



Designing a Better Bankruptcy Resolution

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This paper discusses the research that has been completed by the Resolution Project on developing a new chapter in the bankruptcy code: Chapter 14. The paper also discusses the financial crisis and the perceived shortcomings of the current bankruptcy code and the Dodd-Frank Act.

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To begin, I will offer some background on the origin and activities of the Resolution Project which has been spearheading research and development on a new chapter in the bankruptcy code: Chapter 14. The Resolution Project was formed in 2009, in the aftermath of the September 2008 financial panic, under the aegis of George Shultz and John B. Taylor. It has consisted (apart from John and myself and originally Andrew Crockett) of two finance professors, two former regulators, two bankruptcy professors, two industry participants, and two United Kingdom experts. It has produced thus far several conferences and two books: *Ending Government Bailouts As We Know Them* in 2010 and *Bankruptcy Not Bailout: A Special Chapter 14* in 2012 (both published by Hoover Institution Press). The objectives have been to respond to the crisis situation and to the perceived shortcomings of both the current bankruptcy code and, after it was enacted, the Dodd-Frank Act.

On the bankruptcy code, of course, numerous criticisms have related to the Lehman Brothers failure. As for Dodd-Frank—in theory, if you’re an optimist, then you believe the problem has been rendered moot by Title I: there will no longer be failures of “too-big-to-fail” institutions or any need for bailouts. But there is a certain amount of skepticism about whether failure has really been abolished and bailouts made extinct. With regard to bailouts, should such a failure reoccur, some of the skepticism may come from the fact that the statute in Title II creates a receiver with an explicit pipeline to the Treasury. There are a lot of provisions about how it is to be used (only for short term liquidity, and there should be a repayment plan) and how the resolution should be conducted. Section 214, for example, mandates that the failed firm is to be liquidated and taxpayer losses are prohibited. The Federal Deposit Insurance Corporation (FDIC) as receiver is given extensive authority and discretion, and various instructions and determinations are specified to govern how it is used. But there is no way of legally enforcing them, and everything is taking place internally within the agency.

How is it supposed to work? Title II—assuming Title I hasn’t ended all failures—creates an Orderly Liquidation Authority (OLA), as has been described by Randy Guynn.¹ The political slogan in passing Dodd-Frank was that it would end bailouts of Wall Street, but what that meant was limited to taxpayer-funded bailouts. To understand the problem, you have first to define what constitutes a bailout in the event of a failure, a term often used loosely. We define the bailout of a stakeholder as the receipt of more than what would be received in a normal bankruptcy.

But who is being bailed out, exactly? Is it a bailout of “the firm”? What would that mean—a bailout of the stockholders of a large financial company, so they suffer little or no loss? In point of fact, that has been a rare—if not nonexistent—event. Usually in a financial resolution

the stockholders have been completely wiped out or nearly so—completely in Lehman, largely so in Citigroup.

The concern really is—and should be—more over bailouts of major creditors. Why is that the important group to focus on? Because what's at stake is the preservation of effective market discipline on management. Historically, it's usually been actions by creditors that have led to the failure or restructuring of large financial institutions, often ahead of—and forcing—regulatory intervention.

So in these OLA receiverships, how are they supposed to work and what perceived flaws are there that we have been concerned to try to deal with? The procedures currently contemplated involve the receiver using a "single point of entry" to take over the failed institution and transfer its business to a new "bridge" company, as outlined by Guynn. The place where I think we have problems comes with the extent and use of the discretionary powers that are vested in the receiver in this process:

- Discretion over what liabilities are transferred to the bridge institution, which means that those creditors will be fully protected, as opposed to the liabilities that are not transferred and are left behind in the debtor's estate, so that those creditors will take large losses.
- Discretion with respect to the valuation of the assets that are being transferred to the bridge.
- Discretion with respect to allocation of losses—not only as between one creditor and another at the level of the parent holding company but also with respect to the subsidiaries.

