its benefits as compared to administrative resolution are considerable, which suggests that lawmakers should seek to make the set of institutions that require administrative resolution as small as possible.[62]

A. The Bankruptcy Process

Although it is quite simple for creditors to file an involuntary bankruptcy, the overwhelming majority of cases are initiated by the debtor's managers.[63] Once a bankruptcy petition has been filed, because its goal is a collective determination of the highest-and-best use of the firm's assets and an allocation of rights according to pre-bankruptcy priorities, the so-called automatic stay (and related rules) prohibits most creditors from grabbing or selling collateral, pursuing litigation against the debtor, terminating contracts based on the fact that the debtor is insolvent or in bankruptcy, or otherwise attempting to collect pre-bankruptcy obligations.[64] Of significant importance for financial institutions, because of special provisions added after the original Bankruptcy Code of 1978, derivatives, repos and other qualifying financial contracts are not subject to most aspects of this automatic stay.[65]

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[61] *See* Treasury White Paper, *supra* note 20, at 77 (indicating that "[b]ankruptcy is and will remain the dominant tool for handling the failure of a [bank holding company] . . . .").

[62] We discuss in this part the current bankruptcy process. We believe that bankruptcy can be made significantly more effective for the largest financial institutions; we take these reforms up *infra* Part V.B.

[63] *See Bankruptcy*, State Bar of Montana, http://www.montanabar.org/displaycommon.cfm?an=1&subarticlenbr=24 (last visited Mar. 24, 2012).

[64] *See* 11 U.S.C. § 362 (automatic stay).

[65] The special treatment of derivatives and other financial contracts is explored in detail in David A. Skeel, Jr. & Thomas H. Jackson, *Transaction Consistency and the New Finance in Bankruptcy*, 112 Colum. L. Rev. 152 (2012). *See also* Darrell Duffie & David A Skeel, Jr., *A Dialogue on the Costs and Benefits of Automatic Stays for Derivatives and Repurchase Agreements* 2 (Rock Ctr. for Corporate Governance at Stanford Univ., Working Paper No. 108, 2012).

Derivatives counterparties can therefore terminate their contracts or sell collateral in their possession, unobstructed by bankruptcy's ordinary stay rules.

In a traditional bankruptcy, the debtor negotiates with its creditors over the terms of a reorganization plan.[66] When the terms of a plan are in place, the debtor drafts a disclosure statement describing its terms, and the disclosure statement is sent (after court approval) to each creditor or shareholder.[67] The plan is thus submitted to a vote, and if the proper majorities of each class of creditors and shareholders approve the plan, and a number of other requirements are met, the plan is confirmed by the bankruptcy judge.[68] Even if one or more classes objects, the plan can still be approved through a nonconsensual "cramdown" if, among other things, the plan does not discriminate unfairly and satisfies the absolute priority rule.[69]

One obvious difference between financial institution bankruptcies and a traditional bankruptcy is that a substantial portion of a financial institution's assets are often sold very early in the case, because their value to the debtor will evaporate otherwise.[70] Thus, financial institution bankruptcies often involve a prompt sale of time-sensitive assets, followed by a more leisurely decision making process with the institution's other assets. Lehman's brokerage operations were sold four days after Lehman filed for bankruptcy, for instance.[71]

B. Benefits of Bankruptcy

The bankruptcy process has three very important benefits as compared to an administrative resolution process. The first can be loosely described as rule of law virtues. Unlike FDIC resolution of banks, the bankruptcy process is transparent; it is governed by clear priority rules; and it gives creditors a full judicial opportunity to challenge treatment that does not, in their view, honor their entitlements.[72] It is important to acknowledge that bankruptcy is not perfect in this regard. The priority rules are largely but not completely honored. In most jurisdictions, courts permit a debtor to pay its "critical venders" in full, for instance, even though they technically are general credi-

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[66] *See* 5 Norton Bankr. L. & Prac. § 97:31 (3d ed. 2012).

[67] *See* 11 U.S.C. § 1125 (2006) (disclosure and solicitation).

[68] *See* 1 Norton Bankr. L. & Prac. § 3:14 (3d ed. 2012).

[69] *See* 11 U.S.C. § 1129(b). Dissenting creditors are thus protected by a judicially-determined liquidation standard, *see* 11 U.S.C. § 1129(a)(7); dissenting classes are protected by a judicially-determined payment-in-full standard, *see* 11 U.S.C. § 1129(b). While not perfect, the standards are clear and the determinations are made by a neutral decisionmaker.

[70] *See* U.S. Gov't Accountability Office, GAO-11-707, Complex Financial Institutions and International Coordination Pose Challenges 48 (2011), *available at* http://www.gao.gov/products/GAO-11-707.

[71] Julia Werdigier & Landon Thomas Jr., Barclays Agrees to Buy Some Lehman Assets, N.Y. Times (Sept. 17, 2008), http://www.nytimes.com/2008/09/17/business/worldbusiness/17barclays.html.

