The Law and Finance of Bank and Insurance Insolvency Regulation

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I. Introduction

The central assumption of bank and insurance insolvency regulation has long been that regulators must control every facet of the insolvency process. With both banks and insurance companies, regulators decide when to initiate an insolvency proceeding and how to dispose of the failed firm's assets, and they control nearly every decision in between. The explanation for this assumption is simple. Because banks, insurance companies, and related financial intermediaries play an important role in the financial security of the citizenry, the government has a strong interest in assuring their soundness and in preventing the kinds of systemic failures that led to financial devastation in the Depression.

Unlike some academic commentators, I do not take issue with the traditional justification for regulating banks and insurance companies. I am
persuaded that the risk of bank runs and policyholder flight is genuine, and I agree that deposit insurance and other regulatory interventions play a necessary and important role. Moreover, it seems quite unrealistic to suggest that lawmakers jettison the existing framework, given the political implausibility that lawmakers would shift gears so dramatically.

Accepting the public-interest justification for regulatory oversight does not mean that regulators should control the entire process, however. Quite to the contrary. I hope to show in this Article that diminishing regulators’ role in several important respects, while retaining the basic contours of the existing framework, would dramatically improve the effectiveness of the bank and insurance company insolvency process.

The point on which much of the analysis pivots is the rule in both bank and insurance law that only regulators can initiate an insolvency proceeding.\(^2\) If regulators were fully informed and had appropriate incentives to initiate in a timely fashion, their monopoly over initiation would make perfect sense. Regulators’ role in monitoring solvent firms does give them significant information, but because failures may reflect badly on the regulators themselves, they have strong incentives to delay taking action against troubled banks and insurance companies. There are good reasons to prefer that failures take place on someone else’s watch, which seems to many observers to explain regulators’ actions during the bank and insurance insolvency crises of the 1980s.

If regulators draw, at best, mixed reviews as initiators, to whom may we turn to achieve a better result? The answer, in my view, is managers. Managers are even better informed than regulators and are particularly well positioned to know when a troubled firm belongs in an insolvency proceeding.

The obvious problem with turning to managers is that managers have precious little incentive to contribute to the initiation decision.\(^3\) Given that insolvency generally means immediate termination of a manager’s job and elimination of the value of her stock, managers will resist initiation rather

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2. For a discussion of the initiation of bank insolvenues, see infra notes 12-15 and accompanying text, and for insurance companies, see infra notes 36-38 and accompanying text.

3. Managers also have traditionally been seen as part of the problem, rather than a partial solution, because of the historically high correlation between managerial fraud and bank and insurance insolvency. See Peter P. Swire, Bank Insolvency Law Now that It Matters Again, 42 DUKE L.J. 469, 507-08 (1992) (arguing that prior to 1980 local banks rarely failed absent fraud or severe mismanagement). Although bank and insurance insolvenues still often stem from or involve managerial fraud, the correlation has diminished significantly as bank and insurance markets have become more competitive. See id. at 509-10 (arguing that since 1980 “many, and perhaps most, bank and thrift failures have been attributable to stiff competition”); see also George J. Benson et al., The Failure and Survival of Thrifts: Evidence from the Southeast, in FINANCIAL MARKETS AND FINANCIAL CRISES 305, 376 (R. Glenn Hubbard ed., 1991) (finding little evidence that most insolvenues were attributable to insider abuse).
than signal when the time for an insolvency proceeding has come. Yet this problem is far from fatal. Finance theory suggests that lawmakers, or banks and insurance companies themselves, could develop relatively simple mechanisms for realigning managers' incentives. I argue in particular that offering managers a "phantom debt" interest in the firm or providing a shareholder bonus in connection with an insolvency proceeding would give managers a strong incentive to contribute to the initiation decision.

If the analysis stopped here, its conclusions could perhaps be dismissed as a characteristically unrealistic academic proposal. But my assessment of the disposition options in bank and insurance insolvency proceedings not only suggests several potential reforms, but it also provides an alternative justification for managerial initiation.

I begin with the observation that neither bank nor insurance insolvency law includes a traditional reorganization option. Both rely principally on liquidation or third-party sales to resolve financial distress. Although traditional reorganization does not make sense for banks, I argue that managers should be permitted to propose a prepackaged purchase and assumption transaction—that is, a merger effected through the insolvency process—much as other firms can propose prepackaged reorganization plans under Chapter 11 of the Bankruptcy Code. My analysis suggests that insurance insolvency law should go even further and permit a limited version of traditional reorganization.

Each of these reforms would expand the range of disposition options and lead to better resolutions of financial distress in many cases. Such reforms also would enhance the effectiveness of managerial initiation. Because the reforms would increase managers' influence after insolvency, both would give managers far more reason to participate in the insolvency process than currently is the case. In effect, the right to propose a prepackaged purchase and assumption or to participate in a reorganization process serves as an implicit bonus to managers. As a result, managers could be expected to initiate insolvency proceedings, at least sometimes, even in the absence of more direct incentives such as the phantom debt and shareholder bonus approaches described above.

I do not mean to suggest that managers should completely displace regulators as initiators. Regulators still could initiate, but managers also should have this authority, rather than giving regulators a monopoly over the decision. Even if managers frequently failed to initiate, the prospect of their occasional participation would represent an important improvement

4. See 11 U.S.C. §§ 1121-1129 (1994). In a prepackaged bankruptcy, managers negotiate a reorganization plan prior to filing for bankruptcy to minimize the length of the bankruptcy case. See 11 U.S.C. § 1126(b) (setting forth requirements for the prebankruptcy solicitation of votes). For further discussion, see infra notes 191-96 and accompanying text.
over existing law. To be sure, managers are less likely to take systemic risk concerns into account in their decisions whether to initiate. But many failures do not raise the specter of systemic risk, and regulators could retain the authority to intervene in those cases that do.

As this brief description of my proposals makes clear, I assume throughout the analysis that banks and insurance companies should be permitted to fail. While this is at odds with the traditional inclination to forestall financial intermediary failures at all costs, it accords with the current nature of bank and insurance markets. As competition in these markets has intensified, it has become inevitable that some banks and insurance companies will fail as a consequence of market pressures. In consequence, these intermediaries are more like nonfinancial firms than ever before. My analysis suggests that their insolvency procedures should begin to reflect this transformation.

The Article proceeds as follows: In Part II, I briefly describe the regulatory structures in place for banks and bank-like entities and for insurance companies. I then discuss the initiation issue in Parts III and IV. In Part III, I analyze several of the reforms commentators have proposed in the banking context, as well as the changes Congress actually implemented in 1989 and 1991; in Part IV, I develop my argument for giving managers authority to initiate an insolvency proceeding. I also conclude that there is no reason to deny creditors the right to initiate, although I would expect creditors to play a less direct role in initiation than managers. I turn to the disposition issue in Part V, which describes and defends my proposals for adding to the existing slate of disposition options. I then complete the analysis with a brief conclusion.

It is perhaps worth noting that readers who are familiar with the regulatory structure of banking and insurance law and with the recent reform

5. I also assume that the insolvencies of banks and insurance companies will continue to be regulated separately from other corporate bankruptcies—that is, lawmakers will retain the longstanding exclusion of banks and insurance companies from the Bankruptcy Code. See 11 U.S.C. § 109 (1994). This continued separation seems quite likely as a descriptive matter because bank and insurance regulators, and perhaps even banks and insurance companies themselves, would strongly resist any effort to bring banks and insurance companies within the Code. Perhaps more surprisingly, given that several of my proposals call for bank and insurance insolvencies to be treated more like the bankruptcies of other firms, I also think the exclusion is justified on normative grounds. The best argument for bringing banks within the Bankruptcy Code is that bankruptcy judges face less of a conflict of interest than the FDIC does when it fixed the existence and amount of claims other than the deposit claims held by the FDIC itself. For insurance companies, federal Bankruptcy Code treatment would eliminate the jurisdictional problems that undermine the state insurance insolvency process. In each case, however, perverse effects of Bankruptcy Code treatment, such as the Code's and bankruptcy judges' pervasive bias in favor of reorganization, would more than outweigh these benefits. By far the best existing commentary on the bank and insurance company exclusion is Michael I. Sovern, Section 4 of the Bankruptcy Act: The Excluded Corporations, 42 MINN. L. REV. 171, 207-29 (1957) (arguing that both banks and insurance companies should be regulated by bankruptcy law).
proposals considered by Congress could skip the next two parts of the Article. Parts IV and V contain the heart of my analysis. For most readers, however, Parts II and III should prove useful, particularly given the surprising paucity of legal literature on bank and insurance insolvency issues. In addition, Part III adds several new insights to previous assessments of the recent proposals for reform.

II. A Brief Overview of the Regulatory Framework

A. Banks, Savings and Loans, and Credit Unions

To provide a backdrop for the remainder of the Article, I begin with a brief overview of the regulatory framework in banking and insurance, with a particular focus on the insolvency process. Banking is characterized by a dual system of regulation; a bank can obtain either a federal or a state charter, and state banks can choose to be members or nonmembers of the federal reserve system. The most obvious effect of these choices is to determine who a bank's primary regulator or regulators will be.

The regulators are as follows: the Comptroller of the Currency regulates national banks; state regulators and the Federal Reserve regulate

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6. Prior to the insolvency crisis of the 1980s, the academic literature paid almost no attention to insolvency issues. In his seminal articles on financial intermediaries, for instance, Robert Clark devoted little more than one page to insolvency. See Robert C. Clark, The Soundness of Financial Intermediaries, 86 Yale L.J. 1, 99-100 (1976) [hereinafter Clark, Soundness]; see also Robert C. Clark, The Four Stages of Capitalism: Reflections on Investment Management Treatises, 94 Harv. L. Rev. 561 (1981); Robert C. Clark, The Regulation of Financial Holding Companies, 92 Harv. L. Rev. 789 (1979) [hereinafter Clark, Financial Holding Companies] (each omitting detailed discussion of bank solvency issues). This omission is to some extent understandable, given the rarity of bank and insurance company failures in the decades after World War II. Yet even in the wake of the unprecedented number of failures in the 1980s, and the flurry of legislative activity that resulted, the academic literature remains surprisingly thin.

The single most sustained treatment of the existing banking insolvency framework is by Peter Swire. See Swire, supra note 3, at 472 n.3. Two of Jonathan Macey and Geoffrey Miller's many articles on banking can also be seen as focusing in significant part on insolvency-specific issues. See Jonathan R. Macey & Geoffrey P. Miller, Double Liability of Bank Shareholders: History and Implications, 27 Wake Forest L. Rev. 31 (1992) [hereinafter Macey & Miller, Double Liability]; Jonathan R. Macey & Geoffrey P. Miller, Bank Failures, Risk Monitoring, and the Market for Bank Control, 88 Colum. L. Rev. 1153 (1988) [hereinafter Macey & Miller, Bank Failures]. Helen Garten also has written on bank insolvency issues. See Helen A. Garten, A Political Analysis of Bank Failure Resolution, 74 B.U. L. Rev. 429 (1994).

The literature is even thinner in the insurance context. For an extensive doctrinal treatment of an important insurance insolvency issue, see Stephen W. Schwab et al., Onset of an Offset Revolution: The Application of Set-Offs in Insurance Insolvencies, 95 Dick. L. Rev. 449 (1991).

state banks that choose to become members of the Federal Reserve system; and state regulators and the Federal Deposit Insurance Corporation regulate state banks that do not become members of the Federal Reserve system.⁸

Despite the multitude of regulators and regulatory options (which expand still further once we account for bank-like intermediaries such as savings and loans ("S&Ls") and credit unions), the regulatory framework is much more consistent than varied across the range of banks. Nearly every bank participates in the deposit insurance system, for instance, which currently provides a federal guaranty of up to $100,000 on any given account.⁹ All banks also must satisfy roughly the same capital requirements.¹⁰ Moreover, the trend is toward increasing rather than relaxing the unification of the regulatory framework.¹¹

In the insolvency framework, the increasing unification is reflected, in a sense, in recent changes as to who has authority to initiate an insolvency proceeding.¹² Prior to 1991, a bank's primary regulator made the decisions of whether and when to commence an insolvency proceeding. Thus, the Comptroller made these decisions for national banks, state regulators or the Federal Reserve with respect to state member banks, and state regulators alone for nonmember banks.¹³ In the wake of the

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⁹. See 12 U.S.C. § 1821(a) (1994); Klausner, supra note 8, at 705-07. Federal deposit insurance was implemented under the Banking Act of 1933, ch. 89, 48 Stat. 162 (codified as amended in scattered sections of 12 U.S.C.) and the Banking Act of 1935, ch. 614, § 101, 49 Stat. 684 (codified as amended in scattered sections of 12 U.S.C.). Other key components of the regulatory framework—many of which, like deposit insurance, date to the New Deal—include geographical restrictions and limitations on the products that a bank can offer. Most importantly, the McFadden Act, 12 U.S.C. § 36(c) (1994), and the Bank Holding Company Act of 1956, id. § 1842(d) (the "Douglas Amendment"), long limited banks' ability to expand across state lines. With respect to products, the Glass-Steagall Act of 1933 sought to prohibit bank affiliates from dealing in securities in order to erect a wall between commercial banks and investment banks. See Banking Act of 1933, id. § 24. The restrictions in each of these areas have been significantly eroded in recent years.

¹⁰. See 12 U.S.C. § 3907(a)(1) (1994) ("Each appropriate Federal banking agency shall cause banking institutions to achieve and maintain adequate capital by establishing minimum levels of capital . . . ."); 12 C.F.R. pt. 3 (1997) (setting the minimum for national banks at 8%); id. pt. 208 (setting the minimum for FED-member banks at 8%); id. pt. 325 (setting the minimum for nonmember state banks at 8%).

¹¹. See JONATHAN R. MACEY & GEOFFREY P. MILLER, BANKING LAW AND REGULATION 287 (1992) (noting that the S&Ls are now required to meet capital requirements at least as strict as those applied to national banks).

¹². Here and throughout the Article, I focus almost exclusively on federal insolvency regulation. Although the states have their own bank insolvency provisions, federal regulators invariably step in when a state-chartered bank becomes insolvent. See Macey & Miller, Bank Failures, supra note 6, at 1173; Swire, supra note 3, at 480.

¹³. See, e.g., Paul W. Grace, Regulatory Seizure of Banks and Thrifts, in BANKS AND THRIFTS: INTRODUCTION TO FDIC/RTC RECEIVERSHIP LAW 177, 180-95 (PLI Commercial Law and Practice Course Handbook Series No. 616, 1992) [hereinafter RECEIVERSHIP LAW].
The widespread view that state regulators deliberately stalled instead of responding to insolvencies of state banks, Congress gave the FDIC explicit authority, as part of the FDIC Improvement Act (FDICIA) of 1991, to make the initiation decision itself with respect to any bank.

The FDIC (or other regulator) has two principal choices if it initiates an insolvency proceeding. The first, and less frequent, choice is to set up a conservatorship for the bank. Regulators generally use the conservatorship approach to preserve the bank's assets and re-establish it as a viable going concern; the FDIC ordinarily serves as the bank's conservator.

More often, regulators employ the second, more liquidation-oriented option, which is to put a failing bank into receivership. In contrast to a conservatorship, where appointment of the FDIC as conservator is optional, banking regulation requires that the FDIC be appointed as receiver. Because the FDIC also has an enormous stake in the receivership proceeding as subrogee of depositors' claims, the FDIC ends up wearing two different hats. The FDIC appears both as a claimant, in what is referred to as its "corporate" role, and as the receiver that determines the treatment accorded each claim and the ultimate disposition of the bank's assets. It is important to keep the FDIC's corporate and receivership roles separate because a great deal can turn on the distinction.


15. See Grace, supra note 13, at 180-83. In addition to its right to initiate, the FDIC has a variety of "superpowers" that give it special authority to avoid problematic transactions and otherwise strengthen its hand in an insolvency proceeding. Perhaps the most prominent of these are its "D’Oench, Duhme" powers, derived from the Supreme Court's decision in D’Oench, Duhme & Co. v. FDIC, 315 U.S. 447 (1942), which enable bank regulators to defeat any claim based on an agreement that is not documented in the bank's records. For a detailed description of D’Oench, Duhme and the other superpowers, see Swire, supra note 3, at 481-90.

16. The FDIC also can provide "open bank assistance" rather than initiate an insolvency proceeding if the bank is on the verge of default and assistance might forestall its failure, though Congress has placed significant restrictions on open bank assistance. See 12 U.S.C. § 1823(c)(1)(A)(i) (1994) (authorizing the FDIC to assist an open, troubled financial institution); id. § 1823(c)(1)(A)-(C) (listing statutory prerequisites to providing assistance); see also EDWARD L. SYMONS, JR. & JAMES J. WHITE, BANKING LAW 607 (3d ed. 1991) (discussing various forms of FDIC open bank assistance). Barry S. Zisman & William B. Waites, Federal Deposit Insurance Corporation and Open Institution Assistance, in RECEIVERSHIP LAW, supra note 13, § 11.04, at 7, 23-25 (discussing requirements for assistance).

17. See 12 U.S.C. § 1821(c)(2)(A); see also SYMONS, JR. & WHITE, supra note 16, at 604 (discussing the appointment of the FDIC as conservator).

