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Dodd-Frank for Bankruptcy Lawyers

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Abstract

The Dodd-Frank financial reform legislation creates an “Orderly Liquidation Authority” (OLA) that shares many features in common with the Bankruptcy Code. This is easy to overlook because the legislation uses a language and employs a decisionmaker (both borrowed from bank regulation) that will seem foreign to bankruptcy lawyers. Our task in this essay is to identify the core congruities between OLA and the Code. In doing so, we highlight important differences and assess both their constitutionality and policy objectives. We conclude with a few thoughts on the likelihood that OLA will contribute to market stability.

Dodd-Frank for Bankruptcy Lawyers

Douglas G. Baird[†] and Edward R. Morrison[‡]

The recently enacted financial reform legislation empowers the Secretary of the Treasury to appoint the FDIC as receiver for troubled financial companies when their failure poses a systemic risk. Previously, the resolution process for these companies was left to the bankruptcy process. By common account, the new law reflects a repudiation of traditional bankruptcy law when it comes to the collapse of giant corporations that threaten the economy as a whole.¹ Instead we have a mechanism that brings the regime used to liquidate failed commercial banks to a broader range of institutions. Perhaps the only consolation for partisans of traditional bankruptcy law is a mandate for future studies assessing “the effectiveness of chapter 7 and chapter 11 ... in facilitating the orderly resolution or reorganization of systemic financial institutions.”²

But this view is mistaken. Far from reflecting a rejection of bankruptcy principles, quite the opposite is true. First, the legislation removes bankruptcy court jurisdiction from only a narrow range of cases—“financial companies” whose failure is sufficiently threatening to market stability. The vast majority of giant businesses, including systemically important ones (i.e., the General Motors of the next great recession), are not “financial companies” within the meaning of Title II and remain squarely in the province of bankruptcy law. Moreover, the mechanics of the new receivership process incorporate basic bankruptcy principles. They effectively permit reorganization as well as liquidation, debtor-in-possession financing, asset sales free and clear of existing

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¹ See, e.g., Kenneth Ayotte and David Skeel, *Bankruptcy or Bailouts?* 35 J. Corp. L. 469 (2010); Edward R. Morrison, *Is the Bankruptcy Code an Adequate Mechanism for Resolving the Distress of Systemically Important Institutions?*, 82 Temp. L. Rev. 449 (2009).

² See §216(a)(2)(A).

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liens, claw-back of prepetition fraudulent and preferential transfers, and safe harbors for financial contracts.

Nevertheless, aspects of the receivership process will at first seem alien to bankruptcy lawyers. The necessity for government intervention and the adaptation of a mechanism used for failed banks introduces new terminology and, more importantly, a new decisionmaker. While traditional bankruptcy law reflects a balance of power in which the debtor in possession (DIP), the creditors' committee, the DIP lender, and the bankruptcy judge play discrete roles, this regime concentrates power in a single entity, the FDIC.

The almost complete absence of a judge is especially striking. In the rare cases in which it is invoked, Title II replaces the bankruptcy judge with the FDIC. The FDIC's powers in this new domain largely track its longstanding powers with respect to commercial banks under the Federal Deposit Insurance Act (FDIA). As receiver, the FDIC is vested with "all rights, titles, powers, and privileges of the covered financial company" and may "operate the covered financial company with all the powers of the members or shareholder, the directors, and the officers."³ It also has the power to make postpetition loans.⁴

Although Title II emphasizes that "the purpose of this title [is] to provide the necessary authority to liquidate failing financial companies,"⁵ the concept of "liquidation" here is a very broad one. It encompasses not just piecemeal liquidation. The FDIC's powers include the right to sell substantially all of the institution's assets to another company, "without obtaining any approval, assignment, or consent with respect to such transfer," unless the sale raises antitrust or related concerns.⁶ The FDIC's powers also include (implicitly) the ability to reorganize the failing institution by transferring selected assets and claims to a "bridge financial company" that is owned, controlled, and potentially capitalized by the FDIC.⁷ The FDIC can run this bridge company

³ §210(a)(1)(A)(i), 210(a)(1)(B)(i). In exercising these rights, the FDIC is authorized to continue employing existing directors and managers, §210(a)(1)(C), as long as those directors and managers are not "responsible for the failed condition of the covered financial company." §206(4), (5).

⁴ §204(d).

⁵ §204(a).

⁶ §210(a)(1)(G).

⁷ §210(h)(5)(A), §210(h)(2)(G).

for up to five years,⁸ with a view to merging it with another institution or selling a majority of its equity to private investors.⁹ Of course, the bridge may be short on cash. If it is, the FDIC can authorize the equivalent of DIP financing on terms virtually identical to those permitted by §364.¹⁰ The rights of secured creditors are generally left unaffected. While the bridge can obtain a priming lien, the FDIC must go to court and show it is providing adequate protection.¹¹ Taken together, these powers give the FDIC the ability to implement rough approximations of §363 sales and Chapter 11 reorganizations.

This concentration of power in the hands of one agency, the FDIC, is a marked departure from prevailing bankruptcy law. So is the new law's approach to financial contracts. A key driver of the new regime was the need for a better mechanism to handle these contracts. Ironically, the need for a new law came not so much from their treatment in bankruptcy, but rather from their exclusion from the bankruptcy process altogether. Financial contracts were placed outside the reach of the automatic stay and other key bankruptcy laws for several reasons. One of the most important is that providing debtors with a long window in which to make the assume-or-reject decision creates an opportunity for cherry-picking that ordinary executory contracts do not. Excluding these contracts, however, requires a distressed company to forfeit the bulk of its financial contracts when it reorganizes. While this might not be a problem for an ordinary company, such a categorical rule effectively forces the liquidation of financial companies. The experience of Lehman Brothers suggests that such liquidations are costly, at least for a company that is systemically important.

The new regime modifies this rule, giving the FDIC a short window (up to two business days) to subject financial contracts to a limited automatic stay and transfer them to a solvent counterparty. At the end of that window, the usual rules apply and parties to these financial contracts are free to exercise their contractual rights. The heart of this new regime, in short, reflects not so much a repudiation of bankruptcy principles, but rather finding a treatment for financial contracts that charts a middle course between the Code's treatment for ordinary conventional contracts and for financial contracts. Subjecting financial contracts to a

⁸ §210(h)(12).

⁹ §210(h)(13).

¹⁰ §210(h)(16).

¹¹ §210(h)(16)(C)(ii).

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(very short) automatic stay is costly, but so too is insulating them from the process altogether.