[72] *See* 6 Norton Bankr. L. & Prac. § 113:3 (3d ed. 2012).

tors.[73] Judicial review is sometimes limited by the difficulty of raising and litigating an issue before it becomes moot. Overall, however, bankruptcy priorities are much firmer and clearer than creditors' treatment in an administrative proceeding. This clarity is likely to enhance credit market efficiency as compared to murkier priority rules.

The second benefit of bankruptcy is that the prospect that shareholders and creditors will take losses curbs moral hazard. In 2008, the government punished the shareholders and managers of firms such as AIG that were bailed out, ousting the managers and diluting shareholders.[74] Creditors, by contrast, were fully protected.[75] Nor is there reason to believe that creditors will be punished in future bailouts. This approach invites creditor moral hazard. If a financial institution is likely to be resolved in bankruptcy, by contrast, creditors cannot assume they will be bailed out and are more likely to screen and monitor their debtors as a result. Given that solving financial difficulties will usually be easier when there is "early intervention," and given that there is a strong consensus that most interventions—whether bankruptcy or administrative resolution—occur too late, making it clear that creditors have "skin in the game" is an important way to bring their knowledge and monitoring abilities to bear.

Third, in bankruptcy, the parties themselves make the principal decisions, rather than a government regulator. Because the parties have more complete information than even the most vigilant regulator and creditors have a financial stake in how assets are used and how liabilities are treated, the financial distress is more likely to be resolved efficiently (at least if the parties do not have a disincentive to file, an issue we return to in the next section).

C. The Limitations of Bankruptcy

Bankruptcy also has three major limitations.[76] We consider the first two here. Because the third—the court and its jurisdiction—may be less familiar and has been less fully explored, we discuss it separately in the next section.

The first criticism of bankruptcy is that it is not well designed to handle systemic issues. This criticism is often characterized in terms of the limited

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[73] *See* Anthony Michael Sabino, *The Death of Critical Vendor Motions and Potential Demise of the Doctrine of Necessity: Farewell to Two Misbegotten Doctrines*, 6 TENN. J. BUS. L. 47, 48 (2004). This may make sense in some situations, particularly where the vendors are, in fact, irreplaceable and there is a strong argument that the firm has going-concern value. Similarly, honoring warranties on pre-bankruptcy sales may be a necessary component of a consumer-goods manufacturer (or retailer) that warrants continuation rather than liquidation. Even so, the potential for an "overly enthusiastic" interpretation of these situations remains.

[74] *See* Michael J. de la Merced, *A.I.G.'s New Chief Seeks to Reassure Workers*, N.Y. TIMES, Sept. 19, 2008, at C4.

[75] Brady Dennis, *Fed Criticized for Not Negotiating Harder with AIG Creditors*, WASH. POST, Nov. 17, 2009, at A24.

[76] Its ability to handle complex international bankruptcies is perhaps a fourth. Since we have already discussed this as a potential advantage of Dodd-Frank, we won't repeat it here.

focus of the bankruptcy process.[77] Bankruptcy is designed to maximize the value of a particular firm, the argument goes; in contrast to bank regulators, the principal players do not consider third party effects such as the possibility that a filing will have systemic consequences.[78] The distinction between bankruptcy and administrative resolution is not as sharp as this argument often assumes. Bankruptcy judges do not ignore systemic issues.[79] But neither they nor the parties can take control as fully and effectively at the outset of a case as regulators can under the Dodd-Frank resolution rules. The difficulty is exacerbated by the absence of a stay on derivatives, which are often the most systemically sensitive contracts. These limitations will not prove debilitating in the vast majority of cases—even with Lehman, for instance, no counterparties failed after the company's default[80]—but in a few they might.

Second and related, financing cannot be put in place as quickly in bankruptcy as in administrative resolution. Financing is ordinarily approved through a two-step process—an interim hearing at the outset of the case, and a final hearing a week or two thereafter.[81] If the debtor needs immediate liquidity, even a temporary delay at the beginning of a case could be problematic. The funding limitations should not be overstated. As soon as the debtor files for bankruptcy, the automatic stay goes into effect with most obligations, and the debtor does not have to continue making payments.[82] Derivatives are a major exception to this.[83] But a financial institution could stop payments on other obligations, such as bonds, which would reduce its funding needs somewhat. In addition, bankruptcy does not preclude the gov-

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[77] *See, e.g.*, Christopher W. Frost, *Bankruptcy Redistributive Policies and the Limits of the Judicial Process*, 74 N.C. L. Rev. 75, 98 (1995).

[78] *See, e.g.*, Adam J. Levitin, *In Defense of Bailouts*, 99 Geo. L.J. 435, 483 (2011) (discussing the potential harmful consequences of bankruptcy imposed on systemically important institutions).

[79] Systemic issues can be overstated; correlation is not necessarily causation. *See* John Taylor, *Defining System Risk Operationally*, *in* Ending Government Bailouts as We Know Them 33 (Kenneth Scott et al., eds., 2009).