18. See Grace, supra note 13, at 188 ("In practice, the comptroller rarely appoints a conservator.").

19. See 12 U.S.C. § 1821(c)(2)(A)(i) (allowing discretion in both the appointment of the FDIC as conservator and the FDIC's acceptance of such an appointment); id. § 1821(c)(2)(A)(ii) (requiring both that the FDIC be appointed receiver and that it accept the appointment); Grace, supra note 13, at 181 (contrasting the obligations of both the Comptroller of the Currency and the FDIC regarding receiverships and conservatorships).
As receiver, the FDIC has a variety of disposition options. One option is to simply liquidate all of the bank’s assets piecemeal, distribute the proceeds to claimants, and, in its corporate capacity as insurer, pay off the bank’s insured depositors. To keep the deposits intact, the FDIC also can “sell” the deposits to another bank in an insured deposit transfer, pursuant to which the FDIC pays another bank to assume the deposit liabilities, and then it can liquidate the bank’s assets and pay its other creditors with the proceeds. The FDIC’s third option is to transfer most or all of the bank’s assets and liabilities to a third party in what is referred to as a purchase and assumption (“P&A”) transaction.\(^\text{20}\)

Regardless of which option it chooses, the FDIC disposes of the bank’s assets quickly and often does not announce the bank’s receivership until after it arranges the disposition. Regulators justify the speed and secrecy as necessary to minimize the effect of one bank’s failure on other banks and to minimize the erosion of the bank’s deposit base after it fails.\(^\text{21}\)

The general regulation of, and insolvency proceedings with respect to, savings and loans, credit unions, and other bank-like intermediaries closely parallel banking regulation in most respects. Until the passage of FIRREA in 1989,\(^\text{22}\) the Federal Home Loan Bank Board regulated the most important of these intermediaries—savings and loans. Thereafter, the Office of Thrift Supervision was given primary regulatory authority over savings and loans; the FDIC assumed authority of their deposit insurance, as with banks; and the Federal Home Financing Board was given the role of regulating credit allocation issues.\(^\text{23}\) In the insolvency context, the Resolution Trust Company (RTC) served as the FDIC’s counterpart for savings and loans, acting as receiver for those that failed.\(^\text{24}\) But it was dissolved by statute at the end of 1995, and its functions were assumed by the FDIC.\(^\text{25}\) In consequence, banks and savings and loans have both the same regulator and essentially the same regulatory framework in the insolvency context with which we are concerned.

The remaining bank-like intermediaries face a roughly comparable regulatory structure, as noted above.\(^\text{26}\) One additional aspect of savings and

\(^{20}\) Each of these options can be further divided to produce a more exhaustive typology. For a complete description, see Barry S. Zisman & William B. Waites, Failed Financial Institution Transactions, in RECEIVERSHIP LAW, supra note 13, at 45, 50-58.

\(^{21}\) See, e.g., Clark, Soundness, supra note 6, at 101.


\(^{23}\) For a brief overview of these developments, see Symons, Jr. & White, supra note 16, at 55.


\(^{25}\) See id. § 1441a(m)(1).

\(^{26}\) Savings banks traditionally have been most popular in the East; they generally are subject to somewhat lower capital requirements due to the long-term nature of their deposits, and states often restrict their investment options. Credit unions historically have consisted of groups that share related
loans, credit unions, and savings banks that warrants brief mention is that many are owned by members rather than shareholders. As we shall see, this ownership structure is even more prevalent in the insurance context and will play a part in our analysis of the initiation and disposition of insolvency proceedings.

B. Insurance Companies

The most striking difference between banks and insurance companies from a regulatory perspective is that insurance companies are regulated almost entirely by the states, with very little federal overlay.27 Although state legislatures thus are the ultimate source of insurance law, other groups play an enormous role. The most important of these is the National Association of Insurance Commissioners (NAIC), which proposes model insurance provisions and engages in extensive lobbying on insurance issues.28

In the insolvency context, the vast majority of states have adopted either the NAIC's Insurers Rehabilitation and Liquidation Act (NAIC Model Act), or the Uniform Insurers Liquidation Act.29 The NAIC Model Act,30 patterned in many respects after the statute Wisconsin enacted in 1967,31 is more prominent and current, but many states still pattern their insolvency statutes on the Uniform Act.32

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27. State regulation appears to a certain extent to have been a historical accident. The Supreme Court held in Paul v. Virginia, 75 U.S. (8 Wall.) 168, 183 (1868), that federal regulation of insurance would violate the Commerce Clause and thus solidified state control for nearly eight decades. Paul was eventually overruled in United States v. South-Eastern Underwriters Ass'n, 322 U.S. 533, 543-49, 553 (1944), but Congress quickly reaffirmed state authority by enacting the McCarran-Ferguson Act, ch. 20, 59 Stat. 33 (1945) (codified as amended at 15 U.S.C. §§ 1011-1015 (1994)); see also Spencer L. Kimball, The Purpose of Insurance Regulation: A Preliminary Inquiry in the Theory of Insurance Law, 45 MINN. L. REV. 471, 509-11 (1961) (suggesting that the insurance industry would have welcomed federal regulation in the early twentieth century had it been constitutionally permissible).
28. The NAIC's most prominent product is the National Insurers Rehabilitation and Liquidation Act. See infra notes 29-38 and accompanying text.
29. For a listing of the states that have adopted each of the statutes, see Kent M. Forney, Insurer Insolvencies and Guaranty Associations, 43 DRAKE L. REV. 813, 817-18 nn.42-44 (1995) (listing 17 states that have enacted the NAIC Model Act and 30 states and Washington, D.C. that have some version of the Uniform Act).
32. See supra note 29.
As with depositors in banking law, a major concern of insurance law is to protect the interests of policyholders. Starting in the late 1960s, in response to the perceived threat of federal regulation, the industry devised and states began to implement a guaranty fund system which, somewhat like deposit insurance in the banking context, guaranties payment to policyholders up to a specified ceiling in the event an insurance company becomes insolvent.33 Guaranty funds have been established on a state-by-state basis. Most of the funds are overseen by a board comprised of representatives elected by member insurers,34 and each fund protects only policyholders who reside within the given state.35

Although the state guaranty funds have played an increasingly important role in the insolvency context, only the state insurance commissioner has authority to initiate an insolvency proceeding.36 Assuming one or more of the statutory grounds for action is present,37 the commission can initiate either a liquidation or a rehabilitation. Either way, the commissioner’s office continues to exercise pervasive control because it serves as rehabilitator in a rehabilitation and liquidator in a liquidation.38

As the names suggest, rehabilitation proceedings are designed to stabilize and rehabilitate a troubled insurer, whereas liquidation proceedings provide for a relatively immediate liquidation. One respect in which the insurance insolvency process differs noticeably from banking insolvency is that insurance regulators are more likely to rehabilitate an insurance company than are bank regulators with banks—that is, regulators

34. See id. at 643.
35. The guaranty funds initially were based on the domiciliary of the troubled insurer—that is, when an insurer domiciled in a state became insolvent, that state’s guaranty fund was responsible for protecting all of its covered policyholders, both in state and out of state. The Baldwin-United insolvency exposed major problems with this approach, and the NAIC changed its model guaranty fund act to a policyholder-based framework as a result. See Jack H. Blaine, Organization and Capabilities of Life and Health Guaranty Associations in the United States, in LAW AND PRACTICE OF LIFE INSURANCE COMPANY INSOLVENCY 6-1, 6-4 to 6-5 (David M. Spector ed., 1993) [hereinafter ABA, LIFE INSURANCE INSOLVENCY].
36. See, e.g., Forney, supra note 29, at 819 (noting that “[t]he [Iowa Insurance] Commissioner has the sole discretion to decide whether to undertake delinquency proceedings”).
37. The NAIC Model Act lists 18 different grounds for initiating a rehabilitation or liquidation, ranging from insolvency to control of the company by a person “found after notice and hearing to be dishonest or untrustworthy in a way affecting the insurer’s business.” Insurers Rehabilitation and Liquidation Model Act, supra note 30, § 16, at 555-17 to -19.
38. See, e.g., id., § 17 (commissioner to be appointed rehabilitator); § 20 (commissioner to be appointed liquidator). Many states also have a conservatorship option which is used to preserve an insurance company’s assets until regulators can evaluate its status. See Schwab et al., supra note 6, at 451 n.3.
sometimes rehabilitate the insurer rather than liquidating it or selling its assets to a third party.\textsuperscript{39}

The frequency of rehabilitation should not be overstated, however. Even when state commissioners put a company into rehabilitation, they often do so simply as an interim measure to give the commissioner’s office a better opportunity to assess the status and prospects of a troubled insurer.\textsuperscript{40} Many of these proceedings end up in liquidation, and many others start there. It is principally with extremely large insurers that state commissioners effect a true rehabilitation.\textsuperscript{41}

Another difference between bank and insurance insolvencies is that state insurance commissioners do not place quite so great a premium on speed and secrecy as their counterparts in the banking context. While insurance regulators are similarly concerned that a public acknowledgment of insolvency will lead to policyholder flight, insurance regulators do not ordinarily arrange in advance for the disposition of a troubled insurer’s assets.

\textbf{C. A Brief Definitional Note}

Before turning to the particular insolvency issues we will be considering, I should note that I will use (and already have used) several simplifying terms throughout the analysis. Given the differences in terminology in the bank and insurance company insolvency contexts, I will often use the general term “insolvency proceeding” to refer to one or more of the insolvency options.\textsuperscript{42} I also will refer to “bank regulators” and “insurance regulators” rather than specifying the particular regulator, and I will use “banks” as a catch-all category including both banks and bank-like intermediaries such as savings and loans and credit unions. Finally, in Part V, I will characterize each of the possible disposition options in terms of one of three choices: liquidations, third-party sales, or

\textsuperscript{39} Recall that banking regulators have a similar option—defined as “conservatorship” in that context—but that conservatorships are rare.

\textsuperscript{40} See, e.g., Leonard Minches, Roadmap to Rehabilitation and Liquidation Proceedings, in ABA, LAW AND PRACTICE, supra note 33, at 93, 101.

\textsuperscript{41} When Mutual Benefit Life Insurance Company became insolvent, for instance, the insurance commissioner’s office began a lengthy rehabilitation process that ultimately included the enactment by New Jersey of a retroactive modification of its insurance insolvency provisions to provide for policyholder priority. See In re Rehabilitation of Mutual Benefit Life Ins. Co., 609 A.2d 768 (N.J. Super. Ct. App. Div. 1992) (affirming the rehabilitation plan). The rehabilitation of large insurers bears an obvious resemblance to the “too big to fail” doctrine in the banking context, and its use to justify open bank assistance in cases such as Continental Illinois.

\textsuperscript{42} I also refer to “insolvency” proceedings and insolvency options in keeping with general practice, despite my view that balance sheet insolvency may not be the optimal time to take action with respect to a troubled bank or insurance company. For further discussion of this point, see infra note 43.
reorganizations. These general terms may diminish at least one source of distraction as we make our way through bank and insurance insolvency law.

III. The Initiation Issue: Existing Law and Current Proposals

The first step in a formal insolvency process is the initiation of an insolvency proceeding. In the corporate bankruptcy and insurance insolvency contexts, observers have long wrestled with the issue of how to ensure that insolvency proceedings are commenced at the right time. Whether initiation does or does not occur at an appropriate time turns in large part on who—that is, which of a company's constituencies has authority to initiate an insolvency proceeding and what its incentives are for doing so.43

Roughly speaking, one can imagine three different models for initiation: (1) regulator initiation; (2) creditor (or market) initiation; and (3) manager initiation. In corporate bankruptcy, lawmakers have long looked to creditors or managers, or some combination of these parties, to initiate a bankruptcy case.44 Revisions in the bankruptcy laws have often been designed to adjust the authority or incentives of creditors or managers to file a bankruptcy petition.45

43. Although I will focus primarily on the issue of who should initiate insolvency proceedings, another important issue, and one that has not received nearly enough attention, is the timing question—that is, when an insolvency proceeding should be commenced. In the banking context, commentators almost invariably assume that the initiator should act when a bank's net worth becomes zero, see, e.g., Sankarshan Acharya & Jean-Francois Dreyfus, Optimal Bank Reorganization Policies and the Pricing of Federal Deposit Insurance, 44 J. Fin. 1313, 1313 (1989), but zero net worth may only be a rough approximation of the optimal initiation time. For an exception, and a more persuasive account, see William W. Lang & Leonard I. Nakamura, Optimal Bank Closure for Deposit Insurers 1-3 (Jan. 1990) (unpublished manuscript, on file with the Texas Law Review) (suggesting that closure is only appropriate when the expected return on a bank's assets is less than the expected return from an alternative use of the assets). Lang and Nakamura's analysis is similar in intriguing respects to George Triantis and Ron Daniels's characterization of bankruptcy in the general corporate context as a governance alternative that is available when other governance mechanisms, such as the market for control, have not induced a more efficient deployment of a firm's assets. See George G. Triantis & Ronald J. Daniels, The Role of Debt in Interactive Corporate Governance, 83 CAL. L. REV. 1073, 1102 (1995). Frank Buckley has argued for a somewhat different focus, suggesting (also in the general corporate context) that termination is appropriate when the adverse incentive costs of equity exceed those of debt. See F. H. Buckley, The Termination Decision, 61 U. MO.-KAN. CITY L. REV. 243, 257 (1992).

44. The current Bankruptcy Code, for instance, permits either the debtor or its creditors to file a bankruptcy petition. See 11 U.S.C. § 301 (1994) (allowing voluntary petitions by debtors); 11 U.S.C. § 303 (permitting involuntary petitions by creditors).

45. One of the goals of the current Bankruptcy Code when it was enacted in 1978 was to make it easier for creditors to initiate a bankruptcy case. See, e.g., Susan Block-Lieb, Why Creditors File So Few Involuntary Petitions and Why the Number Is Not Too Small, 57 BROOK. L. REV. 803, 803-04 (1991). Despite the changes, debtors still file the vast majority of bankruptcy cases, although most observers believe that many, and perhaps most, cases are filed in response to creditors' actions. See id.
Although bank and insurance insolvency developed from somewhat similar origins, lawmakers have relied exclusively on regulator initiation for much of this century. Thus, as discussed in Part II, only the state insurance commissioner can initiate an insurance receivership, and either the relevant bank regulator or the FDIC must initiate bank receiverships. In some respects, regulators are a sensible choice to initiate insolvency proceedings in heavily regulated industries such as banking and insurance because their involvement in the regulatory process gives them extensive information about a given bank or insurance company. Regulators ideally will know when a financial intermediary has encountered financial distress and can commence a receivership or other insolvency proceeding at that time. Regulators also are well positioned to consider the systemic effects of a bank failure rather than focusing solely on the troubled bank.

In practice, however, the advantages of regulator initiation often prove more theoretical than real. Because regulators do not have a financial interest in any given bank or insurance company, they often have little to lose if they wait too long to initiate a receivership, and much to gain by delaying: bank or insurance company failure may reflect badly on the regulators, so a regulator may be better off if the failure occurs after they have departed.

In the face of the bank and insurance failure crises of the 1980s, and the widespread belief that some of the damage might have been prevented if regulators had not waited so long to put distressed companies into insolvency proceedings, lawmakers began to consider alternative approaches to the initiation issue. The most dramatic reforms proposed that, as an antidote to regulator inadequacies, creditors be given a much greater role in initiation. Other reforms, such as those actually adopted in the

46. See, e.g., Cyril B. Upham & Edwin Lamke, CLOSED AND DISTRESSED BANKS: A STUDY IN PUBLIC ADMINISTRATION 30 (1934) (stating that bank receiverships were handled like those of any other corporation until the 1930s).


48. See Macey & Miller, Kaye, Scholer, supra note 47, at 1118-19, 1140 (discussing the more than two year delay in closing Lincoln Savings & Loan after it was insolvent and concluding that such delays are the primary cause of the negative consequences of bank failure); Macey, supra note 47, at 1294 (explaining that if insolvent banks remain open there is an incentive to take extremely high risks since such risks are the only hope of regaining solvency).

49. See Macey & Miller, Bank Failures, supra note 6, at 1193-1225 (arguing that banking law should be deregulated so depositors will have increased incentives to monitor bank risk); Jonathan R. Macey & Elizabeth H. Garrett, Market Discipline by Depositors: A Summary of the Theoretical and Empirical Arguments, 5 YALE J. ON REG. 215, 215 (1988) (noting that the majority of reform proposals in the wake of bank failure crises are designed to encourage depositors to monitor banks). For a discussion of the details of several of the proposals, see infra subpart III(A).
banking context, were designed to retain regulator initiation but force regulators to act in a more timely fashion. Somewhat surprisingly, few observers have had much to say about the role of managers in initiation.

In the next two Parts, I consider each of the three general approaches and their likely efficacy in bank and insurance insolvency. I start in this part by discussing several of the market reforms that have been proposed in the banking context, each of which would entail what I have characterized as creditor initiation. I consider both their virtues and the substantive reasons why none have yet been adopted. I then turn to regulator initiation and consider its current parameters in the banking and insurance contexts. In Part IV, I explore in detail the role that managers might play in the initiation process.

A. Creditor Initiation: Proposals that Call for a Market Trigger

An obvious attraction of creditor initiation is that creditors, unlike regulators, have a direct financial interest in the health of a bank or insurance company. Several of the most prominent proposals to reform the deposit insurance system in banking regulation can be seen as adopting this kind of approach to initiation. The first of these proposals would supplement federal deposit insurance with private insurance for five to ten percent of a bank's insured deposits. Proponents view partial private insurance as a means of injecting market pricing into the deposit insurance system and, more importantly for our purposes, contend that private insurers will have an incentive to initiate insolvency proceedings in a timely fashion in order to assure full recovery of their claims.

