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Bankruptcy for Banks: A Tribute (and Little Plea) to Jay Westbrook

David Skeel

Jay Westbrook articles are fun to read. When the latest reprint arrives, I always read at least a few pages, and usually read it all, no matter the topic. Jay is of course one of the top private law scholars of the past generation. But the promise of clever metaphors and unexpected connections is what pulls me in first. Who else would call the executory contract rules “psychedelic” or dismiss an aspect of their use as “like discussing a sunset after dark?”¹

This is a tribute, so I’ll take my time getting to my assigned topic: a conversation with Jay about possible “bankruptcy for banks” legislation.

Thirty years ago, when I first encountered Jay’s work, I was primed to view it with suspicion. Law and economics was in its adolescence, and there was a sharp divide between its advocates and its critics. Law and economics scholars viewed bankruptcy’s role as limited to avoiding the “race to the courthouse” that might ensue in the absence of bankruptcy, due to creditors’ inability to coordinate.² Although bankruptcy is needed to solve the creditors’ collective action problems, it should not otherwise interfere with the parties’ nonbankruptcy rights. Bankruptcy’s role is primarily procedural, as one of the pioneers of this perspective put it.³ Critics of this perspective—call them progressives—insisted on a more robust role for bankruptcy. Bankruptcy should seek to facilitate reorganization, and it needs to mediate among the diverse interests of the stakeholders of the troubled debtor.⁴

Jay was a pillar of the progressive camp. Jay cheerfully and consistently critiqued the law and economics perspective.⁵ As a child of law and economics, and having employed it in much of my own writing (and having bracketed any tensions with my literature background), I took up residence on the opposite side of the bankruptcy divide.

¹ Jay Lawrence Westbrook, *A Functional Analysis of Executory Contracts*, 74 TEX. L. REV. 227, 228, 243 (1989).

² Our foundation text was THOMAS JACKSON, *THE LOGIC AND LIMITS OF BANKRUPTCY* (1986).

³ Douglas G. Baird, *Bankruptcy’s Uncontested Axioms*, 108 YALE L.J. 573 (1998).

⁴ Their foundation text, written by Jay’s most illustrious protégé, was Elizabeth Warren, *Bankruptcy Policy*, 54 U. CHI. L. REV. 815 (1987).

⁵ For a more recent example, see Jay Lawrence Westbrook & Elizabeth Warren, *Contracting Out of Bankruptcy: An Empirical Intervention*, 118 HARV. L. REV. 1197 (2005).

Yet I found that I liked Jay’s work a great deal, even agreed with some of it. Jay and his co-authors Teresa Sullivan and Elizabeth Warren had already published *As We Forgive Our Debtors*,⁶ the first of the books that emerged from their landmark study of consumer bankruptcy, and *The Fragile Middle Class* would appear a few years later.⁷ Law and economics scholars grumbled that Jay and his co-authors had cherry-picked their data—after all, how else could it so strongly confirm the vulnerability of bankruptcy debtors?—but none questioned the seriousness and significance of the project. Jay and his co-authors had examined thousands of consumer bankruptcy filings, producing the most extensive empirical analysis of U.S. consumer bankruptcy ever, long before empirical legal scholarship became fashionable.

Another article that Jay published during this period spoke more directly to corporate bankruptcy scholars. In *A Functional Analysis of Executory Contracts*, Jay sought to reconceptualize the handling of executory contracts in bankruptcy.⁸ From the very first sentence, Jay lures the reader in: “Bankruptcy is that volume of the law that might have been written by Lewis Carroll,” he writes, “every conventional legal principle refracted through the prism of insolvency.”⁹ “In no chapter of that volume,” he continues, decades before we learned LSD may be good for us, “has the law become more psychedelic than in the one titled “executory contracts.”¹⁰

According to the standard view, which derived from an article by Vern Countryman, a key predecessor of Jay’s and his fellow bankruptcy progressives,¹¹ a contract is executory if the performance of the contract is sufficiently incomplete that failure by either party to complete its performance would constitute a material breach by that party. Under the Bankruptcy Code, the debtor can either “assume” or “reject” a contract that qualifies as executory.¹² Jay saw both the traditional definition and the Code’s terminology as fraught with problems. The Countryman test suggested, for instance, that a debtor could not reject a contract that one party had performed, even if rejection was in the best interests of the debtor and its estate.

Jay advocated that lawmakers scrap the existing executory contract apparatus, and replace it with a functional approach. From a functionalist perspective, he argued, there is nothing special about the supposed “power” to assume or reject contracts, and the executoriness concept is irrelevant.¹³ This rejection of formalism and commitment to pragmatic, functional analysis is one of the signature features of Jay’s jurisprudence. It also hints at the subtle links that connect Westbrookian jurisprudence to legal realists such as Karl Llewellyn and, especially, William Douglas.