[80] *See* Jean Helwege, *Financial Firm Bankruptcy and Systemic Risk*, 20 J. Int'l. Fin. Markets, Insts. & Money 1, 6 (2010).

[81] *See* Douglas Baird & Martin Bienenstock, *Panel 5: Debtor-in-Possession Financing (Pre-Petition & Lock-Up Agreements)*, 1 DePaul Bus. & Com. L.J. 589, 594 (2003). These can be accelerated, particularly where there has been pre-bankruptcy planning. In the recent Eastman Kodak bankruptcy, for example, almost a billion dollars of new funding was made available, with administrative expense priority, within 24 hours of Kodak's bankruptcy filing. *See* Joseph Checkler, *Judge Says Kodak Can Tap $950M Bankruptcy Loan From Citi*, Daily Bankr. Rev. (Jan. 20, 2012), *available at* http://bankruptcynews.dowjones.com/article?pid=10&an=DJFDBR0020120120e81kdb07v&ReturnUrl=http%3a%2f%2fbankruptcynews.dowjones.com%3a80%2farticle%3fpid%3d10%26an%3dDJFDBR0020120120e81kdb07v.

[82] *See* 11 U.S.C. § 362 (2006).

[83] *See id.*

ernment from offering backup funding, as the government did with Lehman's brokerage operations at the outset of its bankruptcy case.[84]

Nevertheless, systemic issues and the timely availability of funding are greater concerns in a bankruptcy case than in administrative resolution.

D. The Role and Status of Bankruptcy Judges

The final major limitation of bankruptcy concerns the status of bankruptcy judges. The status of bankruptcy judges poses two problems. One is inherent in the bankruptcy process; the other is an artifact of the odd, artificial structure of the U.S. bankruptcy courts.

Casual observers of bankruptcy often assume that the bankruptcy judge dictates the terms of a reorganization plan and makes the other important decisions in the case. In reality, the bankruptcy judge functions more like an umpire than a player in most respects. The parties themselves decide whether to sell assets or to propose a reorganization, and the judge either approves or disapproves their handiwork.[85] The limited role that the court plays, and the wide scope the parties are given to determine the resolution of the case, is part of the genius of bankruptcy. But it also introduces a complication. Because the judge's role is reactive, she has only limited information at the outset of the case. If important decisions need to be made very quickly, as often is the case in large bankruptcies and will almost always be the case if the debtor is a large financial institution, the judge is put in a difficult position. After Lehman filed for bankruptcy, the bankruptcy judge was asked to approve the sale of Lehman's brokerage operations to Barclay's almost immediately, based on relatively limited information.[86] The judge does have the benefit of the debtor's having concluded that the transaction is in its best interests, but many creditors will not be in a position to weigh in effectively, so the judge herself may have to exercise discretion based on much less information that would be ideal.

Bankruptcy judges' other limitation stems from their odd constitutional status. Unlike federal trial judges, circuit court judges, and Supreme Court justices, who are appointed for life under Article III of the Constitution, bankruptcy judges are Article I judges who serve for fourteen year terms.[87] This status is the result of a torturous history that came to head when the current bankruptcy laws were put in place in 1978.[88] Although it would have made obvious sense to give bankruptcy judges Article III status, Warren

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[84] *See* Alman Onaran and Christopher Scinta, *Lehman Files Biggest Bankruptcy After Suitors Balk*, BLOOMBERG (Sept. 15, 2008), http://www.bloomberg.com/apps/news?pid=newsarchive&sid=a6cDDYU5QYyw.

[85] *See* NORTON BANKR. L. & PRAC. Appendix § 112-A:7 (3d ed. 2012).

[86] *See* Stephen Lubben, *The Sale of the Century and Its Impact on Asset Securitization: Lehman Brothers*, AM. BANKR. INST. J., Dec. 2008–Jan. 2009, at 1.

[87] 9 AM. JUR. BANKRUPTCY § 825 (2d ed. 2012).

[88] *See generally* DAVID A. SKEEL, JR., DEBT'S DOMINION: A HISTORY OF BANKRUPTCY LAW IN AMERICA (2001).

Burger, the Chief Justice of the Supreme Court, and a number of other federal court judges resisted, apparently feeling that the status of the federal trial judges would be diluted if the large number of bankruptcy judges were given equivalent status.[89] Under the structure that was put in place in 1984, after the Supreme Court struck down the 1978 framework, bankruptcy judges were made adjuncts of the federal trial court.[90] Bankruptcy cases technically go to the district court, but every district automatically refers them back to these Article I bankruptcy judges.[91]

Because bankruptcy judges are not appointed for life, some worry that they are not sufficiently "independent" to handle especially sensitive cases.[92] The independence deficit seems minimal at most. Fourteen years is a considerable term—long enough to limit any concerns about job security—and the initial appointment process is less politically charged than with other federal judges, since the circuit court rather than politicians selects bankruptcy judges. Moreover, even the most politically-charged bankruptcy cases tend to raise significantly fewer political hackles than the kinds of issues that district judges routinely face, making the likelihood that reappointment becomes a political football unlikely.[93] Non-Article III status does, however, constrain bankruptcy judges on the margin. The limits were brought home last year when the Supreme Court held that a bankruptcy judge could not handle a dispute involving Anna Nicole Smith.[94] This jurisdictional limitation could easily be remedied, as discussed below. The limitations of an ex post overseer are more indigenous to bankruptcy itself.