In this paper we examine the general structure of this new regime from the perspective of the bankruptcy lawyer. We first examine the part of Title II that is most foreign to the bankruptcy lawyer, the mechanism it puts in place for determining eligibility and for commencing the receivership. In the next part, we recap briefly the substantive provisions of the law itself. We highlight some of the unsettled questions and potential areas of uncertainty, but for the most part it is quite familiar ground. It is commonly said that the law reflects a decision to embrace the regime for failed banks and turns its back on Chapter 11, but the end place may not be that different from where we would have been if a new chapter of the Bankruptcy Code had been crafted to deal with the problem of systemically important financial companies. In the final part of the paper, we focus in particular on features of the law that may blunt its effectiveness.

I. Commencing the Title II Receivership

Much of the mystery associated with the new receivership regime lies at the start of the process. There is a complicated mechanism for identifying an eligible entity, and then a rather exotic avenue of judicial review. That the trigger for this new kind of receivership is new should come as no surprise. It arises from the need to protect the legitimate interests of investors while at the same time ensuring that decisive action can be taken when unanticipated systemic risks suddenly manifest themselves.

A. Eligible Entities

Title II, like the rest of Dodd-Frank, is squarely focused on Wall Street. A company is eligible only if it is Fed-regulated or if at least eighty-five percent of consolidated revenues arise from activities that are “financial in nature.”¹² The eighty-five percent threshold precludes large industrial giants (the GMs of the world), no matter how systemically important they may be.¹³

It is easy to name companies excluded from Title II, but harder to say which are included. Title I provides for a Financial Stability Oversight Council that identifies nonbank financial companies that are “systemically important.” These companies will be subject to regulation and those involved with these companies will know that they are potentially exposed to Title II. The triggering mechanism in Title II, however, is largely independent of Title I. A financial company can be eligible for receivership under Title II even if it was never before thought systemically important for purposes of Title I. This reflects the intuition that, while comparatively few companies whose activities are financial in nature are systemically important, they cannot always be identified in advance.

¹² §201(a)(11)(iii), (iv); §201(b).

¹³ In theory, this criterion also prevents companies like Enron from entering Title II. Much of Enron’s business was focused on trading activity that would fall within the definition of a “financial activity,” but it also owned enough hard assets, such as pipelines and power plants, to remove it from the ambit of the statute. However, Title I of Dodd-Frank gives the Federal Reserve authority to force a company like Enron to separate its financial activities into an “intermediate holding company” that is subject to both Fed oversight and receivership under Title II. See §113(c)(3).

In the abstract, the eligibility standards are relatively straightforward. Only a “financial company” is potentially subject to receivership. “Financial company” is a defined term. Only domestic entities fall within its ambit, which includes bank holding companies and nonbank companies supervised by the Federal Reserve, as well as any company predominantly engaged in activities that are “financial in nature.” Activities that are “financial in nature” are those the Federal Reserve Board identifies pursuant to a section of the Bank Holding Company Act, which limits the activities in which a financial holding company can engage beyond owning a bank.¹⁴ The identified activities can evolve over time, but the statute provides a set of activities that are explicitly financial in nature. These include “providing financial, investment, or economic advisory services” and “insuring, guaranteeing, or indemnifying against loss, harm, damage, illness, disability, or death, or providing and issuing annuities, and acting as principal, agent, or broker.” Most importantly, financial activities include “lending, exchanging, transferring, investing for others, or safeguarding money or securities.”¹⁵

This last provision has the effect of making hedge funds and private equity funds potentially subject to Title II. Thus, while commercial banks are subject to FDIC oversight when they are healthy and when they are distressed, many financial companies are, in theory, exposed to the risk of seizure without having any previous interactions with the FDIC, or even knowing that they might be subject to it. The risk of seizure does not diminish even if the financial company files a petition under the Bankruptcy Code: A Title II proceeding can be commenced regardless of any pending bankruptcy case.¹⁶ Not only is there the potential surprise, but, again in contrast to an ordinary bank, the financial company may find itself in the hands of a regulator who knows nothing about it and lacks both the information and the competence to handle its assets effectively.

Of course, the inexperience of the FDIC does not distinguish Title II from the bankruptcy process, which calls for decisions by judges who know comparatively little about the firm or its industry. What does distinguish Title II is the concentration of decisionmaking authority in the hands of a single regulator. That authority is fragmented in the bank-

¹⁴ 12 U.S.C. §1843(k).

¹⁵ 12 U.S.C. §1843(k)(4)(A).

¹⁶ §208(a).

ruptcy process. Although judges issue final orders, they are primarily refereeing a bargaining process that vests considerable power in the hands of the debtor in possession and its creditors.

This concentration of authority in the hands of the FDIC may find some justification in the experience of Long-Term Capital Management. While LTCM was a well-known hedge fund, few anticipated in advance that, when its derivative contracts turned sour, many large financial institutions were potentially exposed to catastrophic loss. In the case of LTCM, private parties (after significant coaxing from the Federal Reserve) were able to execute a successful workout. But it is easy to imagine a scenario in which this would not have been possible. Dodd-Frank gives the government the ability to step decisively into the breach in such a case. Such speedy decisionmaking could be substantially harder in a regime, like the Bankruptcy Code, in which decisionmaking authority is fragmented across multiple parties.

We have highlighted the danger that a Title II liquidation could take a company by surprise, but Title II puts many safeguards in place. Before a Title II liquidation can begin there are both substantive and procedural hurdles. Section 203(b) provides that, before the liquidation can begin, the Secretary of the Treasury, in consultation with the President, must first find that a financial company is “in default or is in danger of default.” This inquiry is much like the Bankruptcy Code’s provisions for the commencement of an involuntary case. It requires the Secretary to find that a case is likely to be commenced under the Bankruptcy Code, that the company has or is likely to incur losses that will deplete its assets and it will be unable to protect them, that its assets are less than its obligations to creditors, or that it is unable or likely to be unable to pay its obligations in the ordinary course of business.¹⁷ Because these rules are largely in harmony with the rules for an involuntary case, the company itself cannot be too surprised to find control wrested from it. Circumstances have to be so bad that, in the absence of Title II, the same company could have been pushed into bankruptcy. The difference is largely the decisionmaker—the Secretary, rather than unhappy creditors.

Less clear-cut and more important is the requirement that, before the receivership begins, the Secretary find that alternative ways of resolving the financial distress “would have serious adverse effects on the

¹⁷ §203(b)(4).

financial stability of the United States.” The success of Chapter 11 in handling the collapse of very large corporations (such as Enron, General Motors, and Consec) suggests that this threshold is a high one. Moreover, the Secretary has to find that “no viable private sector alternative is available to prevent the default.” In theory, this should further limit the scope of this provision as workouts of the sort that we saw in LTCM need to be off the table as well. Of course, the absence of such a receivership regime may be what brings private parties to the table in such cases. The presence of Title II may make them less inclined to do so.