⁶ TERESA A. SULLIVAN, ELIZABETH WARREN, & JAY LAWRENCE WESTBROOK, *AS WE FORGIVE OUR DEBTORS: BANKRUPTCY AND CONSUMER CREDIT IN AMERICA* (1989).

⁷ TERESA A. SULLIVAN, ELIZABETH WARREN, & JAY LAWRENCE WESTBROOK, *THE FRAGILE MIDDLE CLASS: AMERICANS IN DEBT* (2000).

⁸ Westbrook, *supra* note 1.

⁹ *Id.* at 228.

¹⁰ *Id.*

¹¹ Jay solutes Countryman at the outset of the article, calling his executory contract articles “a brilliant accomplishment.” *Id.* at 230.

¹² 11 U.S.C. 365.

¹³ Westbrook, *supra* note 1, at 281.

The 2005 amendments to the Bankruptcy Code were so unpopular among bankruptcy scholars and professionals that we often found ourselves being asked a difficult question: could we name one good provision in the 2005 amendments? Were there any provisions that made bankruptcy better? On more than one occasion, when I heard a colleague respond to this question, the answer they gave was, yes, the 2005 reforms did include one important innovation: Chapter 15.

Chapter 15 is a small cluster of provisions governing cross-border bankruptcy filings. It gives broad authority for U.S. bankruptcy courts to permit cross border filings and provides flexible rules for determining the extent to which courts should incorporate, through principles of comity, the rulings and rules of other countries. It is hard to imagine a better fit with Jay's jurisprudence. The fit is not altogether accidental: Jay was a very early promoter (and I suspect drafter) of the principles that coalesced in Chapter 15.¹⁴

Jay's involvement was an outgrowth—or so I surmise, not having been there and Jay not having published memoirs—of his long involvement in cross-border insolvency projects. Jay's bankruptcy globetrotting dates back more than thirty years, to an era that comfortably predates American scholars' recognition of the importance of international issues. Jay has participated in numerous international projects to develop model bankruptcy principles or laws.

I first experienced Jay's international status at a conference in Geneva shortly after the turn of the new century. Three or four dozen insolvency scholars and professionals, including many of the world's leading experts, gathered in a lovely Geneva hotel to discuss a wide range of bankruptcy issues. From the first session or two, I noticed how often the international experts in the room looked toward Jay when a knotty issue emerged, especially if the issue was one that Chapter 11 addresses. Jay was a cheerful advocate for the Chapter 11 approach to financial distress—particularly the emphasis on reorganization—though he repeatedly emphasized that Chapter 11 isn't the only, and may not be the best, approach.

Given his enthusiasm for Chapter 11, which he has vigorously defended in the academic literature,¹⁵ Jay's hostility to the recent proposal to enact "bankruptcy for banks" legislation may seem surprising.¹⁶ The proposal would add a handful of provisions to existing bankruptcy law to better accommodate the insolvency of a large financial institution. Why would anyone be against this—particularly an enthusiast for Chapter 11?

¹⁴ Jay has written extensively about Chapter 15. See, e.g., Jay Lawrence Westbrook, *Chapter 15 Comes of Age*, ANN. REV. INSOLV. L. 173 (2013).

¹⁵ Elizabeth Warren & Jay Lawrence Westbrook, *The Success of Chapter 11: A Challenge to the Critics*, 107 MICH. L. REV. 603 (2009).

¹⁶ Jay's hostility is reflected in the letter he and several colleagues recently wrote urging lawmakers to eschew bankruptcy for banks. Edward Janger, John A.E. Pottow & Jay Lawrence Westbrook, *Frying Pan to Fire: Bankruptcy for Sifis is a Very Risk Choice* (2017).

There's a logic to Jay's opposition, of course, but before I unveil it and conclude with a little plea for Jay to reconsider, I will briefly describe the proposal and its discontents, including Jay and some of participants in this celebration.

In the first few years after the Dodd-Frank Act was enacted in 2010, the FDIC and Federal Reserve developed a strategy known as "Single Point of Entry" or "SPOE" for resolving the failure of a systemically important financial institution under Title II of the legislation. Under "Single Point of Entry," the FDIC would transfer the assets, short-term debt and secured debt of the holding company of a distressed financial institution to a newly formed bridge institution, leaving behind its stock and long-term debt.¹⁷ The newly recapitalized bridge institution would be fully solvent, and could contribute liquidity to troubled subsidiaries as necessary. The transaction would be effected quickly, minimizing disruption.