III. Is Bail-In the Solution?

Especially in Europe, and increasingly in the U.S., the most popular resolution strategy among banking experts is not either bankruptcy or Dodd-Frank-style administrative resolution. The word that makes their eyes light up is "bail-in." The best way to earn appreciative nods at a banking conference is to propose that what we really need is "some kind of bail-in."

Just what is bail-in? The first step toward understanding bail-in and its popularity is to recognize that the bail-in concept predates the recent crisis. The term first came into common usage after the sovereign debt crises of the

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[89] *See* Troy A. McKenzie, *Judicial Independence, Autonomy, and the Bankruptcy Courts*, 62 Stan. L. Rev. 747, 761 (2010).

[90] 2 The Law of Debtors and Creditors § 11:4 (2011).

[91] Bankruptcy Law Manual § 2.1 (5th ed. 2011).

[92] *See, e.g.*, McKenzie, *supra* note 89, at 750–52 (noting and rejecting this concern).

[93] Reappointment battles are uncommon in general, and in the rare instances when they occur (as with the denial of reappointment to Judge David Scholl in the Eastern District of Pennsylvania in the 1990s), the denial has not been for political reasons. In re United States, 463 F.3d 1328, 1329–1330 (2006) (denial of Judge Scholl's reappointment the result of Third Circuit decision based on questionnaires regarding his competence submitted by attorneys and bankruptcy trustees who have appeared before him).

[94] *See* Stern v. Marshall, 131 S.Ct. 2594, 2601 (2011).

late 1990s and early 2000s, which culminated with the most recent Argentine default.[95] As unhappiness with the IMF's bailout policies grew, policy makers began talking about bail-in—by which they meant participation by private creditors in any rescue effort.[96] Less euphemistically, bail-in meant that private creditors should be expected to take haircuts—perhaps automatically and certainly by pre-existing knowledge of the possibility.

Under this conception of bail-in, it is easy to understand its initial attraction. The almost uniform protection of creditors in 2008 financial crisis, and the creditor moral hazard this created, has been widely criticized. A genuine bail-in would address this concern. But nothing mentioned thus far would distinguish bail-in from bankruptcy or even Dodd-Frank resolution—at least to the extent Dodd-Frank resolution would not bail out all of the financial institution's creditors. What, then, do bail-in proponents have in mind when they contrast it with bankruptcy and the OLA rules?

The answer seems to be that bail-in would preserve the financial institution as an ongoing entity, rather than liquidating it, and that regulators' discretion would be channeled. Under some of the existing proposals, bail-in would take place outside of the resolution process; under others, the bail-in would occur as a form of regulatory resolution.[97] Lawyers at Clifford Chance have proposed, for instance, that financial institutions be required to issue bail-in eligible senior debt.[98] If bail-in were triggered, the financial institution's stock would be wiped out and the bail-in eligible senior debt would be restructured.[99] Deposits and other obligations would be protected. This, they argue, would more effectively recapitalize the institution than simply wiping out stock and converting some low priority debt obligations to stock, as contingent capital-based proposals contemplate.[100]

It is perhaps worth noting that the FDIC could achieve the essentially the same effect under Dodd-Frank's resolution rules. At least in theory, the FDIC could set up a bridge financial company after invoking the resolution rules, transfer important assets and any liabilities that FDIC wishes to protect to the bridge financial company, and issue equity to the creditors that have been left behind.[101] Although this strategy would violate the spirit of the resolution rules, as discussed earlier, it would recapitalize the institution in the same way as the leading bail-in proposals advocate.

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[95] *See* NOURIEL ROUBINI & BRAD SETSER, BAILOUTS OR BAIL-INS? RESPONDING TO FINANCIAL CRISIS IN EMERGING ECONOMIES (2005).

[96] *See id.* at 3.

[97] *See, e.g.*, Riva Froymovich, *EU Insists on Bail-In as Part of Bank Resolution Legislation*, WALL ST. J. (Mar. 30, 2012), http://online.wsj.com/article/BT-CO-20120330-713022.html.

[98] *See* CLIFFORD CHANCE, *supra* note 14, at 9.

[99] *See id.*

[100] *See id.* at 6.

[101] *See generally* Randall G. Guynn, *Are Bailouts Inevitable?*, 29 YALE J. REG. 121 (2012) (outlining how this might work).