The Secretary must also engage in some balancing of the interests of creditors, counterparties, and shareholders, but the balancing required is somewhat toothless. The Secretary must find only that the effect on their claims and interests is “appropriate” given the danger posed to the “financial stability of the United States.”¹⁸ Moreover, in making her decision, she must be on guard for how her failure to take action has the “potential to increase excessive risk taking on the part of creditors, counterparties, and shareholders.”¹⁹

In addition to the substantive criteria for taking action, there are also significant procedural hurdles. Before the Secretary of the Treasury can act, a “recommendation” must be obtained from both the Federal Reserve Board and the FDIC.²⁰ Two-thirds of the Board of Governors of the Federal Reserve and, separately, two-thirds of the members of the FDIC’s Board of Directors must issue a recommendation regarding the proposed receivership (curiously, though, the statute does not say that the “recommendation” must be a recommendation *in favor* of the receivership).²¹ This approval protocol has often been dubbed a “three-key” process because three approvals are required.²² By placing two of the keys in the hands of independent agencies, the trigger is insulated from the pressures of day-to-day political forces.

¹⁸ §203(b)(4).

¹⁹ §203(b)(5).

²⁰ For some entities, other agencies replace the FDIC. The SEC replaces the FDIC for brokers and dealers, and the Director of the Federal Insurance Office for insurance companies.

²¹ §203(a)(1)(A).

²² See, e.g., Jeffrey N. Gordon, “Avoiding Eight-Alarm Fires in the Political Economy of Systemic Risk Management,” working paper (2010), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1553880.

Absent extraordinary circumstances, the entities that will find themselves in Title II are likely those financial companies already subject to oversight under Title I. This regulatory oversight, like any other, may be done badly, but it seems unlikely that those regulated will be caught unawares or that those who trigger the Title II liquidation will be wholly in the dark or that the FDIC will be caught flat-footed when it becomes the receiver.

B. Judicial Review

The seizure of a financial company, like the seizure of anything else by the government, entitles those affected some access to judicial review. At first blush, it might seem that this legislation may fall short. The Act emphasizes repeatedly that “[e]xcept as provided in this title, no court may take any action to restrain or affect the exercise of powers or functions of the receiver hereunder, and any remedy against the Corporation or receiver shall be limited to money damages determined in accordance with this title.”²³ The Act permits only challenges to the threshold decision to commence the receivership, not to the details of its administration. A court enters the picture during the receivership principally to review claims and ensure adequate protection of secured creditors subject to priming liens.

After the Secretary decides to take action, she must first seek consent from the board of directors of the financial company. The question of whether the government is overreaching arises only if such consent is not forthcoming, and one suspects it almost always will be. Board members will likely see the folly of trying to fight off the Secretary, the Federal Reserve, and the FDIC simultaneously. Moreover, they will also look to the comfort provided by §207, which protects them from liability for consenting in good faith to the receivership.

If she fails to obtain the consent of the board of directors of the financial company, the Secretary must petition the United States District Court for the District of Columbia for an order authorizing the ap-

²³ §210(e). Similarly, §210(a)(9)(D) states that “[e]xcept as otherwise provided in this title, no court shall have jurisdiction over—(i) any claim or action for payment from, or any action seeking a determination of rights with respect to, the assets of any covered financial company for which the Corporation has been appointed receiver, including any assets which the Corporation may acquire from itself as such receiver; or (ii) any claim relating to any act or omission of such covered financial company or the Corporation as receiver.”

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pointment of the FDIC as receiver.²⁴ This is the only process that the company enjoys, and the scope of the court's review is narrow. It is limited to assessing whether "the determination of the Secretary that the covered financial company is in default or in danger of default and satisfies the definition of a financial company under section §201(a)(11) is arbitrary and capricious."²⁵ The district court is required to act within twenty-four hours.²⁶ If it fails to act, the petition is granted by operation of law.

Once FDIC receivership commences, any pending proceedings in bankruptcy courts or before the SIPC must be dismissed.²⁷ The FDIC may exercise its authority as receiver for up to five years (the receivership can be extended additional years if necessary to pursue litigation).²⁸ The scope of FDIC authority varies with the type of institution. With respect to brokers and dealers, the Corporation must appoint SIPC as trustee. If any assets and liabilities are not transferred by the FDIC to a bridge financial company, they are administered by SIPC pursuant to the typical rules applied in broker-dealer liquidations.²⁹ With respect to insurance companies, resolution must be conducted by the appropriate state regulators pursuant to state law.³⁰ With respect to other financial companies, the FDIC serves as receiver and trustee and applies the procedures outlined in the Act, particularly §210. Thus, with respect to brokers, dealers, and insurance companies, the same government actor administers the institution's insolvency, whether it is subject to FDIC receivership or not. For other financial institutions, the relevant govern-

²⁴ §202(a)(1)(A)(i).

²⁵ §202(a)(1)(A)(iii).

²⁶ §202(a)(1)(A)(v).

²⁷ §208.

²⁸ §202(d)(4)

²⁹ §205(a), (b). Although the SIPC must apply to a district court for a protective decree, the court is required to issue the decree automatically, §205(a)(2)(A), and "no court may take any action ... to restrain or affect the exercise of powers or functions of the Corporation as receiver for a covered broker or dealer." §205(c). To the extent that counterparties or creditors are aggrieved by the transfer of assets to a bridge financial company, they may bring suit for money damages in a district court. §205(e).

³⁰ §203(e)(1). If state regulators fail to act promptly (within 60 days after the Secretary's decision, or after district-court approval of that decision), the FDIC may step into the shoes of the regulators. §203(e)(3).

ment actor is different outside receivership (the bankruptcy courts) than inside (the FDIC, subject to limited judicial review).

The district court's decision is appealable, but there is no stay of the decision pending appeal, the appeal must be brought within thirty days, the appellate court must consider the appeal on an expedited basis, and the court is again limited to arbitrary and capricious review.³¹ More to the point, the court's decision "shall not be subject to any stay or injunction pending appeal."³² As a practical matter, virtually any appellate review is likely to be equitably moot by the time it is heard.

While this highly accelerated judicial process is extraordinary, in all likelihood it is not constitutionally suspect. The most obvious constitutional questions here arise from the Takings and Due Process Clauses of the Fifth Amendment. The former forbids government seizure of private property for public use without just compensation. An FDIC receivership is undoubtedly a taking of private property for public use. The Corporation "succeed[s] to all rights, titles, powers, and privileges of the covered company and its assets, and of any stockholder, member, officer, or director of such company."³³ And the Act undoubtedly offers compensation to aggrieved parties: "any person having a claim against the Corporation as receiver" is guaranteed compensation equal to what the person "would have received if the Corporation had not been appointed receiver" and the company instead were liquidated under state or federal law.³⁴ In theory, this compensation formula guarantees something close to just compensation. To be sure, recoveries are likely to be small or nonexistent. If the company's failure would indeed imperil the overall economy, we need to imagine what creditors would be paid in a world in which the overall economy is cratering and the government is doing nothing to stop it. Recoveries in that world are likely to be minimal. In application, of course, the FDIC may not compute just compensation correctly, but even then claimants could bring suit against the FDIC under the Tucker Act. Although Dodd-Frank repeatedly states that "no court may take any action to restrain or affect the exercise of powers or functions of the receiver," it acknowledges claimants' ability

³¹ §202(a)(1)(B), §202(a)(2).