There have been assertions or expectations that the receiver could simply take assets, shuffle them around, and bestow them upon certain subsidiaries that have incurred losses, thus keeping those subsidiaries in full operation with their creditors fully paid. When it's a foreign subsidiary, this has been a point (to which we will return) of considerable concern for foreign regulators: whether that would actually take place and how and why.

Procedural fairness is an issue in this discretionary environment because the decisions are made by internal agency processes that are closed to outside participation. That brings us to the question: what kind of judicial oversight or role is there in OLA? This has two levels. One is the original decision by the secretary of the treasury, *ex ante*, to take over a particular financial institution and put it through this OLA process. To do that, he has to file a petition in the District of Columbia district court in which the judge is asked to determine whether or not certain statutory conditions are met. (There are seven determinations the secretary has to make, but only two of them may be considered by the court.) That starts a twenty-four-hour statutory deadline for the judge to hold a hearing, get all the relevant evidence, hear arguments, make findings of fact, reach a conclusion, and write an opinion. If the petition was filed at the close of business on one day, then the deadline is five o'clock the next day. Should the judge decline to play his

truncated role so superficially, the petition is deemed granted by operation of law. This treatment of judicial oversight reduces it to an empty formality.

The second level of judicial oversight takes place *ex post*, after the institution has been put into receivership. The financial company apparently can file an appeal from the district court to the court of appeals, and perhaps further. But stays are prohibited during appeal, and the firm is supposedly being altered and sold off during this receivership process. So if at the end of the day, months later, you actually got a ruling in your favor from a court that had an opportunity to consider the grounds and the evidence more fully, what would be the remedy? The answer is: it's very unclear that there is any. The firm no longer exists and the statute gives no authorization for a damage remedy by shareholders.

From the standpoint of the creditors who went through this process, some of whom were fully paid off and many of whom were not, there is an express prohibition of any judicial review of those decisions by the receiver in its conduct of the receivership. Substantial constitutional issues are embedded in all of this—certainly debatable ones. And if the debate were ever actually undertaken in a legal action and pursued to a decision, one might find that it had invalidated the whole mechanism of Title II.

To address some of these problems, the Resolution Project has been drafting a proposal for a new chapter in the bankruptcy code: Chapter 14. Let me give a brief overview of its structure and of some issues still under discussion.

The coverage is of financial institutions with total consolidated assets greater than \$50 billion. This simply tracks the Dodd-Frank definition of the institutions to which it applies, and includes a lot of financial institutions that are very far from being systemically important.

There are special provisions for systemically important financial institutions (SIFIs), including mechanisms to facilitate (through a section 363 sale) the special-point-of-entry bridge mechanism advocated by FDIC as a means of resolution. Proceedings can be commenced voluntarily by management, as is true under the bankruptcy code now, or by a supervisor, which is not a provision in the current code. Filing serves as a pathway to reorganization under Chapter 11 or liquidation under Chapter 7. In the case of SIFIs, where the concern is to continue operations so as to reduce systemic risk, the choice would of course normally be reorganization rather than liquidation (a point that was lost on California Senator Barbara Boxer's section 214 amendment requiring liquidation under Dodd-Frank).

The relationship of Chapter 14 to Title II is that bankruptcy is stated to be the preferred mode of resolution. SIFIs are supposed to prepare resolution plans ("living wills") that are designed to be effectuated under the bankruptcy code; to invoke a Title II receivership there first has to be a determination that a bankruptcy resolution would have serious adverse effects on financial stability.

If a Chapter 14 bankruptcy case has begun, Dodd-Frank would still give the secretary of the treasury power to put the institution into an OLA receivership under Title II. How would that be accomplished? One way would be to provide that the secretary would simply file an ex parte transfer motion in the bankruptcy district court that would be automatically granted. A preferable provision might be to require that the motion be accompanied by a statement of the reasons for the secretary's determination that there is otherwise a substantial possibility of the systemic risk consequences necessary for invocation of jurisdiction under Title II.

Under Chapter 14, a main difference is in the treatment of creditors. There is adherence to core bankruptcy code principles, strict priority, and equal treatment. In other words, the selection and treatment of claims is a great deal less discretionary. The reason is that creditors are the source of the most timely and best-informed discipline on management risk-taking, through the terms of credit extension—or its denial. That is the key function that we're trying to preserve and, indeed, strengthen.