The chief attraction of bail-ins is the prospect of a prompt reconfiguration of the financial institution's capital structure. One possible strategy would be to conduct the bail-in entirely at the holding company level. This would minimize disruption of the institution's operations, since few of the operations of large American financial institutions are conducted in the holding company. So long as the parent holding company had sufficient debt in its capital structure, as currently is the case and could be mandated by law, the rest of the enterprise could be left intact. If the bail-in worked as designed, the basic contours of the restructuring would be put in place almost immediately. The actual distribution of securities to the old creditors might take longer, but creditors' entitlements would be determined much more quickly than in bankruptcy. The FDIC and at least one Federal Reserve governor appear to have embraced this general strategy. In a recent speech, Daniel Tarullo offered a succinct overview and endorsement:

> In developing the orderly liquidation authority established by Title II of the Dodd-Frank Act, the FDIC has recently expressed a preference for resolving a failed SIFI under a single receivership and internal recapitalization model. Under this model, the parent company of the failed SIFI is placed into receivership; all, or substantially all, of the assets of the parent company are transferred to a bridge entity; the parent company and its residual assets are liquidated; and the bridge entity is capitalized, in part, by converting the holders of long-term unsecured debt of the parent company into equity holders in the bridge. Under the single receivership model, the major subsidiaries of the SIFI continue to operate as going concerns. This approach holds great promise, but ensuring its viability as a resolution option requires, among other things, that each SIFI maintain an amount of long-term unsecured debt that is sufficient to absorb very significant losses at the firm.[102]

Bail-ins have many of the same shortcomings as traditional administrative resolution, however: in particular, most of the recent proposals depend on regulators to decide when to trigger the bail-in and how much of a haircut creditors should receive. The principal existing proposals contemplate that

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[102] *International Harmonization of Wall Street Reform: Orderly Liquidation, Derivatives, and the Volcker Rule: Hearing Before the S. Comm. on Banking, Housing, and Urban Aff.*,, 112th Cong., 5 (2012) (statement of Daniel K. Tarullo, Governor, Fed. Reserve Bd.), *available at* http://www.federalreserve.gov/newsevents/testimony/tarullo20120322a.htm; *see also* Enforcement of Subsidiary and Affiliate Contracts by the FDIC as Receiver of a Covered Financial Company, 77 Fed. Reg. 18128–29 (proposed Mar. 27, 2012) (stating that "orderly liquidation of a covered financial company may best be accomplished by establishing a single receivership of the parent holding company and transferring valuable operations and assets to a solvent bridge financial company, including the stock or other equity interests of the company's various subsidiaries. Accordingly, the Dodd-Frank Act provides the FDIC with the tools and flexibility to act effectively as receiver for the covered financial company at the holding company or parent level without placing solvent subsidiaries into receivership."), *available at* http://www.fdic.gov/regulations/laws/federal/2012/2012-03-27_proposed-rule_02.pdf.

long-term debt will be subject to bail-in, while regulators will protect short-term obligations.[103] The *extent* of the haircut is left to administrative discretion. In addition, the commitment to bail-out short-term obligations could magnify the temptation of financial institutions to rely on these forms of funding, which proved highly fragile in 2008.

There also is something incongruous about the strategy underlying bail-ins. The bail-in proposals assume that systemically important financial institutions must be preserved as going concerns. Not only is this assumption less compelling with financial institutions than with sovereign debtors—the original subject of bail-in proposals—but the bail-in proposals seem to assume that the institution's distress can be solved by making simple adjustments to its balance sheet. In reality, liquidity may be a more important concern for a troubled institution that regulators wish to rescue; a bail-in may ease a financial institution's liquidity constraints somewhat, but it doesn't solve a liquidity problem.

As an alternative to a bail-in that depends on the exercise of administrative discretion, a bail-in could also include automatic, market-based triggers. Contingent capital securities that are converted into equity if the issuer's capital falls below a specified level are in a sense a limited version of automatic bail-in.[104] This approach, which is the subject of an extensive legal literature in the corporate bankruptcy context,[105] could be used more fully, to provide for automatic haircuts to other classes of securities. The attraction of this approach is that it addresses the problem of regulator delay or inaction. Its limitations are also considerable, however, as is well known.[106] The most obvious triggers—such as capital requirements—could be manipulated by a troubled financial institution. Automatic triggers may also be subject to manipulation by the institution's creditors. The trigger also may be over-inclusive or under-inclusive, particularly where the issue is liquidity rather than capital.[107] As the turmoil in Greece has made clear, regulators may also be reluctant to allow the markets to function in a crisis.[108] Just as regulators

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[103] *See, e.g.*, CLIFFORD CHANCE, *supra* note 14, at 7 (stating that "if the bank is to be preserved as a going concern its 'trade creditors'—payment services customers, short term creditors, securities and trading exposures, etc.—must be preserved intact, and for the purposes of illustration it can be assumed that the bail-in process will be applied to the long-term investment creditors of the bank—loosely, bondholders and holders of subordinated debt.").

[104] John Coffee has recently written a similar proposal. John C. Coffee, *Systemic Risk After Dodd-Frank: Contingent Capital and the Need for Regulatory Strategies Beyond Oversight*, 111 COLUM. L. REV. 795 (2011).