50. See infra subpart III(B).
51. This may be a good place to note that I am focusing principally on the "merits" of the respective alternatives, rather than on the political prospects for any given reform.
52. See Herbert Baer, Private Prices, Public Insurance: The Pricing of Federal Deposit Insurance, CHICAGO ECON. PERSP. (Federal Reserve Bank of Chicago), Sept./Oct. 1985, at 45, 48-49 (proposing a system in which the private market determines price, but the government provides most of the deposit insurance). See generally Charles W. Calomiris, Deposit Insurance: Lessons from the Record, ECON. PERSP. (Federal Reserve Bank of Chicago), May/June 1989, at 10, 28 (advocating a two-tier system of deposit insurance in which the government offers national insurance but adds local incentives to monitor). For an excellent summary and critique of each of the proposed deposit insurance reforms, see DEPARTMENT OF THE TREASURY, MODERNIZING THE FINANCIAL SYSTEM: RECOMMENDATIONS FOR SAFER, MORE COMPETITIVE BANKS VII-1 to VII-37 (1991) [hereinafter TREASURY REPORT].
53. My analysis of partial private insurance throughout this section will assume that deposit liabilities would be treated as unsecured claims in a partial private insurance regime, as they were when the reform was proposed. Under the new federal depositor preference provision, 12 U.S.C. § 1821(d)(11)(A), deposit liabilities receive preference over all claims except for the receiver's administrative claims. Thus, private insurance would only be effective as an initiation device if the vast majority of a bank's liabilities were deposit liabilities (as is true with many small banks). Otherwise, the possibility of depositor losses, and thus the triggering of an insolvency proceeding, would not become an issue until well after the bank encountered financial distress. For a more detailed discussion of the depositor preference provision and its significance, see infra notes 174-76 and accompanying text.
The second approach is to require banks to issue a specified amount of puttable subordinated debt. Puttable debt ideally would introduce debt monitoring and thus counteract the disincentive that depositor insurance creates for depositors to monitor. Holders of puttable subordinated debt could, and presumably would, put their debt back to the bank if its value fell below par. If lawmakers tied initiation to investors' exercise of their put options, insolvency proceedings might routinely be triggered as soon as a bank's net worth fell below zero.

The puttable subdebt proposal is similar in intriguing respects to the stock cancellation schemes recently proposed in the corporate bankruptcy context. The stock cancellation proposals suggest that corporations should issue equity that is automatically canceled in the event the debtor defaults on any of its obligations. As with puttable subdebt, one of the principal attractions of the stock cancellation proposal is that it assures a timely response to financial distress.

The most widely noted impediment to adopting puttable subdebt, partial private deposit insurance, or any other creditor initiation proposal in

54. Puttable subordinated debt is debt that is explicitly subordinated to a bank's depositors, general creditors, and priority creditors, and which gives holders the right to demand payment at any time. See Larry D. Wall, A Plan for Reducing Future Deposit Insurance Losses: Puttable Subordinated Debt, ECON. REV. (Federal Reserve Bank of Atlanta), July/Aug. 1989, at 2-3; Charles W. Calomiris & Charles M. Kahn, The Role of Demandable Debt in Structuring Optimal Banking Arrangements, 81 AM. ECON. REV. 497, 500-01 (1991) (contending that demandable debt creates an incentive for depositors to monitor their banks).

55. See generally Macey & Miller, Bank Failures, supra note 6, at 1165 (arguing that deposit insurance destroys the incentive of depositors to monitor risky investments by managers).

56. Under Wall's approach, a bank would have 90 days to satisfy any redemption requests without violating its capital requirements. The bank would be put into an insolvency proceeding if it could not make the redemption. See Wall, supra note 54, at 3.

Commentators also have offered several other reform proposals. First, Bert Ely and Thomas Petri have suggested that deposit insurance could be replaced with an elaborate framework of cross-guarantees. See Thomas Petry & Bert Ely, Real Taxpayer Protection: Sound Deposit Insurance Through Cross-Guarantees, POL'Y REV., Spring 1992, at 25-26. Second, other commentators have argued for a "narrow bank" approach which would restrict at least some banks to liquid investments such as government securities to eliminate the existing mismatch between banks' long-term assets (e.g., loans) and short-term liabilities (e.g., deposits). For a discussion of these proposals and the problems with each, see TREASURY REPORT, supra note 52, at VII-19, VII-24 to VII-30.

57. See Michael Bradley & Michael Rosenzweig, The Untenable Case for Chapter 11, 101 YALE L.J. 1043, 1082 (1992) (proposing that a firm's equity securities will "evaporate" in the event of a default on obligations to senior creditors); Barry E. Adler, Financial and Political Theories of American Corporate Bankruptcy, 45 STAN. L. REV. 311, 323-26 (1993) (describing stock cancellation "Chameleon Equity"). For an extensive critique of these and several other proposed corporate bankruptcy reforms, see David A. Skeel, Jr., Markets, Courts, and the Brave New World of Bankruptcy Theory, 1993 WISC. L. REV. 465.

58. One interesting comparison inheres in the differences in debt monitoring of corporations, as compared to banks. Because automatic cancellation would require the elimination of creditors' foreclosure rights, see Adler, supra note 57, at 332-33, it would interfere with debt monitoring. See Skeel, supra note 57, at 487-91. Given that deposit insurance already has significantly undermined debt monitoring in the bank context, on the other hand, puttable debt could improve debt monitoring of banks.
the banking context is a perceived externality problem. The creditors dealing with any given bank have little incentive to consider the potential effect of that bank's closing on other banks. Stated differently, they have little reason to take the possibility of a contagion effect—that is, that a series of bank failures could lead to a run on other, otherwise healthy banks—into account in initiating insolvency proceedings.

Although one can imagine ways to address the externality issue, additional concerns emerge if we focus on how creditor initiation would affect the production of information under the current framework. Currently, banks are required to provide extensive information to regulators, but much of this information is not available to investors and other interested parties. Proponents of creditor initiation suggest that, were a creditor initiation proposal adopted, banks would have an incentive to provide more information to investors, this information production would assure accurate pricing of bank stock and debt, and regulators could sharply curtail the scope of their investigations.

This predicted shift in information production suggests several possible limitations of creditor initiation in the bank and insurance insolvency context. Most obviously, if banks cannot easily produce verifiable information (for example, about the current value of their loan portfolio) for the market, the mispricing of private deposit insurance or puttable subordinated debt could significantly undermine the effectiveness of creditor initiation. Given that existing data raise serious questions about the pricing of bank securities, creditor initiation would only prove effective if, as might plausibly be the case, the proposals forced banks to improve their production of information to the marketplace.

In addition to the issues already discussed, each of the proposed reforms raises further concerns of its own. None of the potential limitations of creditor initiation in the bank and insurance insolvency context. Most obviously, if banks cannot easily produce verifiable information (for example, about the current value of their loan portfolio) for the market, the mispricing of private deposit insurance or puttable subordinated debt could significantly undermine the effectiveness of creditor initiation. Given that existing data raise serious questions about the pricing of bank securities, creditor initiation would only prove effective if, as might plausibly be the case, the proposals forced banks to improve their production of information to the marketplace.

In addition to the issues already discussed, each of the proposed reforms raises further concerns of its own. None of the potential

59. The market still may register the significance of a bank examination, however. For evidence that the market does respond to regulatory downgrades and upgrades, see Allen N. Berger & Sally M. Davies, The Information Content of Bank Examinations (1995) (unpublished manuscript, on file with the Texas Law Review).

60. See Wall, supra note 54, at 9-10.

61. See R. Alton Gilbert, Market Discipline of Bank Risk: Theory and Evidence, ECON. REV. (Federal Reserve Bank of St. Louis), Jan./Feb. 1990, at 3, 11-17 (reviewing existing studies and finding that bank stock prices are inversely related to the risk assumed by the bank).

62. In the secured transactions context, Alan Schwartz has made the somewhat analogous argument that debtors would have an incentive to provide accurate information about their status, even in the absence of a filing system, to obtain better loan terms. See Alan Schwartz, A Theory of Loan Priorities, 18 J. LEGAL STUD. 209, 220 (1989). A potentially intractable problem in the banking context is verifying a bank's information about its assets, given the difficulty of assessing the value of a bank's loan portfolio. On the other hand, many of a bank or insurance company's assets and liabilities are quite liquid and have easily ascertainable values.

63. One objection to partially privatizing deposit insurance is that a private insurer might initiate an insolvency proceeding too soon, in order to eliminate any chance of suffering losses. See TREASURY REPORT, supra note 52, at VII-24. Another problem is that because a private insurer could itself
problems or limitations undermine creditor initiation altogether. But they do suggest that the case for creditor initiation is a somewhat equivocal one.

Two additional points also warrant brief comment. First, the discussion thus far has focused on creditor initiation in the banking context. Somewhat surprisingly, these kinds of reforms do not appear to have received much consideration in the insurance context. This lack of consideration is in part because several of the banking proposals, such as partial private insurance, are tied to the deposit insurance framework in banking law. But some of the proposals—puttable subordinated debt, for example—would offer both similar benefits and similar limitations for insurance regulation. As with banking, a puttable subdebt framework would require insurance companies to provide significantly more information to relevant investors than they currently do, and such a framework is undermined by creditors’ lack of incentive to take systemic effects into account.

Second, the assumption throughout this analysis that any creditor initiation reform would need to be imposed by law raises the question of why, if creditor initiation would improve bank and insurance regulation, banks and insurance companies do not adopt this approach themselves. On inspection, it becomes clear that the existing regulatory framework would stymie efforts to implement even a superior alternative approach. Most obviously, the complete control regulators have over the decision whether to initiate insolvency proceedings makes contractual adoption of creditor initiation difficult or impossible. Moreover, some of the proposals, such as the cross-guaranty scheme, could not be implemented by an individual bank because they require interbank coordination and partial displacement of the existing deposit insurance framework.

B. Refining Regulators’ Role in Initiation

Given that banks and insurance companies now face many of the same market pressures that affect other corporations, including the market for corporate control, one might expect a general shift toward market-oriented, creditor-initiation reforms of the insolvency process. Rather than making the dramatic shift to creditor initiation, however, lawmakers have focused

become insolvent, it would be necessary to regulate the private insurer, perhaps by establishing capital requirements. See id. at VII-22.

An important limitation of the puttable subdebt proposal, like stock cancellation in the corporate bankruptcy context, is that it makes much more sense for large banks than for smaller ones. See Skeel, supra note 57, at 481-91 (discussing the limits of stock cancellation). Most small banks have a much simpler capital structure and could not easily issue publicly traded subordinated debt. To be sure, the increasing use of structured finance suggests that the assets even of relatively small firms can be securitized. Moreover, large certificates of deposit can already be seen as acting somewhat like puttable subordinated debt in the small bank context. But it still is a large step from these examples to the conclusion that puttable debt would function effectively in the small bank context.
on reforming the existing framework of regulator initiation. In the banking context, Congress enacted detailed, prompt corrective-action legislation in 1991 that was designed to force regulators to initiate insolvency proceedings in a timely fashion. The insurance industry has moved in a somewhat similar direction—toward tying regulatory action to new capital standards.

I. Forcing Regulators’ Hand in Banking Law.—In late 1991, in the wake of the thrift crisis and the widespread belief that regulators had acted too slowly in closing insolvent savings and loans, Congress passed FDICIA. FDICIA responded to regulator ineffectiveness by providing an elaborate framework of command and control provisions requiring regulators to take various actions as a bank encounters financial difficulty.

FDICIA’s prompt corrective-action requirements are keyed to five zones of bank capital. Banks in Zones 1 and 2 are deemed to meet or exceed appropriate capital levels, whereas Zones 3, 4, and 5 reflect increasingly serious undercapitalization. FDICIA subjects Zone 3 banks to a series of mandatory sanctions, such as a requirement that the bank submit a feasible plan for restoring its capital to appropriate levels, and discretionary sanctions such as limits on growth or a requirement that the bank issue new equity. Zone 4 banks face the same sanctions, plus additional, more stringent ones. Finally, the statute calls for a forced merger of, or appointment of a receiver or conservator for, every bank within Zone 5 unless regulators conclude that the public interest requires more lenient treatment.

The FDICIA reforms are viewed by many as an appreciable improvement over previous law and as an effective means of forcing regulators to initiate insolvency proceedings in a timely fashion. Even in its current form, however, the regulator initiation framework has significant limitations. For example, as is frequently noted, the touchstone of the

64. For a thorough overview of the prompt corrective action provisions in FDICIA, see Klausner, supra note 8, at 760-64.
65. See Forney, supra note 29, at 829 (describing new NAIC standards for “risk-based capital” which attempt to establish action levels for state regulators based on the financial status of both life insurers and property/casualty insurers).
66. The requirements outlined below are described in more detail in Klausner, supra note 8, at 760-64, and are codified in 12 U.S.C. § 1831o(b)(l) (1994).
68. See id. § 1831o(c) (“provisions applicable to undercapitalized institutions”).
69. See id. § 1831o(b)(3)(A).
70. See Wayne D. Angell, Bank Capital: Lessons from the Past and Thoughts for the Future, 27 WAKE FOREST L. REV. 603, 610 (1992) (stating that although not “a panacea,” the FDICIA reforms are a significant improvement over the prior regulatory regime); Klausner, supra note 8, at 760-64 (suggesting that the FDICIA provisions are an improvement because they remove the often-abused discretion given to regulators under the prior regulatory regime).
entire framework is the level of bank capital. Yet bank capital calculations are notoriously inaccurate because, among other things, they are based on historical rather than current values. The likely effect of such inaccuracies is to give regulators significantly more discretion as to when to initiate insolvency proceedings than might appear to be the case.

The prompt corrective-action requirements counteract this tendency toward inaccuracy to some extent by requiring that insolvency proceedings be initiated when a bank's net worth falls to two percent (on the assumption that a bank whose balance sheet shows assets only two percent greater than liabilities is likely to be insolvent in reality). Nevertheless, regulators still have significant discretion with respect to the initiation decision. Early empirical evidence suggests, for instance, that banks do not fall into the capitalization zones that call for mandatory sanctions until they are already well on their way to financial distress. In consequence, given regulators' political disincentive to close banks promptly and related factors such as the relationships examiners develop with managers of the banks they monitor, one suspects that regulators may continue to initiate insolvency proceedings inefficiently late—particularly in times when the number of troubled banks begins to rise.

The limitation we have just considered—the possibility regulators will continue to act too slowly—supports the proposition that the prompt corrective-action structures may not work as planned. A second limitation, and one which appears to have been largely unnoticed, suggests the possibility of inefficiency even if regulators implement the new requirements as

71. See Klausner, supra note 8, at 765 (noting that a bank's position in the current regulatory scheme is determined primarily by the bank's capital level); Walter I. Conroy, Note, Risk-Based Capital Adequacy Guidelines: A Sound Regulatory Policy or a Symptom of Regulatory Inadequacy?, 63 FORDHAM L. REV. 2395, 2401 (1995) (stating that capital adequacy guidelines have become a foundation of regulatory policy).

72. See Klausner, supra note 8, at 764-65 (suggesting that the FDICIA reforms fall short of the ideal because they measure capital by historical value, rather than by market value); Conroy, supra note 71, at 2433 (noting that because capital adequacy guidelines measure the book value of a bank's assets, they are unreliable in volatile economic periods because during those times the value of a bank's assets can change dramatically).

73. See 12 U.S.C. § 1831o(c)(3)(B) (requiring "tangible equity in an amount . . . not less than 2 percent of total assets"); Swire, supra note 3, at 488-89, 489 n.93 (attributing this approximation to "accounting imperfections" associated with banks' use of historical book value in reporting their capital). For a caveat about the assumption that insolvency is the appropriate time to take action, see supra note 43.

74. See, e.g., David S. Jones & Kathleen Kuester King, The Implementation of Prompt Corrective Action: An Assessment, 19 J. BANKING & FIN. 491, 508-09 (1995) (finding that the zones requiring prompt corrective action would not include "the vast majority of troubled banks," leaving "decisions about whether or not to impose sanctions on these banks . . . largely up to the discretion of supervisors"); Joe Peek & Eric S. Rosengren, Prompt Corrective Action: Does it Make a Difference? (1995) (unpublished manuscript, on file with the Texas Law Review) (suggesting that prompt corrective-action thresholds are triggered too late, and arguing for adjustments to the standards or adoption of a different set of predictors).
intended. Consistent with existing practices, FDICIA invites regulators to require troubled banks to sell assets and to take other steps to stabilize the banks. To the extent bank managers are efficient liquidators of banks, as some commentators have assumed in the corporate bankruptcy context,\textsuperscript{75} forcing managers to downsize is an efficient response to financial difficulty. But it is not at all clear that bank managers do or will act as efficient liquidators.\textsuperscript{76}

Bank managers’ response to regulators’ insistence that they either issue warrants or liquidate assets to increase capital levels is instructive in this respect. Bank managers frequently choose to liquidate assets rather than to issue warrants.\textsuperscript{77} Perhaps liquidation outside of an insolvency proceeding is the efficient alternative,\textsuperscript{78} but the decision seems at least as likely to reflect an agency cost problem—managers resist measures like issuing warrants that would tend to dilute their shareholding interest in the bank. The broader point is that managerial liquidation outside of an insolvency proceeding may not be so attractive an option as might otherwise appear to be the case. To the extent managers’ efforts to preserve their role lead them to liquidate inefficiently, a better framework might encourage earlier initiation of insolvency proceedings so that someone else makes the decision whether and how to liquidate bank assets (a possibility I discuss in detail in Part V).

All of this discussion is simply to say that regulator initiation is imperfect in many respects. It does not necessarily mean, of course, that a better approach exists. The relative merits of regulator initiation as compared to creditor initiation, manager initiation, or a hybrid approach are issues I address below.

2. Risk Based Capital and Guaranty Funds in Insurance Law.— Before turning to this comparison, we first should briefly consider the regulator initiation framework in place in insurance law, which parallels the banking law approach in many but not all respects. As in banking law, the

\textsuperscript{75} James Bowers is the most prominent proponent of this view in the corporate bankruptcy literature. See James W. Bowers, Groping and Coping in the Shadow of Murphy's Law: Bankruptcy Theory and the Elementary Economics of Failure, 88 Mich. L. Rev. 2097, 2140-41 (1990) ("So long as debtors are the superior liquidators of certain assets in their own estates they will liquidate those assets themselves rather than turn the task over to a process which is less efficient.").