³² §202(a)(1)(B).

³³ §210(a)(1)(A)(i).

³⁴ §210(d)(2).

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to bring suit for money damages, presumably under the Tucker Act.³⁵ That is enough to avoid complications under the Takings Clause.³⁶

Due Process questions loom a bit larger. The process here is one in which the financial company is given advance notice and opportunity for a judicial hearing.³⁷ Notice and an opportunity to be heard generally constitute due process.³⁸ The difficulty here, however, is the nature of the hearing. The District Court is not permitted to review the decision of the Secretary on the merits. Instead, it is obliged to focus narrowly on two questions: (i) whether the financial company is in default or in danger of default, and (ii) whether it satisfies the definition of a “financial company.” Moreover, the District Court must apply an “arbitrary and capricious” standard of review. The “arbitrary and capricious” standard standing alone does not seem problematic. The Supreme Court has long held that such review of agency action meets muster as a constitutional matter.³⁹ It is the standard typically used in administrative law and courts have found it appropriate in assessing the decision to appoint receivers under the Financial Institutions Reform, Recovery and Enforcement Act (“FIRREA”).⁴⁰

The potential problem is not the standard of review, but the limitation on what can be reviewed. The court has no power to review the other critical findings that the Secretary must make before triggering the receivership. These findings include that the company’s default exposes the United States to “serious adverse effects on financial stability” and that “no viable private sector alternative is available.”⁴¹ These findings seem as “jurisdictional” as the determinations that are subject to judicial review (the institution is in or danger of default and is a financial company), yet even if these findings are arbitrary and capricious, the legislation deprives the court of the power to do anything about it. We admit

³⁵ §210(e).

³⁶ *See, e.g.,* *Blanchette v. Connecticut General Ins. Corp.*, 419 U.S. 102 (1974).

³⁷ §202(a)(1)(A)(iii).

³⁸ *Mullane v. Central Hanover Bank & Trust Co.*, 339 U.S. 306, 313 (1950).

³⁹ *See, e.g.,* *Yakus v. United States*, 321 U.S. 414 (1944).

⁴⁰ *See, e.g.,* *Franklin Sav. Ass’n v. Director, Office of Thrift Supervision*, 934 F.2d 1127 (10th Cir. 1991).

⁴¹ §203(b).

to being uncertain, however, whether this poses serious constitutional problems.⁴²

Another potential problem is the mandate that the proceedings be conducted within twenty-four hours and in secrecy. It seems implausible that a reviewing court could digest the complex factual and legal issues within twenty-four hours. The time constraint will likely deprive financial companies of a meaningful opportunity for a hearing prior to a taking of their property, which is generally the acid test of a due process violation.⁴³ To be sure, the company's owners can seek appellate review, but the lack of a stay pending appeal means that the issues will likely be moot by the time the appeal is decided.

Secrecy is a potential problem as well. The petition is to be filed under seal and the district court must act without any prior public disclosure. Moreover, no one else is permitted to disclose the pendency of the court proceeding either. A person who recklessly makes such a disclosure is subject to criminal sanctions, including up to five years in prison.⁴⁴ A mandate that such proceedings be secret may be constitutionally suspect, not because of due process, but because of the First Amendment. The Supreme Court has held on multiple occasions that secret criminal trials are inconsistent with the First Amendment rights of the press.⁴⁵ The Court has not yet found a right of public access for

⁴² We are uncertain because the doctrine in this area is complex. Existing caselaw suggests that Congress has wide authority to restrict judicial review in public right cases. *See generally* RICHARD H. FALLON, JR., ET AL., HART & WECHSLER'S THE FEDERAL COURTS AND THE FEDERAL SYSTEM, Ch. 4 (6th ed. 2009). We thank Henry Monaghan for his help here.

⁴³ Thus, although the FDIC has emphasized that the Act permits judicial review sooner than other federal statutes that commence receiverships, immediate review under the Act is likely less meaningful than delayed review under other statutes. See FDIC, "Orderly Liquidation Authority Provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act," 12 CFR Part 380, p. 4208 n. 1 (Jan. 25, 2011).

⁴⁴ §202(a)(1)(C).

⁴⁵ *Press-Enterprise Co. v. Superior Court*, 464 U.S. 501, 508 (1984) ("The open trial thus plays as important a role in the administration of justice today as it did for centuries before our separation from England. The value of openness lies in the fact that people not actually attending trials can have confidence that standards of fairness are being observed; the sure knowledge that anyone is free to attend gives assurance that established procedures are being followed and that deviations will become known. Openness thus enhances both the basic

civil trials, but some lower courts have.⁴⁶ Moreover, the logic of granting access to criminal proceedings applies equally with respect to civil proceedings. Exceptions can be made, of course, but in theory the way in which they must be made creates a problem. While the legislation mandates secrecy, the Court has also held that case-specific findings are required to overcome the presumption of openness.⁴⁷

The secrecy provisions are unlikely to be contested. On the merits, success is far from certain. There is a long history of nondisclosure in the context of bank regulation,⁴⁸ and the adverse consequences of premature disclosure are easy to imagine. More to the point, the only ones in a position to complain about the secrecy are the directors of the financial company, as they are the only ones who know about it, and they are probably the last one who would want the petition for a receivership to be disclosed.

In the abstract, it might seem that even if each of these limitations on due process and freedom of speech were permissible, the combination of all of them might be toxic. It might seem that the government should not be able to gain the right to seize assets worth many billions by providing only a hearing done in the dark of night with the most critical issues taken off the table. But it likely suffices. Those who are adversely affected do have the right to go to court at a later time to adjudicate their claims.⁴⁹ Recoveries are likely to be minimal, but the talisman of a due process violation has long been the inability to have one's claim adjudicated. That never happens here.

fairness of the criminal trial and the appearance of fairness so essential to public confidence in the system."). *See also* *Richmond Newspapers, Inc. v. Virginia*, 448 U.S. 555 (1980).

⁴⁶ *Huminski v. Corsones*, 386 F.3d 116 (2d Cir. 2004).

⁴⁷ *Press-Enterprise Co.*, 464 U.S. at 510 ("The presumption of openness may be overcome only by an overriding interest based on findings that closure is essential to preserve higher values and is narrowly tailored to serve that interest. The interest is to be articulated along with findings specific enough that a reviewing court can determine whether the closure order was properly entered.").