[105] *See, e.g.*, Barry E. Adler, *Financial and Political Theories of American Corporate Bankruptcy*, 45 STAN. L. REV. 311 (1993); Michael Bradley & Michael Rosenzweig, *The Untenable Case for Chapter 11*, 101 YALE L.J. 1043 (1992).

[106] *See, e.g.*, David A. Skeel, Jr., *Markets, Courts, and the Brave New World of Bankruptcy Theory*, 1993 WIS. L. REV. 465, 477–94 (1993).

[107] *See* CEYLA PAZARBASIOGLU ET AL., IMF STAFF DISCUSSION NOTE, CONTINGENT CAPITAL: ECONOMIC RATIONALE AND DESIGN FEATURES 7, 16 (2011), *available at* http://www.imf.org/external/pubs/ft/sdn/2011/sdn1101.pdf.

[108] *See* Louise Story & Stephen Castle, *Four European Nations to Curtail Short-Selling*, N.Y. TIMES, Aug. 11, 2011, at B1 (late edition); Julien Toyer, *EU Reaches Deal on Law to Ban*

repeatedly insisted that Greece's obligations must be restructured without technically defaulting, so that the credit default swaps on Greek bonds were not triggered, there is a real risk they would defuse an automatic bail-in.[109]

IV. Regulator-Brokered Sales

During the height of the financial crisis in 2008, a different strategy was used to resolve the financial distress of several of the large financial institutions that threatened to collapse. Federal regulators brokered the sales of Bear Stearns to JP Morgan Chase, Washington Mutual to JP Morgan Chase, and Wachovia to Wells Fargo.[110] Although the new resolution rules might seem to replace regulator-brokered sales as a resolution strategy, this is unlikely to be the case. The resolution rules may even increase the salience of the forced sale option.

Of the three transactions just mentioned, the Bear Stearns sale looked most like a traditional bailout, and thus like a scenario the Dodd-Frank Act is designed to supersede. As a now-voluminous literature recounts, federal regulators agreed to guarantee $29 billion in problematic assets as a condition of JP Morgan's purchase of Bear Stearns.[111] JP Morgan purchased the banking assets of Washington Mutual as part of a purchase and assumption transaction brokered by the FDIC under the bankruptcy resolution rules; and Wells Fargo acquired Wachovia after Wachovia had received funding (known as Open Bank Assistance) from the FDIC.[112]

The first issue, already alluded to, is the continued relevance of coerced sales after the enactment of new formal resolution rules. Because each company in question was a substantial holding company, each would have been subject to Dodd-Frank resolution if regulators concluded that it met the requirements for invocation of the resolution rules.[113] Theoretically, new restrictions on the Federal Reserve's authority to make extraordinary loans

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Naked Sovereign CDS, Reuters (Oct. 18, 2011), *available at* http://www.reuters.com/article/2011/10/18/eu-shortselling-idUSL5E7LI3L920111018.

[109] *See* Peter Eavis, *Greek Crisis Raises New Fears Over Credit-Default Swaps*, Dealbook (Feb. 21, 2012, 9:06 PM), http://dealbook.nytimes.com/2012/02/21/greek-crisis-raises-new-fears-over-credit-default-swaps/.

[110] Fin. Crisis Inquiry Comm'n, The Financial Crisis Inquiry Report 290, 365, 370 (2011) [hereinafter FCIC Report].

[111] *See, e.g.*, *id.* at 290.

[112] *See* Purchase and Assumption Agreement Among Federal Deposit Insurance Corporation, Receiver of Washington Mutual Bank, and JPMorgan Chase Bank (Sept. 25, 2008), *available at* http://www.fdic.gov/about/freedom/Washington_Mutual_P_and_A.pdf; *The Acquisition of Wachovia Corporation by Wells Fargo & Company: Hearing Before the Fin. Crisis Inquiry Comm'n* (Sept. 1, 2010) (statement of Scott G. Alvarez, General Counsel, Fed. Reserve Bank), *available at* http://www.federalreserve.gov/newsevents/testimony/alvarez20100901a.htm.

[113] *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 203, 124 Stat. 1376, 1450–1454 (2010). (process by which institution is determined to be systemically risky, which is necessary for it to be subject to orderly liquidation authority).

would prevent it from providing a $29 billion backstop in the future.[114] But the new regulatory framework would not necessarily preclude either the Washington Mutual or Wachovia transactions. Moreover, the Fed might be able to circumvent the new restriction on emergency loans if it made the loan available as part of a "broad-based eligibility" program, rather than targeting only the intended recipient of the loan.[115]

Indeed, if Dodd-Frank resolution has made direct bailouts—such as the bailout of AIG—less likely, regulators may have even stronger incentives to try to arrange a sale outside of formal resolution proceedings. Although the resolution rules give regulators enormous power, they also leave the regulators responsible for the outcome of the takeover. If the regulators arrange a sale outside of resolution, they can largely remove the risk that the intervention will blow up in their face. Coerced sales will therefore continue to be an important resolution option.