\textsuperscript{76} For a similar point in the corporate bankruptcy context, see Robert K. Rasmussen, The Ex Ante Effects of Bankruptcy Reform on Investment Incentives, 72 Wash. U. L.Q. 1159, 1188 (1994) (suggesting that in order to preserve their employment with the firm, managers who remain after a Chapter 11 reorganization will support projects for which they personally are essential, even though these projects may be detrimental to the firm).


\textsuperscript{78} Even if managers are poor liquidators, for instance, the adverse signalling effects of issuing warrants might justify liquidating assets instead.
Regulator initation framework in insurance law has been widely criticized, in part because of a perception that insurance regulators do not deal quickly and effectively enough with troubled insurance companies.\(^{79}\) In the face of suggestions that insurance regulation should be federalized, state lawmakers have been prompted to consider their own reforms and have gravitated towards solutions similar to those adopted in the banking context. They, or more accurately, policy-making organizations, such as the NAIC, have proposed risk based capital restrictions that would retain the existing framework but attempt to impose substantially greater curbs on regulator discretion.\(^{80}\) The restrictions would entail benefits and limitations similar to the prompt corrective action provisions in banking law.

One interesting difference with respect to the initiation of insurance insolvency proceedings stems from the development of guaranty funds in the last two decades. Each state’s guaranty fund is responsible for the policyholders, rather than the insurance companies, that reside within the state, as noted earlier. Because a state’s policyholders hold policies of both out-of-state and in-state companies, guaranty fund administrators have an interest in the stability of out-of-state insurance companies. Thus, we might expect guaranty fund administrators to monitor out-of-state insurance companies and, at least on occasion, to pressure regulators to initiate insolvency proceedings in a more timely fashion than might otherwise be the case.\(^{81}\)

It would be a mistake to expect guaranty fund administrators to make an appreciable difference, however. First, and most importantly, guaranty fund administrators have only limited information (and access to information) about the status of insurance companies in other states. As a result, they can only be expected to exert beneficial pressure in the event an insurance company’s financial difficulties are widely known, but state regulators have failed to take action. Second, because guaranty funds provide only partial protection for depositors, guaranty fund administrators

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\(^{79}\) For perhaps the most widely circulated criticism of the state regulators’ response to financial distress in the insurance industry, see SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATIONS, HOUSE COMM. ON ENERGY AND COMMERCE, 101ST CONG., FAILED PROMISES: INSURANCE COMPANY INSOLVENCIES (1990). For a more balanced assessment of insurance solvency concerns, see CONGRESSIONAL BUDGET OFFICE, 102D CONG., THE ECONOMIC IMPACT OF A SOLVENCY CRISIS IN THE INSURANCE INDUSTRY 24-25 (1994).


\(^{81}\) In the life insurance context, the guaranty funds act through the National Organization of Life and Health Insurance Guaranty Associations (NOLHGA), which is run by a nine person board of directors elected by the 52 state guaranty associations. See Blaine, supra note 35, at 6-1, 6-5. NOLHGA’s principal role to date has been to make recommendations on disposition once an insolvency proceeding is initiated. See id. at 6-5 to 6-6. However, it theoretically could push for initiation in an appropriate case.
may face political backlash any time the insurance company’s assets are insufficient to make policyholders whole. Thus, they may have the same kinds of incentives as other state regulators to forestall initiation.

C. Summary and Conclusions: The Comparative Virtues of Creditor and Regulator Initiation

In view of the analysis above, we now can address the question of how the recent reform proposals compare to regulator initiation as alternative approaches to an insolvency proceeding. Although the recent efforts to curtail regulator discretion seem likely to improve bank and insurance insolvency regulation, creditor initiation offers obvious benefits. For example, unlike regulators, who still have incentives to postpone initiation, creditors have a direct financial interest in responding quickly to financial distress. On the other hand, as we have seen, creditor initiation also raises several major concerns. First, particularly in the banking context, information problems could produce significant inefficiencies in initiation. In addition, because creditors have limited incentives to take systemic effects into account, regulators inevitably would continue to play a role and would presumably intervene in some cases. The possibility of intervention would introduce additional uncertainty, which would be passed on to banks and insurance companies in the form of higher capital and insurance costs.

In short, the comparative attractions of creditor initiation prove to be speculative on inspection. There is, therefore, a credible case for retaining something like the existing regime, at least as compared to the recent proposals for implementing creditor initiation. The final issue is whether an entirely different approach to initiation might prove superior to either of the alternatives we have considered.

82. For instance, under the NAIC Life and Health Insurance Guaranty Association Model Act, which has been enacted in whole or in part in 40 states, coverage is limited to $300,000 in death benefits, $100,000 in cash value of a policy, and $100,000 in health benefits, with a cumulative limit of $300,000. See id. at 6-1, 6-3.

83. In addition, guarantee associations tend to be thinly staffed, which undermines their ability to engage in any significant prefailure monitoring. See Telephone Interview with Timothy Goettel, Partner, Hunton & Williams (Nov. 26, 1997).

My speculations are confirmed to some extent by a new article by Soon-Jae Lee, David Mayers, and Clifford Smith. See Soon-Jae Lee et al., Guaranty Funds and Risk-Taking: Evidence from the Insurance Industry, 44 J. FIN. ECON. (forthcoming 1998). These authors tracked the effects of states’ adoption of guaranty funds and found that insurance companies structured as stocks increased the riskiness of their assets after adoption—which suggests that the funds subsidize risk-taking. By contrast, the authors found no evidence that adoption led to increased monitoring.

84. Whether extant creditors, as opposed to the creditors that would be injected into the process in connection with a reform proposal, should have initiation authority is a different question. I take up that question, and conclude that they should, at the end of Part IV.
IV. Rethinking the Role of Managers in Initiation

Given the central role that managers play in initiating corporate bankruptcy cases, it is striking not only that managers have almost no direct role in initiating bank and insurance insolvency proceedings, but also that lawmakers do not appear to have even considered the possibility of expanding managers' role in the initiation decision. On the contrary, nearly everyone seems to assume that the only two alternatives are creditor initiation and the current choice of regulator initiation.

Two plausible explanations for managers' absence from the formal insolvency process come immediately to mind. The first, and most obvious, is the longstanding view that managerial misconduct is the principal cause of most bank and insurance insolvencies. To the extent managerial fraud caused the problem, the reasoning goes, it would not make much sense to give managers a say in how to resolve it. While managerial fraud seems more prevalent in bank and insurance insolvencies than in other contexts, the increasing competitiveness of the banking and insurance markets in the past two decades has dramatically reduced the distinctions between banks and insurance companies and other corporations. Due to these changes in structure, bank and insurance company failures are more likely than ever before to reflect the inevitable consequences of market competition rather than managerial defalcation. It therefore is no longer obvious that managers should be immediately ousted if a bank or insurer runs into trouble.

The second possible explanation may be the difficulty of crafting a role for managers that would improve on the longstanding regulator initiation approach. I will begin with this second explanation, then return to the issue of managerial fraud.

The obvious problem with managers making, or contributing to, the initiation decision, is that managers appear to have even less incentive to act promptly than regulators, because managers usually are ousted when a bank or insurance company is put into receivership. Thus, although

85. This is not to say that managers currently play no part. They currently engage in extensive private negotiations with bank regulators in connection with the examination process. Managerial initiation would thus add formal authority to managers' existing role.
86. See Swire, supra note 3, at 508 (noting that the popular perception for the cause of 1980s bank failures was insider fraud and abuse).
87. See, e.g., Macey & Miller, Bank Failures, supra note 6, at 1166-69 (explaining how fraud and self-dealing are involved in up to one-third of all bank failures); Swire, supra note 3, at 510-18 (detailing factors that may magnify the risk of insider fraud in the banking context).
88. See Swire, supra note 3, at 509-10 (explaining how, following deregulation, banks were forced to compete with insurance companies, securities firms, and other "nonbanks" in a "newly competitive" market).
89. See infra section IV(C)(2).
managers may have better information than either creditors or regulators as to when the bank or insurance company has become insolvent, they have little reason to volunteer this information, at least under current law.

In this Part, I consider several possible mechanisms for encouraging managers to contribute to the initiation decision. The first approach I consider would give managers an incentive to run solvent firms more effectively by penalizing them in the event a bank or insurance company fails. I then consider a related strategy—the use of a “debt incentive” scheme pursuant to which managers would be required to hold debt in their bank or insurance company—designed to encourage them to initiate insolvency proceedings at an appropriate time.

In the third section, I consider a “bonus” approach that would pay managers (or shareholders) a portion of the firm’s going concern value in connection with the filing of an insolvency proceeding. As with the penalty and debt incentive approaches, the goal is to give managers appropriate initiation incentives. After concluding that both the bonus approach and a debt incentive that I refer to as “phantom debt” seem particularly attractive, I briefly reconsider the question of whether private creditors should play a greater role in the initiation process.

As the overview suggests, this Part asks whether various incentive devices would enhance managers’ incentive to contribute to the initiation decision. It is important to emphasize, however, that the case for managerial initiation remains strong even in the absence of these devices, as we will see in the Part that follows.

A. “Pure” Penalties and Managerial Initiation

1. The Pure Penalty Approach.—Perhaps the most obvious means of encouraging managers to participate in initiation would be to penalize them for failing to do so. Giving managers the authority to initiate and penalizing them if they did not would encourage managers to manage more carefully while the firm is healthy and to file promptly in the event it runs into serious financial difficulties.

A “pure” penalty approach of this sort is in some respects more attractive than the bonus approach I will defend later in the Part. Unlike a bonus, penalizing managers is consistent with the traditional view that bank and insurance insolvency almost always stems from managerial misbehavior and that managers therefore should not be rewarded for participating in the insolvency process. In addition, the penalty approach works equally well, at least in theory, for both stock and mutual companies—that is,

91. I refer to the approach discussed in this section as a pure penalty approach to distinguish it from the debt incentive alternative I consider in the next section. The debt incentive approach also penalizes managers who delay initiation, but it does so less directly.
differences in organizational form do not require adjustments to the scheme.

The most obvious initial question about penalties, as with each of the alternatives we will consider in this Part, is how the penalty should be structured. In particular, when should managers be subject to the penalty and how large should it be? One possibility would be to adopt a strict liability approach. The penalty might be triggered, for instance, whenever a financial intermediary’s managers failed to initiate insolvency proceedings within a specified time of the firm’s becoming insolvent. Although such an approach would avoid the need for a determination of fault, the difficulty of pinpointing exactly when a bank or insurance company became insolvent raises serious doubts about the workability of such a standard.

A more likely candidate, then, would be a penalty provision that required some showing of fault. Such a provision might, for instance, impose a penalty on managers who failed to initiate an insolvency proceeding within a specified number of days of the date when they knew or should have known that the firm was insolvent. If the fault-based standard could be implemented perfectly, there would be no need to worry about calibrating the penalty. Because the purpose would be to ensure that managers initiate promptly, and they could avoid the penalty by doing so, the penalty could be infinitely large without undermining the approach. The standard could not be implemented perfectly, of course, and would require difficult judgments on several issues (for example, when the managers should have known the intermediary had become insolvent), which suggests that determining how large a penalty to impose would in fact be an issue.

Calibration questions alone do not counsel against adopting a penalty approach, as one can easily imagine ways of addressing them in at least rough fashion. Yet penalties raise several other concerns which do undermine the approach. First, the possibility of a penalty might excessively chill managers’ willingness to take appropriate risks. Because managers, unlike investors, often have most or all of their human capital

92. By contrast, because strict liability regimes use the magnitude of the penalty to influence a potential violator’s behavior, it is particularly important to calibrate the penalty effectively if strict liability rather than a fault-based standard is employed. For an excellent overview of these and related insights, see Richard Craswell, When Is a Willful Breach “Willful”?: General vs. Specific Deterrence in Contract Remedies (Nov. 1, 1995) (unpublished manuscript, on file with the Texas Law Review).

93. One possibility would be to base the penalty on the manager’s salary—for example, imposing a multiple of two or three times her annual income.

94. At least on the margin, a penalty approach also could affect some firms’ ability to attract good managers.
tied up in their bank or insurance company, they already are likely to be relatively risk averse. Although deposit insurance complicates this to some extent in banks, managers still may eschew risk, and the possibility of a penalty might exacerbate this.

A second concern is whether regulators would invoke the provision in an appropriate fashion. The S&L crisis is not comforting on this issue. Although it is debatable whether regulators were justified in bringing a multitude of suits on negligence and fiduciary duty grounds against thrift managers and their attorneys and accountants, the suits often seemed motivated as much by political concerns as by the defendants' behavior.

Third, while the penalty would have a chilling effect on managers of a solvent bank or insurance company, it might, somewhat paradoxically, have little effect once a bank or insurance company did in fact encounter financial difficulty. Because managers have so great an investment in their firm, and because the firm's financial decline may often be correlated with a decline in their own finances, managers may be effectively incentive- and judgment-proof in the event financial distress actually does occur. 95

Collectively, these concerns raise significant doubts about the efficacy of using pure penalties to encourage managers to initiate insolvency proceedings at an appropriate time. The other possible approaches raise similar concerns, but each also is in important respects more attractive than the pure penalty approach.

2. Current and Historical Versions of the Penalty Approach.—In discussing the "pure" penalty approach, I have treated penalties as if the concept were new to banking and insurance law. In fact this is not the case. Banking law not only featured a variation on the penalty approach prior to the New Deal banking reforms, but recent banking reforms also have introduced what amounts to a penalty regime. Neither aims directly at managers; in part for this reason, briefly discussing them serves both as a useful comparison to our discussion thus far and as a segue to the debt incentive approach we will consider in the next section.

The first example of penalties in action is the "double liability" that Congress and many states imposed on bank shareholders during the nineteenth and early twentieth centuries. In a double liability regime, bank

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95. It is interesting to note that, if the goal of the true penalty approach were to encourage managers to avoid insolvency at all costs, some of the concerns with the approach would turn out to be benefits. The penalty approach would encourage managers to be particularly cautious, both because of what they have at stake and because of uncertainties as to when the penalty would be invoked. Although banks and insurance companies have traditionally been seen as precisely the kinds of firms for which such a strategy might make sense, financial intermediaries increasingly face the same kinds of market pressures as other firms. This change suggests that a certain number of failures is both inevitable and appropriate, as with other kinds of firms.
shareholders could be assessed an amount up to the par value of their stock if the bank subsequently became insolvent.\textsuperscript{96} The premise of double liability is that the threat of assessment will give shareholders a strong incentive to monitor the bank and ensure that it is liquidated before it becomes insolvent so that they can avoid having to pay the additional liability.

Although double liability disappeared after the implementation of deposit insurance in the 1930s, Congress has returned to the penalty approach theme in the banking context with its recent adoption of cross-guaranty and "controlling company" provisions. Under the "cross-guaranty" regulations, when a bank fails, commonly controlled banks must pay the FDIC an amount equal to the amount the FDIC expects to lose in the receivership.\textsuperscript{97} Subsequently enacted "controlling company" provisions focus on the parent corporation, requiring the parent of an undercapitalized bank to contribute the lesser of five percent of the troubled bank’s assets or the amount necessary to restore its capital.\textsuperscript{98}

Congress has not authorized holding companies to initiate insolvency proceedings themselves, an omission that could lead to unfortunate results in some cases,\textsuperscript{99} but the reforms are quite promising in many other respects. Several benefits of the holding company obligations can also be seen as benefits of double liability. Because neither they nor double liability target managers directly, for instance, there is less reason to fear that either will lead to excessive risk aversion than is the case with the true penalty approach we considered above.\textsuperscript{100} Both also have the advantage of leaving relatively little room for misapplication by regulators, because neither requires a nuanced consideration of managerial fault.

But holding-company obligations can also be seen as improving on double liability in important respects. Not only are holding companies a

\textsuperscript{96} Macey and Miller discuss the double liability approach in detail, and with approval, in a much-cited article. See Macey & Miller, Double Liability, supra note 6, at 31.


\textsuperscript{98} See id. § 1831o(e)(2). For detailed consideration of the new bank holding company obligations, see Howell E. Jackson, The Expanding Obligations of Financial Holding Companies, 107 HARV. L. REV. 507 (1994); Lissa Lamkin Broome, Redistributing Bank Insolvency Risks: Challenges to Limited Liability in the Bank Holding Company Structure, 26 U.C. DAVIS L. REV. 935 (1993). See also Swire, supra note 3 at 531-37 (focusing on cross-guaranty requirements and defending them on public choice grounds).

\textsuperscript{99} The possibility that the holding company obligations could misfire stems from the fact that the FDIC’s approach has been to insist that the holding company replenish the capital of an undercapitalized subsidiary. The FDIC’s leverage comes from the assumption that holding companies will be unwilling to let a troubled subsidiary fail. If a holding company were willing to let a subsidiary fail, however, it could simply ignore the FDIC’s ultimatum that it restore the subsidiary’s capital. See Jackson, supra note 98, at 528-32.

\textsuperscript{100} This assertion is particularly true with holding obligations because they impose a penalty on the holding company as a corporation, rather than on individual managers. Double liability may have a more significant impact on managers because managers often are substantial shareholders, especially in small banks. See Macey & Miller, Double Liability, supra note 6, at 34.
more natural monitor than shareholders, who may be widely scattered, but holding company obligations also do not entail the kinds of administrative complexities that raised doubts about the effectiveness of double liability.101

Despite these benefits, the holding company approach also has significant limitations. Most obviously, holding company regulation has, by its very nature, a limited scope, because it only applies to banks that are part of a holding company system. Because holding companies control a substantial majority of bank assets at present,102 this limitation is less dramatic than would otherwise be the case. Nevertheless, it gives banks an incentive to eschew the holding company form on the margin, and the percentage of bank assets that are not held by holding companies is far from trivial.