In terms of judicial oversight, under the bankruptcy code, the procedures both permit and require the involvement of creditors. They participate in the decisions being made about asset sales and loss allocations. The whole proceeding takes place with court hearings and with decisions and authorizations that occur in public and not in secret or in closed internal agency processes. In that way, creditor concerns and valuation issues are addressed more openly and predictably, in accord with constitutional standards.

The actions taken in the crisis, and the driving forces behind the enactment of Dodd-Frank, were motivated by fears of a systemic financial collapse. That is a consideration in some, but certainly not most, failures of financial institutions. In most financial institution failures, reorganization in the normal Chapter 11 fashion would be the way to proceed. But when it comes to SIFIs, and if there is a justifiably great concern with continuing operations to minimize systemic spillover consequences, then the current view is that there ought to be a transfer of the business (as intact as possible) to a new bridge company, whether in Title II or Chapter 14.

There are problems in doing so that must be conceded and addressed. Some are problems that we can try to deal with in the bankruptcy code. For others, the only way to handle them will be outside the bankruptcy code, including:

- Blocking runs by short-term creditors, involving matters like QFCs (qualified financial contracts), termination rights, and stay durations. This is something that David Skeel will address in more detail.²
- Assuring the bridge company has “adequate capital.” How much do you have to have? Are there special concessions for bridge companies? What form does it take—common equity, bail-in debt, other instruments? Is it based on risk-weighted assets or a leverage ratio? These requirements

and their details, which obviously must come from the regulators and supervisors, are still being debated. How they can be met in a resolution is a case-specific empirical question, depending on the magnitude of losses and on where in the firm group the losses are located.

- Liquidity requirements. If the bridge company is strongly capitalized, short-term funding should be available from the market. If need be, there could be a provision for the kind of "administrative expense" priority given DIP (debtor-in-possession) financing for companies reorganizing under Chapter 11. If the market did not have such confidence in the new company's capital strength, as a fallback the supervisor participating in a Chapter 14 case could be authorized to make use of the OLF (orderly liquidation fund) mechanism of Title II.

These are all important aspects of the evolution of financial regulation now taking place and they will have to be accommodated in a Chapter 14 reorganization. But the specifics won't be available until we see what Basel III (which provides global banking standards) or the Fed or the Financial Stability Oversight Council (FSOC) ultimately comes up with.

In addition, there are the problems of cross-border operations and cross-border resolution. These are dealt with to some extent by Chapter 15 of the bankruptcy code, which we think can be modified to work somewhat better in this context—for example, through adoption of a reciprocity provision for recognition of foreign home countries' stay orders. Meanwhile, a great deal of international conferring is going on.

Further analysis of the status of insolvent foreign subsidiaries is a really important issue. Are you going to recapitalize them? Foreign regulators certainly would like to see that happen. But if that's a big black hole, how is it going to take place? The options are basically three. Is it going to be a judgment on the part of the management of the old or the new firm as to whether this is an expenditure of funds that is warranted from a business standpoint? Is it going to be because we've now moved to an organizational form in which, fundamentally, there is an established legal obligation on the part of the parent to meet all debts in subsidiaries (in effect turning a legal entity structure into a consolidated single firm)? Or is it going to be a matter of regulatory discretion, which is the way it seems to be looking at the moment when we try to interpret what FDIC and the Fed have said on the subject (although their authority for this under the statute is far from clear). If it's a matter left to regulatory discretion then, again, the market doesn't know what's going to take place and there are uncertainty costs as well as impairment of market discipline.

So the Resolution Project is ongoing. Our discussions and work are not finished. We are trying to refine bridge procedures, to figure out the best way to accommodate different capital and bail-in debt proposals, and to adapt to different organizational structures that may be required. Where will all this end up? We are trying to bring our part of it to at least an interim

conclusion and hope that soon a more complete version 2.0 of Chapter 14 will be ready for release.