⁴⁸ *See, e.g.*, 5 U.S.C. §552(b)(8) (exempting from FOIA information "contained in or related to examination, operating, or condition reports prepared by, on behalf of, or for the use of an agency responsible for the regulation or supervision of financial institutions").

⁴⁹ §210(a)(4).

More to the point, it is hard to imagine the circumstances under which challenges to these procedures are likely to be entertained. Political forces work to dissuade the Secretary from acting. She has every incentive to convince herself that a company is not systemically important. Given these incentives, it is unlikely that a court would conclude that the Secretary's findings (of systemic risk and the absence of private alternatives) were arbitrary and capricious, even if it had the power to make such a finding.

II. Elements of the Title II Receivership

Title II gives the FDIC expansive discretion in winding-down an institution in receivership. The most striking difference between the Title II receivership and a traditional reorganization is the absence of a debtor in possession. Upon being appointed as receiver, the FDIC succeeds to all powers of the company and its owners, including the power to operate the company, continue the employ of existing employees, and hire third parties, such as attorneys, asset management companies, and brokerage services.⁵⁰ The FDIC may also appoint itself receiver of any distressed subsidiary whose failure would threaten market stability in the United States.⁵¹ The basic dynamics of the case are the same ones we see in Chapter 11.

A. Liquidating and Reorganizing the Institutions

Modern reorganizations of large corporations usually take the form of a sale. Title II contemplates a similar process. The FDIC has the option of a piecemeal asset sale.⁵² Its favored avenue will likely be a merger of the institution with another company.⁵³ The FDIC can also separate the good and bad assets and place the good assets in a new entity at the very start. The specific mechanism is the establishment of a "bridge financial company" to which the FDIC will transfer some of the institution's assets and liabilities. The FDIC will operate the company until it can be merged with another institution or until its equity can be sold to private investors.⁵⁴

⁵⁰ See §210(a)(1)(A)-(D), §210(a)(1)(L).

⁵¹ §210(a)(1)(E).

⁵² §210(a)(1)(G)(i)(II).

⁵³ §210(A)(1)(G)(i)(I).

⁵⁴ §201(A)(1)(F).

Through the creation of bridge financial companies, the FDIC can (implicitly) administer a conservatorship of the failing financial institution. A bridge financial company is a temporary financial institution owned and indirectly managed by the FDIC.⁵⁵ The FDIC is authorized but not required to capitalize the bridge bank.⁵⁶ Alternatively, the bank can raise funds either by issuing equity or debt in private markets. Although it has a Federal charter, articles of association and bylaws that the FDIC drafts, a board of directors that the FDIC selects, and exemption from state or federal taxation, the bridge is not considered “an agency, establishment, or instrumentality of the United States.”⁵⁷

The Corporation has virtually absolute discretion in selecting assets and liabilities to transfer to the bridge.⁵⁸ The bridge will manage this portfolio with a view to merging with another financial company, selling a majority of its capital stock to private investors, or assumption of substantially all of the bridge’s assets or liabilities by another institution.⁵⁹ The bridge financial company can be dissolved at any time by the FDIC.⁶⁰ Merger with another company automatically terminates the company’s status as a bridge financial company. So does sale of at least eighty percent of its capital stock.⁶¹ The FDIC may also choose to terminate the company’s status as a bridge if it sells at least fifty percent of its stock to private investors or if another institution assumes substantially all of the bridge company’s liabilities or purchases substantially all of its assets.⁶²

B. Running the Process and Administering Claims

The landmarks of the Bankruptcy Code—automatic stay, claim allowance, avoidance actions—are evident in Title II. But Title II is littered with sometimes surprising deviations from the bankruptcy lawyer’s norm. Often these deviations are vindicating core policies of the reform legislation: facilitating rapid decisionmaking by the FDIC, avoiding the perception of a “bailout” by forcing the company’s stakeholders to bear

⁵⁵ §210(h)(2).

⁵⁶ §210(h)(2)(G).

⁵⁷ §210(h)(2)(A)-(D), (8)(A), (10).

⁵⁸ §210(h)(1)(B).

⁵⁹ §210(h).

⁶⁰ §210(h)(15).

⁶¹ §210(h)(13)(A), (C).

⁶² §210(h)(13)(B), (D).

losses, and minimizing the burden on taxpayers.⁶³ In some other cases, the deviations aren't deviations at all, but rather a delegation of authority to the FDIC to fill in gaps.

Automatic stay, claims allowance, and executory contracts. The need for FDIC speed likely explains deviations from the Code's rules governing the automatic stay and claims allowance. Any collective process of a distressed firm must put a stop to the individual efforts of investors to grab assets. The Bankruptcy Code does this through its automatic stay, which stops all formal and informal collection efforts everywhere. Title II does something similar by cutting off all rights of shareholders and creditors, "except for their right to payment, resolution or other satisfaction of their claims,"⁶⁴ by barring counterparties to contracts (other than qualified financial contracts⁶⁵) from enforcing ipso facto clauses during the 90 days following commencement of the receivership,⁶⁶ and by forbidding courts from issuing attachment or execution upon assets in the FDIC's possession.⁶⁷ But the commencement of a Title II receivership does not automatically stay judicial proceedings. The FDIC must instead petition to stay these proceedings. Although courts must grant the petition, the stay cannot exceed ninety days.⁶⁸

Similar deadlines force the FDIC to act quickly in allowing and disallowing claims. Under Title II, claims are defined as expansively as they are under the Bankruptcy Code,⁶⁹ but the allowance/disallowance

⁶³ §§204(a), 206.

⁶⁴ §210(a)(1)(M).

⁶⁵ §210(c)(13)(C)(ii).

⁶⁶ §210(c)(13)(C)(i).

⁶⁷ §201(a)(9)(C).

⁶⁸ §210(a)(8).

⁶⁹ §210(a)(4). In this respect Title II differs from the FDIA. Those whose rights against a bank are contingent have found that their rights may be slighted under receiverships under that Act. The FDIC grounds this position in 12 U.S.C. 1821(e)(3). *See, e.g.*, FDIC Statement of Policy regarding Treatment of Collateralized Letters of Credit after Appointment of the FDIC as Conservator or Receiver, 60 Fed. Reg. 27976, May 26, 1995, effective May 19, 1995. *See also* 210(c)(3)(E), which recognizes the FDIC's authority to value contingent claims. The FDIC proposes to value these claims in the same ways that bankruptcy courts do. *See* FDIC, "Orderly Liquidation Authority Provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act," Supplementary Information, 12 CFR Part 380, p. 4213 (Jan. 25, 2011); *see also* Interim Rule 380.4, at p. 4216.

decision must be rendered within 180 days after commencement of the receivership (extensions are possible, however).⁷⁰ If speedier decision-making is necessary to avoid “irreparable injury” to a claimant, the FDIC must render a decision within ninety days.⁷¹ The Corporation may disallow all or part of any timely-filed claim that is “not proved to the satisfaction of the Corporation.” If, however, a claim is disallowed, the claimant may seek judicial determination of its claim in a federal district court.⁷²

The FDIC is free to affirm or repudiate any ongoing contract, free of judicial review, within a “reasonable period of time.”⁷³ Counterparties to repudiated contracts are entitled to damages claims, but claims for punitive damages, lost profits, or pain and suffering are disallowed.⁷⁴ An unusual feature here, from a bankruptcy perspective, is the Corporation’s authority to assume executory loan agreements. Section 210(a)(12)(D) authorizes the FDIC to enforce “any contract to extend credit to the covered financial company or bridge financial company.” This too likely reflects the policy in favor of a speedy receivership process: whenever possible, the FDIC can draw on existing lines of credit.