Another limitation of holding company obligations, as with each of the penalty approaches we have considered, is that the penalty is only effective if the holding company or its affiliates are solvent.103 To the extent one bank’s financial distress reflects trouble within the holding company as a whole, the holding company obligations could lose much of their impact.

Finally, holding company obligations, like the true penalty approach, reflect an implicit bias toward forestalling bank failure whenever possible rather than allowing banks to fail when they prove to be competitively

101. The most obvious administrative difficulty with double liability is that the cost of locating and assessing each shareholder could often be significant, particularly if the bank or insurance company were widely held.

Commentators have criticized recent proposals to eliminate shareholders’ limited liability with respect to tort claims in similar terms. See Joseph A. Grundfest, The Limited Future of Unlimited Liability: A Capital Markets Perspective, 102 YALE L.J. 387, 424 (1992) (defending limited liability against alternative regimes, particularly proportionate liability, since shareholder liability rules that deviate from the limited liability regime are subject to capital market arbitrage). Anticipating similar concerns in the double liability context, Macey and Miller have reviewed courts’ responses to administrative difficulties and conclude that the courts largely devised sensible solutions. See Macey & Miller, Double Liability, supra note 6, at 39-48. Howell Jackson has been more skeptical of the benefits of double liability. See Howell E. Jackson, Losses from National Bank Failures During the Great Depression: A Response to Professors Macey and Miller, 28 WAKE FOREST L. REV. 919, 921 (1993) (suggesting Macey and Miller’s data overestimate the recovery from shareholder assessments). But see Jonathan R. Macey & Geoffrey P. Miller, Double Liability of Bank Shareholders: A Look at the New Data, 28 WAKE FOREST L. REV. 933, 936-41 (1993) (defending their previous conclusions against Jackson’s new findings).

102. See generally Allen N. Berger et al., The Transformation of the U.S. Banking Industry: What a Long, Strange Trip It’s Been, 2 BROOKINGS PAPERS ON ECONOMIC ACTIVITY 55, 65-68 (1995). Given that the removal of geographic barriers to expansion has diminished one of the major reasons for adopting the holding company form, it is plausible that some banks will eschew holding companies at least in part to avoid holding company obligations.

103. The likelihood that a parent or affiliate will be able to satisfy its obligations also depends crucially on the priority status of the obligation. If the obligation is treated as a priority claim vis-a-vis a parent or affiliate’s other creditors, for instance, the likelihood of satisfaction will be high even if the parent or affiliate is insolvent. Current law subordinates cross-guaranty obligations but give priority to controlling company liability.
inviable. I will argue below that a major advantage of shifting from penalties to a bonus approach is that it avoids this bias. Before we turn to bonuses, however, we must first consider a very different kind of penalty approach.

B. A "Debt Incentive" Approach to Managerial Initiation

Our discussion of holding companies raises the question of whether it would be possible to design a penalty approach that focused directly on managers and thus avoided the built-in limitations of holding company obligations, but which also raised fewer concerns than a pure penalty approach. In this subpart, I will consider the best candidate for such an approach—a penalty-like strategy that I will refer to as a "debt incentive" approach.104

In concept, the approach is quite simple: it suggests that all lawmakers need to do is require that managers of a bank or insurance company hold a specified amount of its debt in addition to any stock they may hold. Although Professors Jensen and Meckling first suggested the approach as a response to agency cost issues generally,105 it also could be used as a strategy for giving managers appropriate incentives for initiating insolvency proceedings. To show this, I will briefly explore how a debt incentive approach might work before turning to some of its difficulties and considering a variation I call "phantom" debt.

The simplest approach—an approach that is essentially equivalent to the one Jensen and Meckling considered—would require that each manager hold a specified amount of the firm's debt.106 Lawmakers could mandate that each manager hold debt in the firm in an amount equal to, say, twice...
her annual salary or in a fixed amount tied to the size of the firm.\textsuperscript{107} If a manager were required to hold a substantial amount of her net worth in debt, she theoretically would have a strong incentive to initiate insolvency proceedings if financial distress began to impair the value of her debt, and the prospects for reversing the firm's fortunes were bleak.

Notice that this approach would function much like the puttable debt proposal discussed earlier.\textsuperscript{108} As such, it has several significant attractions. Not only does it target the party that is likely to have the best information about the status of the firm—its managers—but also it functions automatically, without requiring (as a true penalty would) regulators to trigger its effects. Moreover, that the debt incentive approach focuses on managers rather than outside creditors gives it an important advantage over puttable subdebt. Recall that one concern with puttable subdebt stems from questions as to whether the market would accurately price bank or insurance debt.\textsuperscript{109} Market pricing is much less important in a debt incentive scheme because the incentive is based on managers' view as to the likely recovery on the debt in the event of a liquidation. Thus, to the extent managers have better information than the market, the debt incentive could function effectively even if the market misprices the firm's debt.\textsuperscript{110}

In concept, then, requiring managers to hold debt is a promising means of encouraging managerial initiation. On inspection, the picture is somewhat more complicated, however. One concern with requiring managers to hold debt is the difficulty managers might have in maintaining a large, inaccessible investment in the firm. One can easily imagine the hardship to a small bank's manager of an obligation to hold, for instance, $500,000 of the firm's debt. An obvious solution to this difficulty would be for managers who had a liquidity problem to borrow the necessary amount, but injecting a lender into the process could interfere with managers' incentives to respond to fluctuations in the value of the debt. If the loan were secured by the debt, for instance, the lender rather than the manager herself would in a sense become the principal monitor.

The second concern is evasion. In its most obvious form, if lawmakers required managers to acquire a specified amount of debt but did not impose an ongoing requirement to hold the debt, managers could simply

\textsuperscript{107} This approach would have many of the same benefits and problems as employing the proportional approach recommended by Jensen and Meckling. One benefit of this version, as compared to a strict proportional approach, is that the managers of a publicly held firm may own a small enough percentage of the firm's stock that the debt holding requirement would not be sufficient to counteract their incentive to forestall initiation.

\textsuperscript{108} See supra notes 54-58 and accompanying text.

\textsuperscript{109} See supra notes 61-62 and accompanying text.

\textsuperscript{110} Notice, too, that taking holding company issues into account appears to reinforce the value of the debt incentive approach. Unlike holding company obligations, the debt incentive strategy applies equally well both within and outside of the holding company structure.
cash out their position or replace it with equity once they had satisfied the initial obligation. But even requiring managers to maintain a specified debt holding would not eliminate the prospect of evasion. The manager or the firm's other shareholders could adjust the manager's salary in such a way as to counteract the effect of her debt holding. Structuring the obligation to minimize the risk of evasion obviously would complicate the approach.

A third concern involves the managers' employment relationship with the firm. Through her salary and, more generally, her human capital stake, a manager already has what amounts to a debt claim against the value of the firm. To the extent these factors already make managers risk averse, superimposing an additional debt holding obligation could exacerbate the tendency. In the banking and, to a somewhat lesser extent, the insurance context, depositor and policyholder protections make managerial risk aversion somewhat less likely, because risktaking is partially subsidized by the deposit insurance system. Yet the concern remains.

Interestingly, a simple twist on the debt incentive approach could address several of the concerns we have just considered. Rather than requiring managers to actually purchase debt of the firm, lawmakers could provide for the issuance of phantom debt to managers. Thus, the firm might issue managers a debt interest that would become an actual claim against the firm only in the event of an insolvency proceeding.

Phantom debt would provide nearly all of the same benefits as actual debt. Thus, if a manager were given a phantom debt interest in her firm, a decline of the firm's fortunes would diminish the manager's expected return in the event of an insolvency proceeding. Therefore, phantom debt provides the same kind of incentive as actual debt to initiate while a manager's interest still has significant value. Yet phantom debt not only would eliminate the need for managers to actually purchase debt, but it also

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111. Barry Adler appears to have evasion of this sort in mind in his consideration of other corporations' failure to require managers to hold debt. See Barry E. Adler, Bankruptcy and Risk Allocation, 77 CORNELL L. REV. 439, 449-51 (1992); see also Jensen & Meckling, supra note 105, at 352-53 (noting that firms seldom require managers to hold debt). More generally, the debt incentive approach requires ongoing oversight of managers' compliance to assure timely initiation for the subset of firms that actually encounter financial distress. I return to this point in summarizing the three approaches we are considering. See infra subpart IV(D).

112. If the debt incentive were tied to a manager's salary, for instance, shareholders could give the manager a low fixed salary and supplement it with other benefits such as stock options exercisable in the future. Lawmakers would thus be forced to address shareholders' contentions that the benefits should not be treated as current salary, or should at the least be deeply discounted.

113. As with an actual debt requirement, the phantom debt should have junior status, so that a decline in its value would give managers an incentive to take action. I have adapted the term "phantom debt" from the "phantom stock" arrangements that nonfinancial firms sometimes use to compensate key executives. Cf. supra note 104 (discussing a similar parallel between my use of "debt incentive" and executives' stock incentives).
would require significantly less oversight, because there would be no need for managers to hold actual debt on an ongoing basis.

An obvious concern with phantom debt is that if managers could only cash it in after an insolvency proceeding, the phantom debt might give them too great an incentive to initiate. To assure herself the phantom debt payoff, a manager might initiate even if the firm were not genuinely in financial distress. Both managers' shareholding interest in the firm and their human capital stake would significantly counteract this problem. But a manager who thought she was about to be ousted (and thus had a diminished human capital interest) might still have an incentive to initiate prematurely.

One can imagine a variety of ways to minimize this concern. Perhaps the best would be to give managers a partial payment on their phantom debt in the event they were terminated under circumstances other than insolvency. Paying managers a specified percentage, say fifty percent, of the phantom debt's face value at termination would reduce premature initiation.

The effect of phantom debt would be very much like that of the third and final approach to managerial initiation, an initiation "bonus." I turn to the bonus approach in the next section and describe it at some length, then summarize and compare the three approaches.

C. Initiation Bonuses

The principle underlying the bonus approach is simple: rather than penalize managers who fail to initiate insolvency proceedings in a timely fashion as a true penalty does, lawmakers could use a bonus to "bribe" managers to serve as initiators. The promise of a bonus, such as a portion of the firm's going concern value, could encourage managers to initiate timely insolvency proceedings.

I begin the analysis of bonuses by developing a simple illustration to show how a bonus approach could encourage managers to participate in initiation. Under the simplifying assumptions I use in the illustration, the bonus induces managers to take the initiation decision into their own hands and to make the appropriate choice. In the sections that follow, I relax the

114. Golden parachutes raise very similar concerns in other contexts. Golden parachutes often are designed to counteract managers' inclinations to resist a takeover, but many observers fear that they tend to be so generous as to give managers too great an incentive to agree to a takeover. See John C. Coffee, Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offer's Role in Corporate Governance, 84 COLUM. L. REV. 1145, 1237 (1984). For evidence that these concerns are overstated and that golden parachutes provide significant benefits for the shareholders of a target, see Judith C. Machlin et al., The Effects of Golden Parachutes on Takeover Activity, 36 J.L. & ECON. 861 (1993).
assumptions to address potential objections and to provide a more complete account of both the promise and the limitations of the bonus approach.

1. A Simple Illustration of the Bonus Approach.—For the purposes of our initial illustration, assume that Manager is the sole stockholder of Firm, a bank or insurance company. We will further assume that Firm has encountered financial distress and that the presence or absence of a bonus did not affect Manager’s decisionmaking prior to Firm’s difficulties. That is, we will focus solely on the bonus’s effect once Firm has encountered financial distress.115

If the financial distress is serious, the optimal response is to initiate an insolvency proceeding promptly rather than delaying. The dilemma under existing law is that regulators are likely to initiate too late, allowing Firm’s overall value to decline.

We can restate the problem in simple algebraic terms. If regulators initiate an insolvency proceeding immediately, the total social value of Firm can be defined as the sum of the value of its assets \( V \) and the private benefits available to Manager \( b \), such as her salary and whatever benefits she receives (for example, status or a company car) as the manager of Firm.116 If regulators permit Firm to continue, rather than initiating an insolvency proceeding, Firm’s value will be the sum of \( V_c \) and \( b_e \). Our assumption that permitting Firm to continue will sacrifice value means that

\[
V_i + b_i > V_c + b_e
\]

The cost of tardy initiation is thus the difference between \( (V_i + b_i) \) and \( (V_c + b_e) \).

Under existing law, Manager’s interests directly conflict with the goal of maximizing the overall value of Firm. The value of Manager’s stock interest \( S \) (which gives Manager a contingent interest in the value of Firm’s assets \( V \)) and her private benefits \( b \) are higher if Firm continues because initiation will destroy whatever value remains in Firm’s equity and will cost Manager her job.117 Because of this conflict, Manager is far more likely to thwart than encourage initiation.

The intuition underlying the bonus approach is that a properly structured bonus might counteract Manager’s aversion to initiation and harness her superior information as to the extent of Firm’s financial distress. To

115. I discuss the ex ante effects of a bonus infra section IV(C)(3).
116. The value of Manager’s equity or other investment interest in Firm is not included in \( b \) since, as noted below, this is an interest in the value of Firm’s assets \( V \), rather than a private benefit.
117. That is, \( S + b_i > S + b_e \). Manager’s private benefits from continuing obviously will be discounted to reflect the likelihood that an insolvency proceeding eventually will be commenced, but they retain some value in the interim.
prove effective, the bonus must assure Manager that she will be at least as well off under a prompt initiation as she would be if Firm were allowed to continue. This suggests that an appropriate bonus \( (B) \) should be structured as follows:

\[
B > (S_c + b_c) - (S_i + b_i)
\]

Because initiation is likely to eliminate the value of Firm's stock \( (S_i = $0) \) and terminate Manager's job and its related benefits \( (b_i = $0) \) under existing law, the required bonus may simplify to \( (S_c + b_c) \) as a practical matter.\(^{119}\)

To put this in less abstract terms, assume that Firm's assets will be worth $1 million if regulators initiate an insolvency proceeding immediately but will be worth only $700,000 if there is a delay. Manager's private benefits are worth $100,000 if she retains her job for the time being, but they are worth very little after initiation. The value of Firm's stock is $50,000 if Firm continues\(^{120}\) and declines to zero after initiation. On these facts, Manager would encourage initiation only if she were assured a bonus worth more than $150,000.

As with each of the incentive devices we have considered, the obvious question is how to structure the bonus in practice, given that the actual values of, among other things, Manager's private benefits are quite difficult to determine prospectively.\(^{121}\) The best approach, in my view, would be to set the bonus as a percentage of the firm's going concern value.\(^{122}\)

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118. \( B \) ideally should be only slightly greater than \( (S_c + b_c) - (S_i + b_i) \); if it is significantly more, the bonus will give Manager too great an incentive to initiate.

119. This equation is true at least with respect to banks. Managers are marginally more likely to be retained, at least temporarily, in an insurance insolvency, which suggests that \( b_i \) has a positive value. The changes that I propose in Part V would reinforce this effect and thus reduce the amount of bonus necessary to give managers an incentive to initiate.

120. The stock has value even if the firm is insolvent due to the possibility that a dramatic change in fortunes will reverse the firm's financial distress. Delaying initiation keeps this possibility open and thus temporarily preserves the implicit option shareholders have on the assets of the firm.

121. Alan Schwartz's recent discussion of contracting over bankruptcy procedures assumes that the parties can calculate a manager's private benefits \textit{ex ante} and thus raises closely analogous issues. See Alan Schwartz, Contracting About Bankruptcy, 13 J.L. ECON. & ORG. 127, 137 & n.21 (1997) (suggesting some firms would contract to give managers a portion of a firm's value in bankruptcy to induce the appropriate choice between liquidation and reorganization).

122. By going concern value, I mean the difference between the firm's piecemeal liquidation value and its value as an ongoing enterprise. Cf. Douglas G. Baird & Thomas H. Jackson, Bargaining \textit{After the Fall and the Contours of the Absolute Priority Rule}, 55 U. CHI. L. REV. 738, 750 n.33 (1988) (using a much narrower definition of going concern value). For a bank, the going concern value includes, among other things, roughly one percent of the bank's deposits (which includes the cost to another bank of attracting the deposits and the cost to depositors of switching to another bank), together with the value of the bank's existing relationships with borrowers and its existing network of branches. See Telephone Interview with Leonard K. Nakamura, Senior Economist, Federal Reserve Bank of
For now, however, the most important point is that bonuses could be used to enhance the role of managers in initiation.

2. Concerns About Managers as Initiators.—Having considered bonuses in a somewhat pristine form, we now can begin to relax some of the previously used assumptions.

Let us begin with the managers. In contrast to our assumption that insolvency is an exogenous event, observers have long believed that most bank and insurance company insolvencies can be traced to managerial fraud. To the extent this is true, it raises significant doubts about a proposal which, like bonuses, rewards managers for pushing the company into an insolvency proceeding.

Although banks and insurance companies seem particularly susceptible to managerial fraud, the increasing competitiveness of financial services and insurance markets suggests that banks and insurance companies now are much more likely to fail for the same reasons that other firms fail, including competition and exogenous shocks, rather than simple managerial misbehavior. Moreover, the bonus approach could respond to managerial fraud by removing managers who have committed fraud and denying them the benefits of an initiation bonus.

Another concern is that even honest managers simply do not have an adequate grasp on their company's financial status on many occasions and thus would not be effective initiators. In other words, managers may not have the kind of superior information I have assumed. My own suspicion is that this may sometimes be true, at least in small banks and insurance companies, but that managers will nevertheless often have the best information about their firm. Moreover, to the extent managers are inadequately informed, their information deficiencies seem more likely to lead to false negatives—that is, a misguided belief that the company is still healthy—than false positives. This assertion suggests only that

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Philadelphia (Mar. 8, 1996). Insurance companies are likely to have an analogous going concern value.

One advantage of focusing on going concern value is that bank regulators already calculate this value when they resolve a bank insolvency. An obvious alternative would be to base the bonus on the firm’s total value.