The lawmakers who debated the Dodd-Frank Act would have been incredulous-- or at the least, would have feigned incredulity-- had they been told that SPOE would be the strategy of choice for Title II. By its terms, Title II calls for liquidation, whereas SPOE is a recapitalization. Title II's liquidation requirement was a terrible idea.¹⁸ It would have discouraged regulators from ever using Title II. As a result, the SPOE alternative quickly caught on. By 2011, U.S. regulators and U.K. regulators had published a joint op-ed extolling SPOE.¹⁹ The Fed and FDIC subsequently outlined the SPOE approach in a request for comments,²⁰ and they have imposed so-called TLAC requirements to ensure large financial institutions have plenty of long term debt to use for a recapitalization if necessary.²¹

Bankruptcy for banks—aka the Financial Institution Bankruptcy Act or Chapter 14—would adapt SPOE for bankruptcy. I should perhaps add that I have been an active and enthusiastic member of the working group that created the Chapter 14 proposal that inspired FIBA.

The proposed FIBA legislation²² consists of a handful of provisions that would authorize the bankruptcy court to approve the transfer of a holding company's assets to a new bridge institution, would define the required notice, and would insulate the transaction from fraudulent conveyance attacks. As of this writing, versions of the legislation have passed the House multiple times but have not been voted on in the Senate.

¹⁷ See, e.g., David A. Skeel, Jr., *Single Point of Entry and the Bankruptcy Alternative*, in *ACROSS THE GREAT DIVIDE: NEW PERSPECTIVES ON THE FINANCIAL CRISIS* 313 (Martin N. Baily & John B. Taylor, eds. 2013).

¹⁸ See, e.g., Dodd-Frank Act § 204(a).

¹⁹ Martin J. Gruenberg (chairman, FDIC) & Paul Tucker (deputy governor, financial stability, Bank of England), *Global Banks Need Global Solutions When They Fail*, *FIN. TIMES*, Dec. 10, 2012.

²⁰ Request for Comments Regarding Resolution of Systemically Important Financial Institutions: The Single Point of Entry Strategy, 78 *FED. REG.* 76,614 (Dec. 18, 2013).

²¹ Federal Reserve, Total Loss-Absorbing Capacity, Long-Term Debt, and Clean Holding Company Requirements for Systemically Important U.S. Bank Holding Companies and Intermediate Holding Companies of Systemically Important Foreign Banking Organizations (Jan. 24, 2017).

²² Which Adam Levitin cleverly lampoons as "FIB" in his critique for the Westbrook celebration. Adam Levitin, *Bankruptcy's Lorelei: The Dangerous Allure of Financial Institution Bankruptcy*, 97 *N.C. L. REV.* (forthcoming, 2019).

One can plausibly argue that bankruptcy for banks, or something like it, is necessary to satisfy one of the Dodd-Frank’s core requirements. Title I of Dodd-Frank instructs the largest financial institutions to prepare rapid resolution plans—often called “living wills”—detailing how the financial institution could be resolved in bankruptcy causing systemic instability.²³ It is not clear if this objective can be achieved under current bankruptcy law. Bankruptcy for banks would facilitate an SPOE-style strategy that provides more confidence that large financial institutions could be resolved effectively in bankruptcy, as the living will provision requires.

Although bankruptcy for banks appears to have broad support in Congress, it is more controversial among bankruptcy scholars. Several of the common objections are somewhat puzzling. One posits that Title II is better than bankruptcy for banks, so bankruptcy for banks is a bad idea. Even if Title II is indeed superior in some respects (its enthusiasts often point to the federal funding provided by Title II, for instance), the conclusion that bankruptcy for banks therefore needs to be prevented is a non sequitur. At most, it suggests that Title II should not be repealed, as some versions of the bankruptcy for banks legislation have proposed. It is not, however, an argument against bankruptcy for banks legislation.²⁴ In my view, the optimal approach would include both Title II and bankruptcy for banks.

The other puzzling tendency is critics’ condemnation of features of bankruptcy for banks that also are features of the use of SPOE in Title II—the approach these same critics seem to favor. Critics argue that bankruptcy for banks would privilege derivatives and other short-term debt, thus perpetuating the perverse pre-2008 incentive to use derivatives. This is true—I consider to be one of the chief downsides of bankruptcy for banks—but it is just as true of SPOE resolution in Title II. SPOE is precisely the same approach in this regard. A problem with bankruptcy for banks is also a problem for SPOE.²⁵

If we set the more puzzling objections aside, three major objections remain. The first is that bankruptcy is ill-suited for resolving a large financial institution, because financial institution resolution needs to be done quickly and secretly, rather than through the more cumbersome, rule of law oriented procedures that characterize bankruptcy for banks.²⁶ SPOE, as incorporated into bankruptcy, is an alien graft that will inevitably be rejected. Second, unlike bank regulators, who can easily coordinate with their foreign counterparts, bankruptcy judges operate in isolation. The absence of coordination would make bankruptcy for banks ineffective for financial institutions with substantial foreign operations.²⁷ Finally, the SPOE or bankruptcy for banks process will require enormous amounts of funding, which will need to come from the federal government. Title II provides for this funding, whereas bankruptcy for banks does not.