Avoidance actions. Some differences between the Bankruptcy Code and Title II may be unintentional. For example, Section 210(a)(11) sets out avoidance powers that are virtually identical to the fraudulent conveyance and preferential transfer provisions of §547 and §548 of the Bankruptcy Code. One important difference is the use of the bona fide purchaser for value as the benchmark for determining whether a transfer is perfected rather than hypothetical lien creditor.⁷⁵ Another difference is the standard for intentional fraudulent transfers to non-insiders. The Bankruptcy Code permits the trustee to attack intentional fraudulent transfers regardless of the debtor’s financial condition at the time of the transfer.⁷⁶ By contrast, Title II subjects them to attack only if they

⁷⁰ §210(a)(3)(A)(i).

⁷¹ §210(a)(5)(B).

⁷² §210(a)(4).

⁷³ §210(c)(1),(2).

⁷⁴ §210(c)(3)(A),(B).

⁷⁵ §210(a)(11)(H)(i)(II). The Proposed Rules provide, however, that the FDIC will avoid transfers properly only if they can be avoided by a creditor on a simple contract who acquires a judicial lien. See Proposed Rule §380.9(b)(3).

⁷⁶ 11 U.S.C. §548(a)(1)(A).

rendered the firm insolvent or occurred while the firm was insolvent.⁷⁷ In light of the Reform Act drafter's obvious intention to track the Bankruptcy Code, this may be an unintentional drafting error. Someone who engages in a sham transaction that has many badges of fraud should not get off the hook merely because her machinations took place while the firm was still above water.

Another puzzling difference is the absence of a provision analogous to §544 of the Bankruptcy Code, which (among other things) gives the trustee power to attack unperfected security interests. That power may be implicit in §210(a)(1)(D), which states that the FDIC "shall, as receiver for a covered financial company, and subject to all legally enforceable and perfected security interests and all legally enforceable security entitlements in respect of assets held by the covered financial company, liquidate, and wind-up the affairs of a covered financial company"⁷⁸

Creditor priorities. A desire to protect taxpayers likely explains the priorities among unsecured claims set out in §210(b)(1). These deviate substantially from the Code,⁷⁹ particularly with respect to the claims of the federal government. First priority goes to administrative expenses,⁸⁰ followed by any amounts owed to the United States,⁸¹ then wages, salaries, and commissions owed to ordinary employees, and finally contributions owed to employee benefit plans. These employee claims are subject to the same \$11,725 ceiling (indexed for inflation) as in §507 of the Bankruptcy Code. After these priority claims come all other general unse-

⁷⁷ §210(a)(i), (ii).

⁷⁸ The power may also be implicit in Article 9 of the Uniform Commercial Code, which gives a lien creditor priority over creditors unperfected security interests. §9-317(a)(2). A "lien creditor" includes "a receiver in equity." §9-102(52).

⁷⁹ But the priority provisions of the Bankruptcy Code are hard to derive from first principle, and hence it is hard to argue that these make less sense.

⁸⁰ Super-administrative expense priority goes to debt incurred by the FDIC as receiver for the financial company. §210(b)(2).

⁸¹ It remains unclear, however, what constitutes "amounts owed to the United States." Might it include fines levied by the SEC? See National Bankruptcy Conference, Letter dated May 21, 2011, responding to Notice of Proposed Rulemaking, 12 CFR Part 380, Federal Register, Vol. 76, No. 56, p. 16324 (Mar. 23, 2011) (available at www.fdic.gov/regulations/laws/federal/2011/11comad73.html) ("NBC Letter").

cured claims and then subordinated unsecured claims, followed by wages, salaries, and commissions owed to senior executives and directors. Anything left goes to equity holders.

But the FDIC can deviate from this scheme to promote market stability. The Corporation has broad authority to favor some creditors over others with equal priority, provided that the favored treatment maximizes asset value, minimizes losses, or is otherwise essential to the receivership.⁸² The Corporation may also pay some creditors immediately, but defer payments on others.⁸³ But even these outcomes are not unfamiliar to bankruptcy lawyers. In Chapter 11 reorganizations, creditors as a class can agree to take less than others if it is the sensible course. Moreover, the debtor enjoys a limited ability to make payments to critical vendors and others if it advances the interests of the estate as a whole. Title II permits much the same,⁸⁴ though it is vindicating a different policy (market stability).

Secured claims, setoffs, and adequate protection. At first glance, the Act appears congruent with the Bankruptcy Code: Secured claims are bifurcated under the Act in much the same way that they are under Section 506 of the Code;⁸⁵ rights of setoff are preserved under the Act unless they run afoul of tests that resemble Section 553 of the Code.⁸⁶ But there are fundamental omissions in the Act's treatment of secured claims and setoff rights. The most important is the absence of adequate protection remedies analogous to Sections 361, 362(d), and 363(e) of the Bankruptcy Code. If collateral is depreciating in value, there are no avenues by which a secured creditor can petition the FDIC for either (i) adequate protection or (ii) permission to exercise its contractual rights against collateral. Nor are there avenues for relief in the event that the covered fi-

⁸² §210(b)(4).

⁸³ §210(a)(7)(A).

⁸⁴ While the language of Title II seems to give the FDIC broad discretion to pay some and not others, the FDIC's proposed rules thus far reflect the understanding that this provision will operate in the same fashion as a critical vendor order. It would generally prohibit the FDIC from using its Title II authority to favor holders of long-term senior unsecured debt, subordinated unsecured debt, and equity (though the FDIC's Board can, under special circumstances, make exceptions to this rule). Interim Rule §380.2(b), 12 CFR Part 380, p. 4215 (Jan. 25, 2011).

⁸⁵ §210(a)(3)(D)(ii).

⁸⁶ §210(a)(12)(A), (B).

nancial company has no equity in collateral that is unnecessary to successful completion of the receivership process.