123. See supra notes 86-88 and accompanying text.
124. See supra note 88 and accompanying text.
125. Regulators' handling of the savings and loan crisis does suggest at least one concern, which is that regulators would be excessively quick to characterize managerial behavior as fraud.
126. This possibility would also raise questions about debt incentives and, to a lesser extent, the true penalty approach.
127. One might also expect false negatives if managers continued to fear the stigma of having been associated with a bank or insurance company failure, as they do under the current regime. But the proposals in this Article are designed to counteract the insolvency stigma.
managerial initiation may not always improve on the existing regime, not that it will lead to affirmative harm.

3. Concerns About Ineffectiveness, and Perverse Incentives.—Relaxing our assumption that insolvency stemmed from an exogenous shock raises two more concerns about the effect of a bonus. The first is that such a bonus might have no effect at all on the initiation decision, and the second is that it could have a perverse effect on ex ante incentives.

The ineffectiveness concern reflects a fear that bonuses would simply give managers a way to have their cake and eat it too. In particular, if managers receive a bonus regardless of when they initiate an insolvency proceeding, the bonus might have little effect on initiation because the managers could delay for as long as possible and still receive the same benefit they would get if they had filed more promptly.\textsuperscript{128}

While this is in fact an important limitation of bonuses, it is important to note that it only holds true if the value of the bonus does not diminish as the firm’s financial troubles worsen. Thus, if the bonus is based on going concern value, and this value does not deteriorate as a company encounters financial distress, the concern is a serious one; but if financial distress tends to impair going concern value, the bonus approach should have a beneficial effect on managers’ incentives.\textsuperscript{129}

I am not aware of any empirical data on the degree of correlation between going concern value and financial distress, but it seems likely that going concern value does decrease as a bank or insurance company’s financial difficulties deepen.\textsuperscript{130} Moreover, the lowering of regulatory burdens in recent years may actually have increased this effect in the banking context because banks no longer have nearly as great an inherent (and thus

\textsuperscript{128} This is the problem with Oliver Hart’s offhanded suggestion that, in the corporate bankruptcy context, lawmakers could give managers senior debt to encourage them to accede to bankruptcy in both existing U.S. bankruptcy procedures and in his proposed substitute for the Chapter 11 reorganization process. See \textit{Oliver Hart, Firms, Contracts, and Financial Structure} 161, 178 (1995). The problem with senior debt is that it would retain its value as the firm’s fortunes declined. Managers could therefore actively resist bankruptcy with the full assurance they would receive most or all of the face value of their debt if the firm did eventually fail.

\textsuperscript{129} Recall that the ability of the debt incentive approach to address this concern is one of its chief attractions. In particular, because the value of managers’ debt security will deteriorate as the firm’s fortunes worsen, the approach gives managers an incentive to initiate sooner rather than later.

\textsuperscript{130} An alternative approach, if one concluded that going concern value is not adequately correlated with financial health, might be to tie managers’ bonuses to regulators’ assessments of a firm’s current capital status. In the banking context, for instance, lawmakers could provide for a bonus if managers sought to initiate an insolvency proceeding while the bank fell within Zone 4, but deny any bonus for banks in Zone 5. This approach might force managers to act more promptly and to do so at a time when the regulators had not yet fully appreciated the extent of the bank’s problems. But the approach also has appreciable downsides, such as the incentive it would give managers to focus more on when they thought regulators were about to downgrade the bank to Zone 4 than on the bank’s actual status.
inelastic) franchise value as they did when the chartering process was more monopolistic in nature. Finally, many of the sources of bank and insurance company going concerns, such as the deposit or policyholder base, are sensitive to financial distress.

In contrast to questions about efficacy, another possible criticism of a bonus approach is that it will exacerbate managers' perverse decision-making incentives. Because the promise of a bonus ensures that managers and shareholders will not lose their entire investment even if the firm fails, they have even more incentive than they might otherwise have to take excessive risks. While there is no question that the concern is a real one, the consequences to managers when a bank or insurance company fails are draconian enough that a bonus seems likely to produce at most a marginal increase in risktaking.

4. Managers or Shareholders: Who Should Receive the Bonus?—Thus far, I have assumed that the bank or insurance company is wholly owned by its manager. Many financial institutions, like other firms, are characterized by a separation of ownership and control. A crucial question for these firms is whether the bonus should be given to managers alone or to all shareholders.

Although the most obvious goal of the inducement is to counteract managerial agency costs, several factors counsel in favor of basing the bonus on shareholdership rather than managerial status. First, limiting the bonus to managers would create shareholder-manager conflicts that could significantly complicate the approach. Shareholders might routinely challenge managerial initiation—for instance, charging that managers were focusing more on their own interest in obtaining the bonus than on the best interests of the bank or insurance company. The second factor is in a sense the opposite concern: although the bonus should give managers an incentive to initiate, some still may resist initiation, particularly if their

131. Barry Adler has criticized risk-sharing theories of corporate bankruptcy in these terms. See Adler, supra note 111, at 473-75. Notice that the concern is precisely the opposite of the one that arises with the true penalty and debt incentive approaches. In contrast to the concern that bonuses would produce excessive risktaking, penalties and penalty-like approaches raise the specter of excessive risk aversion.

132. Moreover, the bonus approach has the same kind of offsetting, beneficial effects as risk-sharing has in other contexts. See, e.g., Thomas H. Jackson & Robert E. Scott, On the Nature of Bankruptcy: An Essay on Bankruptcy Sharing and the Creditors' Bargain, 75 VA. L. REV. 155, 169-74 (1989) (explaining how risksharing reduces eve-of-bankruptcy conflicts without many of the costs of the Bankruptcy Code's redistributive provisions); cf. Adler, supra note 111, at 488 (suggesting that redistributing some of the proceeds of an auction would be a better risk sharing device than current bankruptcy law).

133. In addition to the factors discussed below, a managerial bonus would function very much like phantom debt. It is therefore useful to consider a shareholder-based approach for purposes of comparison.
prospects for obtaining another, similar job are bleak. Targeting shareholders with the bonus would give shareholders an incentive to pressure managers to initiate an insolvency proceeding either directly or through the threat of displacing the firm’s current board. Finally, that managers frequently are significant shareholders and their pay increasingly is correlated with firm performance reinforces the conclusion that any bonus should be based on shareholdings.\footnote{See generally R. Glenn Hubbard & Darius Palia, Executive Pay and Performance: Evidence from the U.S. Banking Industry, 39 J. FIN. ECON. 105 (1995) (finding evidence of higher managerial turnover and a greater correlation between pay and performance in deregulated interstate banking markets).}

Despite these attractions, it is important to emphasize that shareholder bonuses only partially reconcile the interests of managers and shareholders if the firm’s stock is widely held. Their principal limitation is that a manager’s stake includes her private benefits, whereas most other shareholders are concerned only with the value of the firm’s stock. Setting the bonus high enough to compensate managers for their potential loss of private benefits runs the risk of making nonmanager shareholders too anxious to initiate, while a smaller bonus might not be sufficient to realign fully the managers’ incentives.\footnote{To put this in terms I used previously, shareholder bonuses can be seen as an adjustment to the value of shareholder’s stock in connection with an insolvency proceeding ($S$). If the adjustment is increased to account for a manager’s loss of private benefits ($b$), the adjustment will produce a windfall for shareholders whose interests do not include private benefits. A more precise bonus would compensate $S$ and $b$ separately.}

This concern obviously is diminished if the managers hold a large equity stake in the bank or insurance company.

5. **Bonuses in Companies Structured as a Mutual.**—The last issue I will consider arises from the mutual structure of many insurance companies (and some bank-like intermediaries). Although insurance companies have tended away from rather than toward the mutual structure in recent years, mutuals are responsible for nearly half of the life insurance and one-fourth of the property insurance in force.\footnote{See Henry Hansmann, The Organization of Insurance Companies: Mutual Versus Stock, 1 J.L. ECON. & Org. 125, 125 (1985). Hansmann argues, with respect to life insurance, that the mutual form can be explained as a response to asymmetric information and the lock-in effect of long term contracts with a limited exit option. See id. at 129-33. In the property insurance context, he attributes the mutual form to intra-industry efforts to obtain lower insurance rates. See id. at 149. For a somewhat different theory of the mutuals, see David Mayers & Clifford W. Smith, Jr., Ownership Structure Across Lines of Property-Casualty Insurance, 31 J.L. & ECON. 351, 356-57 (1988) (characterizing mutuals as controlling incentive problems between policyholders and stockholders, at the risk of exacerbating managerial incentive problems). For further analysis and evidence supporting their account, see David Mayers & Clifford W. Smith, Jr., Organizational Forms Within the Insurance Industry: Theory and Evidence (Feb. 2, 1997) (unpublished manuscript, on file with the Texas Law Review).} That mutuals are owned by their
policyholders rather than stockholders raises a question of whether the bonus approach makes sense for such companies.\textsuperscript{137}

On inspection, it becomes clear that bonuses would be equally effective for mutuals. But reaching that conclusion requires us to address two issues. The first question, given the absence of shareholders, is who should receive the bonus. Initially at least, the obvious group on which to focus is whoever is entitled to the residual profits of the company and thus plays a role somewhat analogous to that of the shareholder—ordinarily, the policyholders.\textsuperscript{138}

Second, what about the managers of the company? In a stock company, because the managers usually hold stock, a stock-based incentive will influence both shareholders and managers. In a mutual, however, managers and policyholders do not have the same commonality of interest. Given that managers would make the initiation decision in a bonus regime, one possible approach would be to give managers, rather than policyholders, of a mutual the bonus. This approach could create significant conflicts of interest between managers and policyholders, however, which suggests that policyholders should also receive a bonus. In view of this suggestion, the most sensible solution might give the majority of the bonus to policyholders but set aside a portion for managers to give them an incentive to initiate an insolvency proceeding in a timely fashion.\textsuperscript{139}

The possibility of dividing the bonus between policyholders and managers leads to an obvious question: what portion should managers receive? One approach would be to base managers’ share on the average percentage of stock that managers hold in stock companies of comparable size. Thus, if the principal managers of mid-sized property and casualty companies own an average of three percent of the company’s stock, lawmakers could give the managers of a similarly situated mutual three percent of the going-concern bonus in connection with an insolvency proceeding.

In the next Part I will argue that adding a reorganization option in the insurance context could diminish the need for an explicit bonus and thus

\textsuperscript{137} Because the concerns discussed below stem from the nexus between the bonus approach I have advocated and shareholdership, they would not arise in connection with the true penalty or debt incentive approaches.

\textsuperscript{138} An article by John Hetherington is perhaps the most widely cited discussion of the nature of policyholders’ role. See John A.C. Hetherington, Fact v. Fiction: Who Owns Mutual Insurance Companies?, 1969 Wis. L. Rev. 1068 (contending that policyholders have only limited control of a mutual). Despite the practical limits of policyholders’ control, policyholders still are the obvious choice to receive any bonus. See generally Theodore Allegaert, Comment, Derivative Actions by Policyholders on Behalf of Mutual Insurance Companies, 63 U. Chi. L. Rev. 1063 (1996) (arguing for policyholder standing to pursue derivative claims in the mutual context).

\textsuperscript{139} Jackson briefly alludes to the possibility of a similar approach in the corporate bankruptcy context. See THOMAS H. JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAW 207 n.44 (1986) (suggesting that shareholders and managers should share in a court-formulated bounty to encourage the timely initiation of bankruptcy proceedings).
might avoid the complexities we have just considered. The present analysis suggests that, even if lawmakers did not adopt a reorganization option, a bonus-based approach to managerial initiation could prove effective for mutuals as well as stock companies.

D. Summary and Conclusions: How Can or Should the Incentive Device Be Implemented?

My analysis of true penalties, debt incentives, and bonuses is intended to emphasize the simple point that, although managers currently have little reason to contribute to the initiation decision, a variety of strategies could be used to realign managers' incentives. Giving managers the authority to initiate, and adopting one of the approaches we have considered, could dramatically improve the initiation process.

Of the approaches we have considered, I am least optimistic about employing a true penalty approach. The difficulty of determining in retrospect when managers "should" have initiated insolvency would make the approach difficult to apply. Further, penalties of this sort might induce managers to avoid failure at all costs, a stance at odds with the increasingly competitive markets within which banks and insurance companies operate.

Both the debt incentive and bonus approaches are more promising in this respect. Through changes in the value of the managers' debt, debt incentives send a much clearer signal to managers as to when to initiate insolvency proceedings. Further, the bonus approach affirmatively rewards managers for initiating insolvency proceedings in timely fashion.

To be sure, both phantom debt and shareholder bonuses, like managerial initiation generally, raise questions similar to those prompted by the creditor initiation proposals we considered in Part III. But the concerns seem much less problematic in this context. While managers are less likely than regulators to take systemic risk into account, for instance, not only have changes such as depositor priority made contagion effects less likely than in the past, but also managerial initiation can easily accommodate adjustments designed to enable regulators to respond to the threat of systemic risk.140

Phantom debt is in some respects the most attractive approach. For instance, it is less likely than a true penalty or other debt incentive approach to induce excessive risk aversion. Phantom debt also shares with bonuses an additional advantage over the use of actual debt. Neither would require nearly as much oversight as an actual debt requirement, which

140. Rather than initiating publicly, for instance, lawmakers could require managers first to notify regulators privately, so that regulators could delay the initiation if its announcement seemed likely to have a contagion effect. Similar protections could be added to creditor initiation, but the prospect of regulatory interference seems likely to be more disruptive in that context.
would impose ongoing implementation costs even in firms that are financially sound.

In addition to providing several of the same benefits as a shareholder bonus, phantom debt also avoids several of the limitations peculiar to bonuses. Phantom debt would not create an incentive to take excessive risk while the firm is healthy, for instance, and the approach would not need to be adjusted for firms that are structured as mutuals.

Yet shareholder bonuses have an offsetting attraction: because they would be given not only to managers, but also to shareholders, shareholder bonuses reduce conflicts between managers and shareholders. This commonality of interest could reduce shareholders' incentive to challenge managers' decision to initiate an insolvency proceeding and give shareholders a reason to prod managers to initiate should the managers of a troubled firm drag their feet.

Given that the choice between phantom debt and shareholder bonuses could vary from firm to firm, the best means of implementing managerial incentives might be to let the firms themselves decide whether to adopt one of the approaches. This is particularly true given the uncertainty regarding how much phantom debt to give managers and how large a shareholder bonus to promise.

The practical obstacles to this strategy are quite straightforward. Because managers are precluded from initiating bank and insurance insolvencies, lawmakers would need to authorize managerial initiation. Permitting managers to remain in place after initiation would further enhance their interest in the initiation decision, as we shall see in the next Part.

Perhaps the most important objection to the private contracting strategy I have just described is that managers would implement plans promising excessive benefits on initiation, which would give them too great an incentive to initiate. The obvious analogy here is to other firms' adoption of golden parachutes that are triggered by a takeover of the firm. Although golden parachutes have the beneficial effect of counteracting managers' incentives to resist a takeover that may cost them their jobs, many observers fear they are so generous that they make managers too willing to agree to a takeover bid.

Given that managers routinely lose their jobs after a takeover, the argument that golden parachutes will make them too anxious for a takeover seems debatable at best. Moreover, market forces will penalize a firm

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141. This of course is a major theme of much of the recent corporate bankruptcy literature.
143. See supra note 114.
that adopts an inefficient golden parachute once it is in place. In consequence, the most significant concern with golden parachutes, and by analogy phantom debt and shareholder bonuses, is that firms will be opportunistic and will implement them immediately before the triggering event.

Although opportunistic changes are a concern in many contexts, the risk is easily remedied in this context. Bankruptcy law addresses related concerns by reversing preferential transfers that a debtor makes on the eve of bankruptcy. By invalidating phantom debt or bonus arrangements adopted shortly before insolvency, lawmakers could eliminate the risk of opportunism.

Another possible concern is that financial intermediaries might have too little incentive to employ either of the two devices. To the extent that the deposit insurance framework in banking and insurance guaranty funds enables firms to externalize risk, firms may be disinclined to encourage initiation. The move to risk-based capital seems likely to reduce, but not eliminate, the risk subsidy.

Despite its limitations, private contracting seems more promising than adopting phantom debt or shareholder bonuses legislatively. But a legislative approach also would improve on the existing framework. Unlike phantom debt, shareholder bonuses could easily be structured as a single, uniform rule for all firms. As a result, shareholder bonuses seem particularly amenable to legislative implementation.

Even if lawmakers eschewed phantom debt and bonuses altogether, permitting managers to initiate insolvency proceedings still would improve on the current, regulator-controlled framework. This will become even clearer in the next Part of my analysis, in which I will show that several relatively simple adjustments to the disposition options in bank and insurance company insolvencies could act as an implicit bonus to managers, thus encouraging initiation in the absence of the kinds of incentive devices I have considered.

E. Creditors' Role in Initiation: A Reprise

As an alternative to the creditor initiation reforms we considered in Part III, I have proposed in this Part that managers be given an incentive

144. See 11 U.S.C. § 547(b)(4)(A)-(B) (1994) (invalidating transfers occurring on or within 90 days of bankruptcy, with a reachback period of one year for insiders).
145. Both Bob Rasmussen and I have proposed similar strategies in connection with proposed reforms of corporate bankruptcy law. See David A. Skeel, Jr., Rethinking the Line Between Corporate Law and Corporate Bankruptcy, 72 TEXAS L. REV. 471, 544 (1994) (proposing that states be permitted to regulate corporate bankruptcy, under a scheme that would disallow eve-of-bankruptcy changes to a firm's state of incorporation); Robert K. Rasmussen, Debtor's Choice: A Menu Approach to Corporate Bankruptcy, 71 TEXAS L. REV. 51, 100-21 (1992) (proposing to allow firms to prospectively choose the type of insolvency proceedings to which they will be subject, but restricting modifications on the eve of bankruptcy).
to initiate an insolvency proceeding. But managerial initiation does not necessarily mean prohibiting creditors from participating. Should a firm's existing creditors also have the authority to initiate, even if lawmakers adopt managerial initiation rather than one of the existing creditor initiation proposals?