²³ Dodd-Frank Act §165(d)(1).

²⁴ I suppose one could argue that managers might use bankruptcy for banks precipitously, and that this would prove destructive. But the prospect of precipitous bankruptcy filings seems remote, and critics do not generally make the argument.

²⁵ Stephen Lubben’s critique is more consistent in this regard. Stephen Lubben, *A Functional Analysis of SIFI Insolvency* (Feb. 13, 2018). He is skeptical both of SPOE and bankruptcy for banks. *Id.* at 11 (concluding that “SPOE has something of the character of a parlor trick”). Although I ultimately disagree, this strikes me as a plausible conclusion.

²⁶ Adam Levitin makes this argument in his essay for the Westbrook celebration. Levitin, *supra* note 22.

²⁷ Levitin makes this argument as well, as do others.

Though not intended as such, Jay’s prior work provides a response to several of these arguments. During the 2008 crisis, when the government effected the bailouts of Chrysler and General Motors through a creative use of the bankruptcy process, Jay pointed out that, although bankruptcy ordinarily is a somewhat leisurely process, “rough justice in the interest of speed is a common trade-off in the world of bankruptcy.”²⁸ Judges need not ignore “public interest” considerations, Jay argued, such as the prospect that a debtor’s collapse could “leav[e] the rest of us to try to help our fellow citizens recover from the blast.” In each case, the same can be said about bankruptcy for banks.

In his work on cross-border insolvency, Jay has noted the increasing tendency of bankruptcy judges to interact with their counterparts in other countries.²⁹ It is not a stretch, in my view, to envision interaction between these same bankruptcy judges and foreign bank regulators—interactions that might take place informally, outside the context of an actual case.

Although I haven’t finished addressing the objections, this is a good place to pause and revisit the question why Jay is so hostile to bankruptcy for banks. Many years ago, after reading a book chapter I’d written about removal of the Securities and Exchange Commission from the central role it had in bankruptcy prior to 1978, Jay wrote me a note reminiscing about his own experience in the earlier era, and suggesting that the SEC had been more effective than I had implied. Jay clearly retained a fondness for the more regulator-centric process that had been put in place by his New Deal predecessors.

I suspect the same fondness for—and confidence in—regulators also has shaped Jay’s thinking about bankruptcy for banks. Although my own inclinations still tend more toward the market side of the market-regulator spectrum than Jay’s, I fully acknowledge that there is an important role for regulators, especially in the financial institution context. Regulators are involved in the oversight of large financial institutions long before there is any hint of financial distress. Regulators are thus likely to be well-informed about an institution that encounters financial distress from the moment the trouble begins. A bankruptcy judge, by contrast, would have little or no contact with the institution until the moment it filed for bankruptcy.

If bank regulators were given a robust role in the process, this would draw bankruptcy for banks a little closer to the regulator-centric process Jay prefers. An obvious way to do this would be to authorize regulators to file the bankruptcy case, rather than simply leaving this to the financial institution itself.³⁰ If regulators believed resolution was necessary, but concluded that bankruptcy for banks would work, they could file the bankruptcy petition unilaterally or encourage the institution to do so.

The most important remaining issue is funding. Although I do not think the financial institution’s funding needs would be as enormous as some bankruptcy for banks critics contend,

²⁸ Jay Westbrook, *Commentary: What Bankruptcy Could Do for GM*, CNN.Com (June 1, 2009), available at <http://www.cnn.com/2009/US/06/01/westbrook.gm/index.html>.

²⁹ See, e.g., Westbrook, *supra* note 14, at 187 (noting that Chapter 15 and various model laws authorize communication between judges and administrators).

³⁰ As the Chapter 14 proposal advocates. The legislation currently in Congress does not authorize regulators to file the petition.

I agree that a source of federal funding should be provided.³¹ My own preference is that the Federal Reserve's emergency funding authority be expanded to include funding in the bankruptcy for banks context.

Here, then, is my plea: that Jay offer a tiny, weeny hint that he might just support bankruptcy for banks if lawmakers gave bank regulators a robust role in the process, if they also added a significant source of federal funding as a financial backstop, and if they promised to leave Title II in place. This beefed up regime does not seem so far removed from the inclinations that run through Jay's writing.

Jay may well say no. But even if he does, he'll have a smile on his face, as he always does. And why not, given the remarkable career he's had.

³¹ I have developed these arguments in detail elsewhere. David Skeel, *Financing Systemically Important Financial Institutions in Bankruptcy*, in MAKING FAILURE FEASIBLE: HOW BANKRUPTCY REFORM CAN END "TOO BIG TO FAIL" (Kenneth E. Scott, Thomas H. Jackson, & John B. Taylor, eds., Hoover Institution Press 2015).