This may be less problematic than it appears. Unlike the Bankruptcy Code, the Act will be fleshed out by a regulator, the FDIC. Congress has directed the FDIC to “harmonize applicable rules and regulations promulgated under this section with the insolvency laws that would otherwise apply to a covered financial company.”⁸⁷ Given that other provisions of the Act require that creditors receive no less than they would in a Chapter 7 liquidation, it seems likely that the FDIC will implement rules that offer secured creditors adequate protection remedies similar to Sections 361, 362(d), and 363(e). These remedies would be available to creditors during a Chapter 7 liquidation.

But the FDIC can harmonize the Act with the Code only to the extent that the Act permits harmonization. In one important respect, it does not. The Act permits the Corporation to sell assets free and clear of setoff claims without offering adequate protection. Once assets are sold, the setoff claim is demoted from the equivalent of a secured claim (under Bankruptcy law) to an unsecured claim (under the Act) with priority above general unsecured claims but below all priority claims (administrative expenses, amounts owed to the United States, and certain employee-related claims).⁸⁸ It is unclear how this rule vindicates core policies of the Act.

Postpetition financing. The desire to avoid anything resembling a “bailout” figured large in the political dynamics of the Act. This manifests itself in several places. One place is in the rules governing postpetition financing. In recent years, the DIP financier has emerged as one of the major players in the reorganization process. Title II contemplates that this role too is one that the FDIC will assume, although private loans are also possible. The FDIC has authority to extend loans to the covered financial company, purchase the institution’s debt obligations, purchase or guarantee its assets, assume or guarantee its obligations, and take a lien on its assets.⁸⁹ The FDIC may not, however, take an eq-

⁸⁷ §209. With respect to post-petition interest, see also §210(a)(7)(B), which guarantees that creditors receive no less than they would in a Chapter 7 liquidation. During such a liquidation, an oversecured creditor would be entitled to the protections of Section 506(b). See also NBC Letter, *supra* note 81, at 3-4.

⁸⁸ §210(a)(12)(F).

⁸⁹ §204(d).

uity interest in the institution, reflecting Congress's aversion to AIG-style bailouts.⁹⁰

Anti-bailout philosophy is more apparent in other limits on the FDIC. The Corporation must finance its activities as receiver through an "orderly liquidation fund," which is funded by borrowings from the Treasury.⁹¹ The FDIC's authority to borrow from the Treasury, however, is tightly constrained. The Corporation cannot issue debt in connection with a receivership that exceeds specified thresholds. During the first thirty days of the receivership, loans cannot exceed ten percent of the covered financial company's total consolidated assets, as measured by the most recent financial statements. As soon as the FDIC determines the fair market value of assets available for repayment of new debt (or after the first thirty days of the receivership, whichever occurs first), the FDIC can extend larger loans to the company, but the loans cannot exceed ninety percent of those assets' fair market value.⁹²

To repay its obligations to the Treasury, the FDIC is permitted to impose "assessments" on a broad range of financial institutions.⁹³ Institutions subject to assessment include those that received more than their pro-rata share of proceeds from a receivership commenced by the FDIC, any bank holding company with at least \$50 billion in total consolidated assets, any nonbank financial company subject to the Fed's systemic risk oversight authority, and any other financial company with total consolidated assets of at least \$50 billion.⁹⁴ In this way, Title II ensures that losses from receiverships are borne primarily by the institution's stakeholders and secondarily by members of the industry.

But the FDIC need not be the sole source of financing. If the Corporation creates a bridge financial company, the company may obtain financing from private lenders. The rules governing this financing are virtually identical to the rules governing DIP financing under the Code. For example, if the bridge is unable to obtain unsecured credit, the FDIC may authorize it to issue debt with priority over all other obligations (super-administrative expense priority), with a lien on unencumbered assets, or with a junior lien on encumbered assets.⁹⁵ The FDIC may also

⁹⁰ §206(6).

⁹¹ §210(n)

⁹² §210(n)(6)

⁹³ §210(o)(1)(B).

⁹⁴ §210(o)(1)(A), (D).

⁹⁵ §210(h)(16)(B).

authorize the bridge to issue debt with first-priority security interests in property that is already encumbered by liens.⁹⁶ Such a priming lien, however, requires adequate protection and a hearing before a district court.⁹⁷ Title II cannot be faulted for providing too much process, but here, as elsewhere, it seems to provide such process when it is due.⁹⁸

Executives. Title II ensures that those responsible for the failure are punished. In contrast with Chapter 11, which ordinarily allows the board of directors to remain in place and continue to run the company, Title II requires the removal of those responsible for the failed condition of the company⁹⁹ and the ability to recover any compensation they received during the two years before the start of the receivership.¹⁰⁰ But like Chapter 11, Title II includes multiple provisions designed to punish senior executives and directors who contributed to the institution's failure. These provisions are similar in spirit to a number of rules added to the Bankruptcy Code in 2005. The FDIC may sue directors, officers, attorneys, accountants, and other actors for grossly negligent conduct that resulted in the "improvident or otherwise improper use or investment of any assets of the covered financial company."¹⁰¹ The FDIC may also claw back compensation paid during the two years preceding the receivership from any current or former executive who is "substantially responsible for the failed condition of the covered financial company."¹⁰² Here, "compensation" is defined broadly to include salary, bonuses,

⁹⁶ §210(h)(16)(C)(i).

⁹⁷ §210(h)(16)(C)(ii).

⁹⁸ Failing to provide secured creditors with adequate protection and adequate protection invites the sort of challenges that spelled trouble for Frazier-Lemke. *See* Louisville Joint Stock Land Bank v. Radford, 295 U.S. 555 (1935); Wright v. Union Central Life Insurance Co., 304 U.S. 502 (1938).

⁹⁹ §206(5).

¹⁰⁰ §210(s)(1). In contrast to some provisions of the Bankruptcy Code aimed at excessive compensation, *see, e.g.*, §548(a)(1)(B)(ii)(IV), this provision does not focus on whether the executives were paid too much. In deciding whether to pursue the responsible executives, the focus is elsewhere. Title II instructs the FDIC to weigh the "financial and deterrent benefits" of recovery against "the cost of executing the recovery." §210(s)(2).

¹⁰¹ §210(f), (g).

¹⁰² §210(s). Under the proposed rules, the chief executive officer, chairman of the board of directors, and the chief financial officer are all presumed to be substantially responsible for the failed condition of a failed financial company. Proposed Rule §380.7(b)(1)(i).

benefits, golden parachute benefits, and “any profits realized from the sale of the securities of the covered financial company.”¹⁰³

Additionally, the Federal Reserve (or other appropriate agency) can bar senior executives and directors from working for any financial institution for a period not to exceed two years. Grounds for this sanction include evidence that the executives or directors, directly or indirectly, “engaged or participated in any unsafe or unsound practice in connection with any financial company,” “received financial gain or other benefit by reason of” this practice, and the practice “demonstrates willful or continuing disregard ... for the safety or soundness of such company.”¹⁰⁴

C. Safe harbors for qualified financial contracts

Financial contracts are typically the core assets of nonbank financial institutions. Before Title II, a distressed institution faced great challenges in managing these assets due to the Bankruptcy Code’s “safe harbors.” These safe harbors permit certain counterparties to qualified financial contracts (QFCs)—repurchase agreements, commodity and forward contracts, security contracts, and swaps—to treat a bankruptcy filing as an event of default. They may terminate all contracts with the distressed institution, net out and set-off multiple contracts, compute a net obligation, and seize available collateral to the extent that the net obligation is owed by the institution. The automatic stay does not apply to these counterparties; nor do the rules governing ipso facto clauses, preferential transfers, or (constructive) fraudulent conveyances.