The analogy to other corporations suggests that they should. Although managers file nearly every corporate bankruptcy petition, even though creditors also have this right, it is widely believed that managers' filing decisions are routinely prompted by creditor monitoring or collection effects. In view of creditors' role in other corporate contexts, it would seem sensible to give creditors similar initiation authority in the banking and insurance context.

The real question is not whether creditors as well as managers should be given the right to initiate, but whether the initiation right would prove effective. To appreciate the obstacles to creditor initiation, we need only consider the parameters of creditor initiation in the Bankruptcy Code. Under the Code, creditors must show that the debtor is not "paying its debts as they come due" to force a debtor into bankruptcy. While it might seem appropriate at first glance to adopt a similar standard for financial intermediary insolvencies, a moment's reflection reveals that such a standard would prove ineffectual. Unlike other corporations, banks and insurance companies do not begin failing to pay creditors when they encounter financial distress because they have an ongoing source of cash flow from, and no ongoing payment obligation to, depositors and policyholders. Thus, if the standard were failure to pay debts, creditors would play little role in initiation.

What, then, might the standard be? The obvious alternative would be to adopt a balance sheet standard authorizing creditors to initiate an insolvency proceeding if the firm's liabilities exceed its assets. This in fact was an implicit requirement for creditor initiation under the old Bankruptcy Act. The chief shortcoming of this standard, and the reason that the

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146. The Bankruptcy Code authorizes creditors of a firm to file an involuntary petition if three creditors (when the debtor has 12 or more creditors) with a total of at least $10,000 in unsecured claims join the petition. See 11 U.S.C. § 303(b) (1994). If the debtor challenges the petition, the creditors are required to show that the debtor is "generally not paying [its] debts as [they] become due," or a trustee or receiver was appointed in the 120 days prior to the petition. Id. § 303(h).


149. Under the old Bankruptcy Act, creditors were required to show that the debtor had committed one or more of six "acts of bankruptcy," such as making a fraudulent or preferential transfer or failing to vacate a judicial lien while insolvent. See Bankruptcy Act, 11 U.S.C. § 531 (1976) (repealed 1978). Each of the acts of bankruptcy either explicitly or implicitly required a showing of insolvency, which
drafters abandoned it with respect to other corporations, was the difficulty of proving that the debtor was in fact insolvent when creditors filed a bankruptcy petition. The problem could be particularly acute for banks and insurance companies, given the notorious opacity of their financial status.

Obstacles of this sort raise the question of whether creditors’ access to information could realistically be improved to enable them to monitor more effectively. The most obvious strategy under the existing regime might be to require regulators to release the information they obtain through the examination process. If creditors had access to even a portion of the nonpublic information regulators obtain through examinations, they could play a much more active role as monitors generally and in contributing to the initiation decision in particular.

However, public release of examination information also would have appreciable downsides. Most importantly, it would dramatically undermine banks’ and insurance companies’ willingness to be forthcoming with examiners. As a result, examinations might produce less information about the status of the company. Moreover, if creditors were given the right to initiate insolvency proceedings, they might themselves insist on greater access to information, thus at least partially obviating the need for regulators’ work product. In view of this, the better approach is not to require regulators to publicize the results of their examinations.

To summarize, the manager initiation regime I have described should also give creditors the authority to initiate an insolvency proceeding if they can show that a bank’s liabilities exceed its assets. Although creditor initiation has obvious limitations, it would provide an additional source of prompting for managers to initiate an insolvency proceeding if the firm encounters intractable financial distress.

V. The Disposition Decision in Bank and Insurance Insolvency Proceedings

At the other end of the insolvency process from initiation, but closely tied to it, is the disposition issue of what to do with a troubled bank or
insurance company that has been put into an insolvency proceeding. It would be possible, of course, to resolve financial distress without resort to an insolvency proceeding. In the corporate bankruptcy context, for instance, commentators have argued for proposals under which financial distress would trigger automatic capital structure adjustments.\textsuperscript{153} I touched on these proposals in Part III and will not revisit them here, but it is important to keep in mind that an insolvency proceeding is not the only possible means of dealing with troubled companies.

Roughly speaking, insolvency proceedings lead to one (or a combination) of three possible dispositions of a troubled company: (1) piecemeal liquidation, (2) a third-party sale, or (3) a traditional reorganization. I begin this Part by describing each of these disposition options and some of the distinctions among them. I then characterize bank and insurance regulators' current practices in terms of the three alternatives. The most striking observation that emerges from the characterization is that neither bank nor insurance insolvency includes a traditional reorganization option. The question this raises, which we will consider for much of the Part, is whether either should—that is, whether reorganization would enhance the overall efficiency of the bank or insurance insolvency process.

A. The Disposition Options: A Brief Overview

The simplest response to financial distress is to effect a piecemeal liquidation. In a piecemeal liquidation, the trustee or receiver closes the firm's doors, sells its assets piece-by-piece, then distributes any net proceeds to the firm's creditors.\textsuperscript{154} The principal attraction of piecemeal liquidation is that it avoids the complexities of the other disposition options, an attribute that is particularly desirable if a firm's financial distress reflects a lack of viability as an ongoing enterprise.

At the far end of the spectrum from piecemeal liquidation is reorganization. The traditional reorganization process entails an extended bargaining process among the debtor and its various classes of creditors, culminating in the confirmation of a reorganization plan that scales down the corporation's debts in order to eliminate its financial distress.\textsuperscript{155} At least with publicly-held corporations, reorganization usually transfers shareholding control to the firm's creditors, although shareholders often

\textsuperscript{153} See \textit{supra} note 57 and accompanying text.
\textsuperscript{155} See Robert K. Rasmussen & David A. Skeel, Jr., \textit{The Economic Analysis of Corporate Bankruptcy Law}, 3 AM. BANKR. INST. L. REV. 85, 94 (1995) (arguing that, because of the business nature of reorganization, markets and private actors are better suited for control of reorganization than are courts).
retain a portion of the stock. 156 As compared to piecemeal liquidation, reorganization is justified as necessary to preserve the going concern value of a troubled enterprise. 157

Third-party sales ideally can offer the best of both worlds. Because a third-party sale does not require an extensive bargaining process, it may be far less costly than a traditional reorganization. 158 Yet third-party sales, unlike piecemeal liquidation, preserve a company’s going concern value because the buyer acquires most or all of the troubled firm. In view of these advantages, some commentators have suggested that it might make sense to eliminate corporate reorganization altogether and simply auction off a firm once it files for bankruptcy. 159

It would be a mistake to view third-party sales as a panacea, however. Third-party sales are unlikely to be effective for small firms, and they may be undermined in other contexts by factors such as the possibility that the most likely buyers of a firm, its competitors, may be weakened by the same economic forces that contributed to the insolvent firm’s decline. 160 Moreover, the prospect of a third-party sale can give managers an incentive to forestall the insolvency proceeding by, among other things, engaging in a potentially inefficient sale of the firm’s assets. 161

Given this array of disposition options and the appreciable limitations and attractions of each, the questions we will want to keep in mind as we turn back to banks and insurance companies are: Which options does the existing framework entail, and are the current choices sound?

B. Disposition Under Current Bank and Insurance Company Law

Although they have a variety of other alternatives at their disposal, 162 bank regulators ordinarily rely on one of three options: (1)
straight liquidation, (2) insured-deposit transfers, and (3) purchase and assumption transactions. In a straight liquidation, regulators simply liquidate the assets of a bank and pay off the depositors of the bank to the extent they are covered by the deposit insurance. Straight liquidation thus corresponds to the category I have referred to as piecemeal liquidation.

The second option, insured-deposit transfers, can be seen as something of a hybrid between a piecemeal liquidation and a third-party sale because the bank’s liabilities are transferred to a third party, but regulators simply liquidate its assets piecemeal. Finally, in a purchase and assumption transaction, regulators sell some or all of the bank’s assets to another bank, which also assumes some or all of the bank’s liabilities, thus effecting what amounts to a third-party sale.

During the bank and thrift crises of the 1980s, many observers were critical of regulators’ decision as to which of the existing options to employ in a given case. The FDIC developed a clear preference for purchase and assumption transactions that ensured full payment not only of insured depositors but also of uninsured ones, even though other approaches, such as an insured-deposit transfer, might have proved far less costly to the deposit insurance system. Commentators also criticized the procedures that regulators used in effecting purchase and assumption transactions.

As noted above, this Part will focus on what bank regulators fail to do, rather than what they do—that is, I will focus on how the FDIC’s standard options all involve what I have referred to as piecemeal liquidation or third-party sales to the exclusion of traditional reorganization. It is worth noting, however, that some of the criticism of the options that the FDIC does employ may have been overstated and that Congress’s recent legislative efforts could significantly alter regulators’ choice among disposition options.

First, with respect to the efficacy of the FDIC’s purchase and assumption auction procedures, Professors Macey and Miller’s criticism draws on the auction theory insight that restricting the number of bidders below the

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163. See, e.g., MACEY & MILLER, supra note 11, at 644-47.
164. See id. at 645.
165. See id. at 646-47. Because the assets of the failed bank are ordinarily less than its liabilities, the sale entails a payment by regulators to the buyer in an amount that reflects the degree of insolvency less the bank’s going concern value. Id.
166. See Macey & Miller, Bank Failures, supra note 6, at 1183 (stating that the FDIC’s “observed behavior” illustrates its preference for purchase and assumption transactions).
167. See id. at 1184-87 (contending that declining to protect fully uninsured depositors would both decrease costs and give uninsured depositors an incentive to monitor the banks).
168. See id. at 1187-91. Macey and Miller argued, for instance, that the FDIC artificially limited the number of bidders for a troubled bank’s assets, thus diminishing the price it received in the purchase and assumption auctions it conducted.
169. See supra section III (B)(1) (discussing FDICIA).
natural equilibrium number will diminish the amount of the winning
bid.170 Although regulators did conduct secret auctions with a group of
handpicked bidders, the process may nevertheless have included most or
all of the likely bidders. The low number of bidders probably stemmed
less from artificial exclusion than from the regulatory constraints on
geographical expansion by banks, which reduced the number of possible
bidders.171 The continued erosion of these barriers could significantly
increase the number of potential bidders in future bank insolvencies.172
On balance, the existing process seems superior to Macey and Miller's
proposal for public auctions, given that public auctions would create a risk
of costly depositor runs during the time it takes to structure and hold the
auction.

As for regulators' choice between purchase and assumption trans­
actions and other disposition options, the recent depositor preference statute
will constrain regulators' flexibility in significant respects.173 Because
depositors now have priority, and regulators must employ the "least costly"
disposition option, regulators cannot effect a purchase and assumption

170. See Macey & Miller, Bank Failures, supra note 6, at 1189 (citing Kenneth R. French &
Robert E. McCormick, Sealed Bids, Sunk Costs, and the Process of Competition, 57 J. BUS. 417, 423-
24 (1984)). For an analysis of some of the limitations of French and McCormick's analysis—most
notably, their widely cited conclusion that the sales price in an auction will equal the asset's value
minus the total costs of all the bidders—see Victor P. Goldberg, The Gold Ring Problem (Apr. 25,
1996) (unpublished manuscript, on file with the Texas Law Review). For our purposes, it is interesting
to note that one of Goldberg's principal concerns may figure less prominently in the banking context
than elsewhere. Goldberg notes that individual sellers may face a collective action problem which
undermines their individual incentives to minimize bidders' costs. Because the FDIC conducts all sales
of troubled banks, it is not an isolated seller, and collective action problems of this sort are unlikely
to figure nearly so prominently as might otherwise be the case.

171. Moreover, bank regulators' ongoing relationship with the banks they regulate makes them
particularly well situated to identify the most likely acquiring banks.

Two aspects of the FDIC's purchase and assumption procedures further enhance the process by
reducing bidders' costs. First, the FDIC provides detailed information to bidders to obviate their need
to generate it themselves. In addition, the FDIC has frequently reduced bidders' concern that the informa-
 tion will imply an overly optimistic value by agreeing to take back loans that prove undesirable after
the purchase and assumption. See French & McCormick, supra note 170, at 430 (stating that reducing
bidders' costs tends to increase the number of bidders). For a criticism of the FDIC's practice of
buying back problem loans at full face value, see Eric S. Rosengren & Katerina Simons, Failed Bank
Resolution and the Collateral Crunch: The Advantages of Adopting Transferable Puts, 22 J. AM. REAL
EST. & URB. ECON. ASS'N 135, 135-36 (1994) (describing how the current FDIC practice gives
incentives to foreclose excessively on loans found on the books of failed banks).

172. Most recently, the Riegle-Neal Interstate Banking Efficiency Act of 1994 has largely
eliminated the McFadden Act's, 12 U.S.C. § 36(c) (1994), prohibition on interstate banking. See
2338. For a description of the effects of Riegle-Neal, see Berger et al., supra note 102, at 62.

potential effects of depositor preference, see Bert Ely, Surprise! Congress Has Just Enacted What
transaction if another option would lead to full recovery for insured depositors at no cost to the FDIC. Given depositors' newfound priority, the liquidation-oriented options will often have precisely this effect even when a purchase and assumption transaction would not. As a result, the current framework should curtail significantly regulators' ability to favor purchase and assumption transactions over liquidation and insured deposit transfers.

From banks, let us now turn briefly to insurance insolvencies. Like bank regulators, insurance regulators frequently resolve financial distress by selling some or all of the insurance company's assets to a third party. The penchant for third-party sales stems both from regulators' strong concern to preserve the company's existing policies and from the administrative convenience of simply transferring everything to a third party.

The most obvious difference in insurance company insolvency proceedings, as compared to bank proceedings, is that regulators do sometimes resolve insurance company insolvencies through something like a traditional reorganization. The reorganization process differs in

174. An earlier version of the "least costly" restriction on disposition pre-dates FIRREA and FDICIA, the two principal sources of the new changes, but FDICIA has significantly enhanced its bite. Whereas the restriction originally required only that a proposed disposition be less costly than liquidation, the provision now requires that the disposition be the least costly possible approach. See 12 U.S.C. § 1823(c)(4)(A); Swire, supra note 3, at 538 n.251. The new federal depositor preference provision should further increase its significance, as I discuss in detail below.

175. Consider a simple illustration. Assume that a bank has assets of $1000; its $1200 in liabilities consist of $400 of secured claims, $600 of deposits, and $200 in unsecured claims. Suppose that regulators can either liquidate the bank or effect a purchase and assumption transaction, pursuant to which another bank is willing to acquire the bank's assets and assume all of its secured claims and deposits if regulators pay the acquirer $110. (Notice that this implies a $90 going concern value since the face amount of the bank's liabilities exceed its assets by $200 ($1200 - $1000), but regulators are only required to make a $110 payment.) Absent the depositor preference statute, regulators could opt for the purchase and assumption, because the purchase and assumption would only cost regulators $110, whereas a liquidation would require them to pay the $150 difference between depositors' pro rata share of the $600 left for unsecured creditors (here, the depositors and the unsecured claims) after the secured claims were paid (($600/$800)x($600) = $450), and the $600 total that depositors are owed. By contrast, under depositor preference, depositors would be paid in full in a liquidation, as compared to the $110 cost of the purchase and assumption. Regulators would therefore have no choice but to liquidate the troubled bank.


177. This is especially true with life insurers, due at least in part to the premium placed on keeping life insurance in place. Property and casualty insurer insolvencies are more likely to result in piecemeal liquidation.

178. See, e.g., Christopher M. Maisel & Robert H. Nunnally, Managing a Large Insurer Insolvency—The Executive Life of California Experience, in ABA, LIFE INSURANCE INSOLVENCY, supra note 35, § 2-1.

179. Recall from subpart II(B) that this is particularly true with large insurance companies.
important respects from that of other companies under Chapter 11 of the Bankruptcy Code, however, because regulators rather than managers and creditors control the proceedings.\footnote{80}

\section{C. Is There a Place for Traditional Reorganization?}

My analysis thus far has highlighted that bank regulators almost never use traditional reorganization as a disposition option, and insurance regulators do so relatively infrequently and in a somewhat limited way. Why is this? The most obvious reasons are that bank and insurance regulation simply has developed in a different direction as a historical matter, or that regulators have eschewed reorganization because it would prove ineffective.\footnote{81}

Although both of these elements contain a certain amount of truth, the increasing tendency to view banks and insurance companies in the same fashion as other corporations and to focus on the financial effects of capital structure choices suggests the need to at least consider the potential efficacy of traditional reorganization as an alternative to liquidation and third-party sales. Moreover, the availability or unavailability of a reorganization option has important implications for our final assessment of the managerial (and creditor) initiation regime I described in the last Part.