Coerced sales raise two concerns of particular note. First, they invariably make a large institution even larger. If one is concerned about systemic consequences from the distress of large financial institutions, a coerced sale could make the potential for systemic consequences worse by postponing without actually solving the problem. Second, these sales invite interference with rule of law. The merger of Bear Stearns into JP Morgan Chase included provisions that violated corporate law,[116] and the sale of Wachovia to Wells Fargo was made possible by a change to its potential tax treatment.[117] While rules can tamp down on these violations, it is not completely clear that they can be eliminated.[118]

V. Implications and Potential Reforms

In the wake of Dodd-Frank's enactment, we are no longer writing on a blank slate in the United States. Dodd-Frank and its resolution rules are unlikely to be repealed. For the foreseeable future, the two basic options will be, as they now are, bankruptcy and Dodd-Frank resolution.

The analysis of this Article suggests that the principal focus of reform should be maximizing the effectiveness and likelihood of use of the bankruptcy process as an alternative to Dodd-Frank resolution, and amending a few of the most problematic provisions in Dodd-Frank. We begin by describ-

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[114] *See id.* § 1101(a) (amending § 13(3) of the Federal Reserve Act to authorize only broad-based eligibility programs).

[115] *See id.*

[116] *See, e.g.*, Marcel Kahan & Edward Rock, *How to Prevent Hard Cases from Making Bad Law: Bear Stearns, Delaware, and the Strategic Use of Comity*, 58 Emory L.J. 713, 744 (2009) (describing the transaction as "pretty clearly invalid under current Delaware law.").

[117] *See* FCIC Report, *supra* note 110, at 370.

[118] Posner and Vermuele heavily emphasize this theme. *See* Eric Posner & Adrian Vermeule, *Crisis Governance in the Administrative State: 9/11 and the Financial Meltdown of 2008*, 76 U. Chi. L. Rev 1613, 1613–14 (2009).

ing a handful of simple adjustments, then turn to a slightly more elaborate proposal to enact a new bankruptcy chapter for large financial institutions.

A. Next Steps for Dodd-Frank and Bankruptcy Reform

In our view, four simple reforms would make the current resolution options appreciably more effective. The first is simply to remove the "thou shalt liquidate"—and related—provision from Dodd-Frank's resolution rules. As critics of the ad hoc bailouts of 2008, we are sympathetic to the impulse that led to the provision. But foreclosing the prospect of reorganization is at odds with over a century of American insolvency law, and few believe that regulators will actually honor the liquidation mandate if the resolution rules are ever invoked. Moreover, the related insistence that management be terminated likely removes the individuals with the best firm-specific knowledge to make decisions in the rapid time-frame any resolution proceeding must work in, at least in part.

The second and third proposals would establish presumptions that could be implemented by bank regulators, without a need for legislative reform. As it currently stands, nothing in Dodd-Frank requires that either regulators or the financial institution that prepares a "living will" actually follow the blueprint of the living will. If regulators committed to honor its terms—in particular, by not invoking Dodd-Frank's resolution rules if the living will contemplates use of bankruptcy in the event of financial distress—the plans would prove more useful and more firms might use bankruptcy rather than Dodd-Frank resolution. Relatedly, Dodd-Frank gives regulators the power to override a bankruptcy filing, and put a firm that has filed for bankruptcy in resolution.[119] This power will create a great deal of uncertainty at the outset of a bankruptcy case. Establishing a strong presumption that regulators will not pluck financial institutions out of bankruptcy would reduce some of the uncertainty.

The last and most important reform would remove the special treatment derivatives and other qualified financial contracts currently receive in bankruptcy. As we have argued in detail elsewhere, subjecting these contracts to a short stay would appreciably enhance the effectiveness of bankruptcy as a resolution mechanism for financial institutions.[120] If derivatives were subject to a stay, the managers of AIG might have considered bankruptcy as a plausible option, since it would have enabled them to stop the collateral grabs that began when AIG was downgraded.

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[119] *See* Dodd-Frank Act § 208.

[120] *See, e.g.*, Skeel & Jackson, *supra* note 65; Chapter 14 Proposal, *supra* note 19, at 2-22–27.

B. A More Ambitious Program: Chapter 14

A working group at the Hoover Institution (of which we are both participants) has devised a set of proposals for large financial institutions (defined as those with more than $100 billion in assets)—called Chapter 14—that would go still further in making bankruptcy an effective resolution mechanism for nearly any large financial institution.[121] Chapter 14 would address several of the limitations of bankruptcy discussed earlier. Of particular note are its proposals for regulator participation, funding in bankruptcy, and the use of Article III judges. The Chapter 14 proposal would marry some of the benefits of administrative resolution with those of bankruptcy.[122]

Start with the role of regulators. In an ordinary Chapter 11 case, the regulators' ability to participate is quite constrained. Perhaps most importantly, they cannot initiate the bankruptcy case.[123] The Chapter 14 proposal would explicitly authorize regulators to file an involuntary bankruptcy case against an insolvent financial institution that was of sufficient financial size;[124] and it would give regulators standing to appear and be heard on any issue in the case.[125] Although regulators have traditionally been slow to take action, this proposal would enable them to file a case if managers failed to do so, and it provides a mechanism for tapping the information regulators have as a result of their ongoing supervisory role.[126] In addition, it ensures that there will be a voice for systemic consequences in the bankruptcy proceeding.