\subsection{I. Reorganization for Banks (and the Practical Obstacles).}

On first inspection, reorganization does not even appear to be a plausible option for banks due to two significant obstacles. First, much more than a liquidation or third-party sale, the reorganization process by its very nature takes time.\footnote{82}

\footnote{80. See supra notes 29-41 and accompanying text. It is important not to overstate this contrast between banks and insurance companies when it comes to the disposition question. Although bank regulators do not ordinarily reorganize insolvent banks in the traditional sense, their invocation of the “too big to fail” doctrine (when they make a cash infusion) can have a similar effect when a large bank encounters financial difficulty.}

\footnote{81. Another explanation is that bank and insurance insolvency law has traditionally been based on the assumption that the goal of bank and insurance regulation is to prevent failure at all costs. Reorganization, by contrast, has tended to assume a willingness to permit failure as a normal incident of market processes. As the analysis of this Article suggests, the traditional reluctance to let banks and insurance companies fail seems inappropriate in the current era of bank and insurance company competition. For an early argument that banks should be allowed to fail, see A. Dale Tussing, The Case for Bank Failure, 10 J.L. & ECON. 129, 131 (1967) (contending that “competition in banking, inclusive of the threat of failure, [is] consistent with the usual purported objectives of bank regulation, namely protection of depositors and maintenance of a viable and efficient payment mechanism”).}

\footnote{82. It is important not to overemphasize the distinction between reorganization and the other alternatives in this respect, however. Liquidations and third-party sales also take time. Currently, bank regulators conduct much of the process secretly, before they formally initiate an insolvency proceeding. See, e.g., Clark, Soundness, supra note 6, at 101. This suggests that the more significant distinction between reorganization and the alternatives may be that it is more difficult (though not impossible) to conduct a reorganization outside of the formal process.}
insured depositors may withdraw their deposits if there is any appreciable delay between the initiation and conclusion of an insolvency proceeding. Regulators could minimize withdrawals by freezing deposits during the pendency of the proceeding, but this action seems unattractive given many depositors' need for ongoing access to their accounts.

The second obstacle stems from the nature of the deposit insurance framework. In Chapter 11 bankruptcy cases, the reorganization process often centers on the negotiations between the firm's managers and a wide range of unsecured creditors who, in bankruptcy, are the firm's residual owners.\(^{183}\) In the banking context, by contrast, the FDIC often dominates the firm's capital structure because it steps into the shoes of all of the bank's insured depositors in the event that the bank becomes insolvent. Because so much of the liabilities are held, in effect, by the FDIC (and depositor preference limits the extent to which deposit liabilities can be adjusted), it is not immediately clear whether a traditional reorganization process would have a meaningful role to play.\(^{184}\)

Interestingly, neither concern is insurmountable. With respect to the first and arguably more difficult issue, bank regulators already have the authority to set up a bridge bank for the duration of an insolvency proceeding.\(^{185}\) In theory at least, regulators could give the managers of a troubled bank a thirty or forty day period to devise a reorganization plan and use a bridge bank to maintain relatively normal operations in the interim. This procedure would not eliminate depositor withdrawals,\(^{186}\) to be sure, but it might limit depositor flight if the transition were smooth enough.

As for the role of reorganization, managers might propose to scale down nondepositor creditors' debts and in some cases to give the FDIC something less than the full amount of the deposits as an alternative to piecemeal liquidation or a third-party sale. If the cost to the FDIC were less than the other disposition options, reorganization could (again, in theory) prove attractive.

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184. Another important question is whether the game is worth the candle: because many of banks' assets are financial in nature, and thus liquid, one could question whether there is likely to be an appreciable bank-specific franchise value to reorganize, particularly now that deregulation has reduced the monopoly value of a bank charter. In my view, and as suggested in the analysis below, many troubled banks would in fact have sufficient going concern value to justify at least considering reorganization.

185. For a description of the FDIC's authority to create a bridge bank, and its applications, see Zisman & Waites, supra note 16, § 13.07, at 60-62.

186. Recall that depositor withdrawal would be a similar concern if regulators were to effect purchase and assumption transactions through a public auction. See supra text accompanying notes 172-73.
The obvious question is whether the advantages of reorganization really would be that significant as compared to the existing disposition options. With respect to reorganization as I have described it, my own inclination is to be skeptical. Reorganization could prove effective in some cases. For large banks, for instance, reorganization might make sense as an alternative to a third-party sale if there were few or no banks that realistically could purchase the troubled bank.\(^{187}\) For small banks, reorganization could sometimes be attractive because a third-party sale—assimilating the bank into a larger bank structure—might sacrifice its effectiveness in engaging in relational lending.\(^{188}\)

Yet the downsides of bank reorganization seem daunting. As we have discussed, even a bridge bank and a quick reorganization process would probably not eliminate the hemorrhaging that would occur during the pendency of the insolvency proceeding. In addition, reorganization could easily magnify perverse incentives for regulators to avoid liquidating banks at all costs due to the political costs and absence of benefits from liquidating.\(^{189}\) In view of these concerns, traditional reorganization may hold only limited promise in the banking context.

The recent trend toward consolidation in the banking industry does, however, suggest that a limited version of reorganization could play a valuable role. In the face of heightened competition, troubled banks in particular have increasingly looked to merge with another bank as a means of enhancing their longterm prospects.\(^{190}\) An obvious limitation of this

\(^{187}\) If regulators view the bank as "too big to fail," however, they would be likely to give it a cash infusion outside of an insolvency proceeding, as they did with Continental Illinois, even if reorganization were an option. Recent legislation has restricted but not eliminated regulators' ability to do this.

\(^{188}\) See, e.g., Berger et al., supra note 102, at 44 ("[L]arge banks may tend to eliminate relationship loans . . . because such loans demand more intimate knowledge of the small business . . . gained through contact over time."); Leonard I. Nakamura, Small Borrowers and the Survival of the Small Bank: Is Mouse Bank Mighty or Mickey?, BUS. REV. (Federal Reserve Bank of Philadelphia), Nov.-Dec. 1994, at 3 (arguing that small banks are better at lending to local small businesses than large banks).

\(^{189}\) The concern is that, because reorganization does not involve an actual market valuation of the bank's assets, regulators might often accept excessively optimistic reorganization plans even if the bank should be liquidated. If the reorganization initially satisfied the least cost requirements—e.g., did not require any payment by the FDIC—regulators would have little incentive to consider the likelihood that the reorganization would simply lead to more financial distress, and higher costs, in the future.

\(^{190}\) For useful case studies of a number of the mergers, see THE BANK MERGER WAVE OF THE 1990s: NINE CASE STUDIES (Charles Calomiris & Jason Karceski eds., 1995), and see also Geoffrey P. Miller, Legal Restrictions on Bank Consolidation: An Economic Analysis, 77 IOWA L. REV. 1083, 1131 (1992) (defending the merger trend, and arguing that "[m]arkets, not politicians or bureaucrats, should decide the future structure of the American banking industry"); Arthur E. Wilmarth, Jr., Too Good To Be True? The Unfulfilled Promises Behind Big Bank Mergers, 2 STAN. J.L. BUS. & FIN. 1 (1995) (criticizing the mergers' failure to improve efficiency, produce higher profitability, promote competition and service, and reduce systemic risk).
approach, however, is the difficulty of effecting a merger if the target bank is or is nearly insolvent.

Bankruptcy law suggests an alternative that could both expand the scope of the bank merger market and enhance bank managers’ incentives to contribute to the initiation decision: the prepackaged bankruptcy plans that are explicitly contemplated by the Bankruptcy Code.191 In a prepackaged bankruptcy case, managers of the debtor negotiate the terms of the reorganization prior to filing a bankruptcy petition, and then they file the plan when or shortly after the debtor enters bankruptcy to minimize the time of the bankruptcy case.192

Lawmakers could easily add an analogous mechanism for effecting third-party sales in a managerial initiation insolvency regime. To see how this process might work, consider a simple illustration. If a hypothetical bank had assets of $1000 and $1300 in liabilities consisting of $400 of secured claims, $800 of deposits, and $100 in unsecured claims, the bank’s managers might propose a sale pursuant to which the acquiring bank acquired its assets and assumed the secured claims and deposits in return for a payment of $120 by the FDIC.193 In effect, a prepackaged approach would give managers the authority to propose transactions that currently are carried out only by regulators. In addition to authorizing managerial initiation, the only other change that lawmakers would need to make to facilitate these transactions would be to eliminate the strong presumption against managers’ retaining their jobs after initiation.194

The most obvious advantage of permitting managers to propose a prepackaged purchase and assumption is, as noted above, that it would dramatically enhance their willingness to contribute to the initiation decision. Managers of troubled banks will often have explored merger possibilities; giving managers more control of the insolvency process by permitting them to propose prepackaged sales would encourage managers to explore this

193. Notice that the transaction implies that the troubled bank has $80 in going concern value since the acquirer is willing to accept a $120 payment in return for its assumption of liabilities that exceed the book value of the bank’s assets by $200.
alternative in the event the bank’s financial condition made an ordinary merger infeasible. A closely related and equally important advantage of permitting prepackaged sales is that it would harness managers’ private information, including the results of their merger discussions with other banks, rather than leaving the disposition process entirely to regulators.

Perhaps the biggest question with a prepackaged purchase and assumption is how much time it would entail.\(^{195}\) In the corporate bankruptcy context, even a successful prepackaged plan can take several months.\(^{196}\) But the process sometimes is much quicker, and the FDIC could use the same authority it currently employs in effecting purchase and assumptions to ensure an immediate disposition. For instance, the managers could propose a prepackaged sale to the FDIC privately and obtain preapproval of the plan before it became public. Moreover, even if the process were entirely public, the probability (assuming that most such transfers were in fact ultimately consummated, as seems likely) of transfer to a known acquirer should diminish depositors’ incentive to withdraw their funds.

Another concern with permitting managers to propose prepackaged purchase and assumptions, as with managerial initiation by itself, is that these changes in the role of managers would undermine the exchange of information between managers and bank regulators. If managers could themselves initiate and even propose a purchase and assumption, the reasoning goes, they might be less candid with regulators about a bank’s status if it encountered trouble. While this could be true to some extent, any change in manager-regulator communication seems likely to be small. Bank managers already have ample reason to understate any bad news, and they still would need to secure regulator approval for any purchase and assumption they propose.

2. Reconceiving the Reorganization of Insurance Companies.—In many respects, the obstacles to reorganization of insurance companies mirror those we saw with banks. As in the banking context, for instance, the time needed for a reorganization could lead to flight by the firm’s most prominent constituency—for insurance companies, their policyholders.

Despite the initial similarities, the insurance context is strikingly different in that concerns of this sort do not loom nearly as large as with banks. Insurance companies do not face anything so dramatic as a bank

\(^{195}\) Another possible objection is that prepackaged purchase and assumptions, like any form of managerial initiation, are suspect because managers do not have an incentive to take systemic risk into account. I address the systemic risk objection in the conclusion to this Part.

\(^{196}\) See NEW GENERATION RESEARCH, INC., THE 1996 BANKRUPTCY YEARBOOK & ALMANAC 156 tbl. (Christopher M. McLough ed., 6th ed. 1996) (listing the initiation and completion dates of the six prepackaged public bankruptcies that were completed in 1995, the longest taking over four months).
Many policyholders cannot shift to another company without forfeiting some or all of the year's premium, and life insurance holders in particular may be unable to secure coverage elsewhere. Moreover, regulators can more easily freeze insurance policies than they can deposit accounts; in fact, they already do precisely this—both freezing accounts and providing exceptions in cases of hardship during the pendency of an insolvency proceeding.

There also may be more leeway for meaningful reorganization in the insurance context. Unlike with bank depositors, for instance, one can even imagine at least a limited restructuring of the terms of insurance policies. A reorganization might adjust future premiums, for instance, although the scope of potential adjustment would need to be quite limited to minimize the likelihood of policyholder flight.

As noted earlier, insurance regulators do effect what amounts to a reorganization—albeit a regulator driven one—in cases where they rehabilitate a troubled insurer. What the analysis thus far suggests is that lawmakers realistically could expand this option to provide for structured bargaining by the parties themselves.

Much more than in the banking context, there are persuasive reasons to actually take this step. Permitting managers to remain in control initially and to frame the initial reorganization plan would give them an incentive to initiate insolvency proceedings in a timely fashion rather than invariably delaying. In addition, reorganization would offer the same kinds
of benefits for insurance companies that it does for other troubled corporations, such as the possibility of preserving a viable company’s going concern surplus in contexts in which a third-party sale may not be realistic. Given these benefits, and the fact that insurance insolvencies already take more time than bank insolvencies and that regulators already freeze policies, the case for adding a reorganization option seems strong.

To be sure, reorganization would raise several possible concerns. One obvious objection, as in the banking context, is that regulators would be too anxious to agree to a reorganization and to forestall a company’s collapse rather than pushing for liquidation or a third-party sale when appropriate. Second, permitting reorganization might open the door to the same kinds of problems that commentators have criticized in Chapter 11 of the Bankruptcy Code, such as the direct and indirect costs of time-consuming bankruptcy cases.201

Neither of the objections undermines the case for reorganization, however. While regulator bias toward reorganization is a realistic concern, regulators already have a similar bias, and the benefits of adding this alternative appear to outweigh any additional bias against liquidation that the reform would entail. Similarly, the problems with the Chapter 11 process are far from inevitable;202 lawmakers could impose a strict time limit on the reorganization process, for instance, to reduce the perverse effects.203 Cabining the reorganization process in this fashion also accords with the need to impose a moratorium on policy activity and the likelihood that the moratorium will only prove effective for a limited time.

Thus, reorganization is appropriate for at least some insurers, but a final question is whether to limit the reorganization option in one of two ways: based on distinctions either between life and property insurers or between stock and mutual companies. As between life and property insurers, reorganization seems most promising for life insurers, as noted

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201. See Skeel, supra note 57, at 472-73, 472 n.24 (describing the costs and citing studies that attempt to quantify these costs).
202. Avoiding these problems may be the strongest argument for continuing to exclude insurance companies from the Bankruptcy Code, as noted earlier. See supra note 5.
203. Several commentators have argued for such an approach in the corporate bankruptcy context. Robert Hansen and Randall Thomas have argued for a limited reorganization period, such as 120 days, followed by a mandatory auction. See Robert G. Hansen & Randall S. Thomas, Auctions in Bankruptcy: Theoretical Analysis and Practical Guidance, 18 INT'L REV. L. & ECON. (forthcoming 1998); see also Skeel, supra note 57, at 514 (arguing for a fixed, 180 day exclusivity period). Perhaps more importantly, George Triantis’s analysis of courts’ approach to bankruptcy in Canada suggests that the excessive delay observed in United States cases is not inevitable. Canadian courts appear to screen debtors more carefully at the outset and quickly liquidate firms that do not appear likely to reorganize. See Lynn M. LoPucki & George G. Triantis, A Systems Approach to Comparing U.S. and Canadian Reorganization of Financially Distressed Companies, 35 HARV. INT'L L.J. 267, 287 (1994); George G. Triantis, The Interplay Between Liquidation and Reorganization in Bankruptcy: The Role of Screens, Gatekeepers, and Guillotines, 16 INT'L REV. L. & ECON. 101, 109-11 (1996).
earlier, because many policyholders are locked in on a long-term basis and protecting them requires continuation of their policy. Although property and casualty insurance tends to be more short term in nature, which may undermine the likelihood of effecting a reorganization, this will not always be true. Moreover, the limited duration of many property and casualty policies is misleading because policyholders tend not to switch companies often. These factors argue in favor of a reorganization option not only for life insurers, but also for property and casualty insurers.

With respect to the stock-mutual distinction, nothing in the reorganization context turns on whether shareholders or some other constituency is entitled to the residual value of the firm. Thus, the reorganization option should be available to both stock and mutual insurance companies.

VI. Conclusion

In both banking and insurance, the insolvency process has long been treated as the exclusive domain of regulators. The bank and insurance failures of the 1980s, and questions about regulators' handling of the failures, have led both to calls for reform and to actual reform. Yet the reform has tended to be more of the same—that is, retaining regulator hegemony, but attempting to force regulators to act more expeditiously, principally through command-and-control legislation.

This Article has argued that lawmakers should take a different tack. Rather than continuing to rely solely on regulators, they should authorize managers (and also creditors) to initiate a bank or insurance insolvency proceeding. An obvious problem with managerial initiation is the near certainty that managers will be ousted in an insolvency proceeding, which undermines their willingness to contribute to the decision. To counteract this disincentive, lawmakers should relax the presumption that managers will be terminated after initiation. By facilitating firms' use of incentives such as phantom debt or shareholder bonuses lawmakers could further encourage managers to contribute to the initiation decision.

204. Notice that the lock-in effect is thus both a problem in the governance context, see Hansmann, supra note 136, at 145-46 (suggesting that the use of the mutual form in the life insurance context is in part a response to asymmetric information and lock-in effects), and an advantage for reorganization.

205. Assuming that regulators retain ultimate control of the disposition decision, one potential concern is whether managers' uncertainty about whether regulators will choose liquidation or a purchase and assumption would adversely affect the initiation decision. Given that the going concern surplus will be smaller in a liquidation than if the bank is sold intact, managers might postpone initiation if they fear that regulators will end up liquidating the bank.

One can imagine ways to correct for this possibility. Lawmakers might provide for a larger amount of phantom debt or a higher-percentage bonus in the liquidation context, for instance, to offset the lower surplus. But the simpler response is that the concern does not seem likely to be a serious one in practice. Given that regulators prefer to sell a troubled bank intact, they seem unlikely to opt
analysis also has suggested important changes to the existing disposition options. Although traditional reorganization is relatively unattractive in the banking context, permitting managers to propose prepackaged purchase and assumption transactions could help facilitate beneficial mergers. With insurance companies, adding a traditional reorganization option would both encourage managerial initiation and enhance the disposition process.

On the surface, the reforms I have advocated are quite dramatic. Yet the reforms not only would fit easily within the existing, regulator-driven regime, but they also accord with pronounced trends in bank and insurance regulation. In recent years, the banking and insurance markets have become increasingly competitive, and regulators have gradually relaxed the restrictions on healthy firms in response to these changes. As banks and insurance companies become more and more like other firms, their treatment in insolvency seems destined to move in this direction as well: from the traditional, closed world of regulator hegemony to a process influenced much more by market forces and the parties themselves, along much the same lines as I have argued for in this Article. In the long run at least, I like to think that the analysis of this Article therefore has history on its side.

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for liquidation when purchase and assumption is a realistic possibility. In consequence, lawmakers need not explicitly adjust the phantom debt or bonus to account for the nature of the ultimate disposition decision. In fact, the possibility that regulators may be unable to effect a P&A if managers wait too long to file should reinforce managers' incentive to file promptly.