The second innovation involves funding. Bankruptcy already facilitates financing through its debtor-in-possession financing provision, which gives the court wide latitude to approve new loans.[127] Under the Chapter 14 proposal, the debtor would be explicitly authorized to use some of this financing to make immediate, partial payments to creditors (such as derivatives counterparties) with time sensitive claims.[128] If the initial payment gives these creditors more than other general creditors eventually receive, the difference could be clawed back.[129] But any clawback would occur much later,

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[121] *See* Chapter 14 Proposal, *supra* note 19.

[122] The proposal is similar to proposals by Robert Bliss and George Kaufman in this regard. *See* Robert R. Bliss & George G. Kaufman, *Resolving Insolvent Large Complex Financial Institutions: A Better Way*, 128 BANKING L.J. 339 (2011).

[123] *See* 11 U.S.C. §§ 301, 303 (only debtors and creditors may initiate a Chapter 11 case).

[124] The Chapter 14 proposal is limited to financial institutions with at least $100 billion in assets. Chapter 14 Proposal, *supra* note 19, at 1-3.

[125] Chapter 14 Proposal, *supra* note 19, at 2-9, 2-11.

[126] *See id.*

[127] *See* 11 U.S.C. § 364

[128] Chapter 14 Proposal, *supra* note 19, at 2-15.

[129] *Id.* at 2-34–35.

after the initial crisis had passed. This should appreciably reduce the risk that the filing would have problematic systemic effects.[130]

One question not fully addressed in the current Chapter 14 proposal is the potential gap between the moment of the filing and the time at which debtor-in-possession financing is put in place. In ordinary Chapter 11 cases, courts approve financing quite quickly, often within a day or two. If the debtor is a financial institution, even a brief delay may be problematic, given the speed at which liquidity can disappear. As noted earlier, the automatic stay relieves a debtor's liquidity needs somewhat, by halting the obligation to make payments on pre-bankruptcy obligations. In addition, the debtor can minimize the gap by arranging its financing prior to filing for bankruptcy. But even a small gap may be problematic. This suggests that it may make sense to give financial institutions that were amenable to Chapter 14 access to a government funding facility on terms analogous to those provided in Dodd-Frank's administrative resolution process that would not require court approval.[131] In practice, this approach might function somewhat similarly to the "blended approach" advocated by several recent commenters. The blended approach proposes the administrative resolution be used for systemically important functions like the payment system, while the remainder would be resolved in bankruptcy.[132] Under Chapter 14, bankruptcy would be used in both contexts, but immediate funding could be used to protect essential functions.

A third innovation of Chapter 14 is its proposed judicial framework. Under Chapter 14, the case would be overseen by a federal district court judge selected by the Chief Justice of the United States from a panel of judges with financial expertise.[133] This would address any concerns about independence or jurisdictional scope. Chapter 14 also would explicitly authorize the judge to make use of special masters if he wished to bring additional expertise into the case.

If fully implemented, Chapter 14 would make a number of other adjustments as well. It would reshape the existing bankruptcy rules to handle the distinctive challenges posed by the financial distress of one or more of the largest financial institutions.

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[130] This proposal is similar to proposals by George Kaufman. *See* George G. Kaufman, *A Proposal for Efficiently Resolving Out-of-the-Money Swap Positions at Large Insolvent Banks*, 9 J. BANKING REG. 3 (2007).

[131] To that extent, the regulator, not the bankruptcy judge, would be the gatekeeper of the first-stage of post-petition funding.

[132] *See, e.g.*, Bliss & Kaufman, *supra* note 122, at 357; Thomas J. Fitzpatrick IV et al., *The History and Rationale for a Separate Bank Resolution Process*, FED. RES. BANK OF CLEVELAND ECON. COMMENT., Feb. 2, 2012, at 3.

[133] Chapter 14 Proposal, *supra* note 19, at 2-7.

Conclusion

In this Article, we have compared the two principal mechanisms for resolving the distress of a large financial institution, administrative resolution and bankruptcy, in the particular context of the new Dodd-Frank resolution rules and U.S. bankruptcy laws. We also have considered recent proposals for "bail-in" of large financial institutions, which turn out to be more similar to Dodd-Frank than might initially seem to be the case. The principal sticking point with each is the dependence on administrative discretion. In the United States, at least, the objective should be to make bankruptcy as effective as possible and to minimize the need—and opportunity—for regulators to invoke Dodd-Frank resolution. We have suggested a handful of changes to the Dodd-Frank Act and to the bankruptcy laws that might help further this objective.