In short, the safe harbors ensure that a counterparty’s rights under a qualified financial contract (QFC) are unaffected by the bankruptcy process. These rules expose failing financial institutions to a rushed, free-for-all liquidation by counterparties. This exposure is said to have prompted the Federal Reserve’s efforts to orchestrate a bailout of Long-Term Capital Management in 1998. The Federal Reserve feared that a free-for-all liquidation of LTCM would have destabilized markets. The safe harbors may also have contributed to the market instability during the days immediately before and after Lehman Brothers’ bankruptcy filing.

¹⁰³ §210(s)(3).

¹⁰⁴ §213.

The Reform Act adopts a different approach to QFCs. The new approach, modeled on the FDIA, continues to offer safe harbors for these contracts. Counterparties to securities contracts, commodity and forward contracts, repurchase agreements, and swaps are still immune to preferential and (constructive) fraudulent transfer avoidance actions.¹⁰⁵ This safe harbor is potentially broader than the one available under the Bankruptcy Code because it applies to all QFC counterparties, not just the particular counterparties singled out for protection by the Code. For example, while all swap counterparties benefit from the Code's safe harbors¹⁰⁶ only designated counterparties to securities, commodity, and forward contracts, such as commodity brokers, may benefit from the Code's safe harbors for those QFCs.¹⁰⁷

Additionally, Title II continues to protect the contractual rights of counterparties and to make clear that commencement of the receivership process *generally* does not alter those rights. For example, it provides that "no person shall be stayed or prohibited from exercising ... any right that such person has to cause the termination, liquidation, or acceleration of any qualified financial contract with a covered financial company which arises upon the date of appointment of the Corporation as receiver for such covered financial company or at any time after such appointment."¹⁰⁸

But the Reform Act does nullify, at least temporarily, some important contractual rights. First, ipso facto clauses (termination, netting, and setoff rights) are stayed from the moment the receivership commences until 5:00 p.m. (Eastern) on the next business day, or until the qualified financial contracts have been transferred to another institution.¹⁰⁹ Along similar lines, the Act nullifies walkaway clauses that "suspend[], condition[], or extinguish[] a payment obligation" of a counterparty "solely because of" either the financial institution's insolvency or the appointment of the FDIC as receiver.¹¹⁰ Additionally, and with one exception,

¹⁰⁵ §210(c)(8)(C)(i).

¹⁰⁶ *See, e.g.*, 11 U.S.C. §101(53C), §546(g).

¹⁰⁷ *See, e.g.*, §546(e).

¹⁰⁸ §210(c)(8)(A)(i).

¹⁰⁹ §210(c)(10)(B).

¹¹⁰ §210(c)(8)(F)(i), (iii). Presumably, these clauses are revived after the qualified financial contract has been transferred to a third party (so that they can be asserted if the third party subsequently becomes insolvent). Section

the Act temporarily suspends the payment obligations of the covered financial institution.¹¹¹ The exception involves QFCs traded through clearing organizations: If the FDIC fails to satisfy any “margin, collateral, or settlement obligations under the rules of the clearing organization, the clearing organization shall have the immediate right to exercise, and shall not be stayed from exercising, all of its rights and remedies under its rules and applicable law.”¹¹²

By suspending ipso facto clauses, walkaway clauses, and payment obligations (at least temporarily), the Act gives the FDIC time to repudiate QFCs or transfer them to other institutions. The time, however, is quite limited. Both walkaway rights and contractual payment obligations become enforceable again after (i) the contract has been transferred to another entity, such as a bridge financial company, or (ii) 5:00 pm EST on the business day following the date on which the FDIC was appointed as receiver.¹¹³ However, a counterparty cannot enforce a walkaway right merely because QFCs have been transferred to a bridge company, which “shall not be considered to be a financial institution for which a conservator, receiver, trustee in bankruptcy or other legal custodian has been appointed, or which is otherwise the subject of a bankruptcy or insolvency proceeding.”

But the FDIC does not possess the same assume-or-reject authority that the Bankruptcy Code gives to trustees and debtors in possession. The Code allows the DIP to “cherry pick” contracts with the same counterparty. Instead of netting multiple contracts to compute an overall obligation owed to or by the DIP, the Code allows DIPs to act strategically by assuming contracts that are in-the-money (assuring full payment by the counterparty) and rejecting those that are out-of-the-money (assuring that counterparties are treated as ordinary unsecured creditors, who typically receive less than full payment). The Reform Act implicitly forbids this cherry-picking by requiring the FDIC to repudiate *all or none* of the QFCs with a given counterparty.¹¹⁴

210(c)(8)(F)(i) only refuses enforcement of walkaway clauses “in a qualified financial contract of a covered financial company *in default*” (emphasis added).

¹¹¹ §210(c)(8)(F)(ii). This suspension of payment obligations does not apply to exchange-traded QFCs.

¹¹² §210(c)(8)(G).

¹¹³ §210(c)(8)(F)(ii), (10)(B)(i)

¹¹⁴ §210(c)(11).

The same all-or-none principle applies to decisions by the FDIC to transfer QFCs to a bridge financial company. The Corporation may transfer *all or none* of the contracts with a particular counterparty. Moreover, the transfer must include not just the contracts, but also any associated claims of or against the counterparty and any property or credit enhancements securing obligations under the contract.¹¹⁵ In sum, Title II ensures that the insolvency of the financial company leaves performance of QFCs unaffected. Appointment of a receiver does not trigger any changes in the contract. After being transferred to a bridge, the contract is performed according to its original terms, as if nothing had happened.

Seen at a distance, these provisions chart a sensible middle course between subjecting financial contracts to something akin to the automatic stay and exempting them entirely. All executory contracts give the debtor in possession an opportunity to take advantage of the third party. If you promise to sell the debtor a particular component at \$100 at the end of the year and the debtor files for bankruptcy when the market price of that component is at \$100, the debtor has an incentive to delay the decision to accept or reject the executory contract. If the price falls, the contract can be rejected; you as seller will receive a claim for damages, but it will be paid pennies on the dollar. If the price of the component rises, the debtor (and all her creditors) will capture the benefit of paying only \$100 for a component that is worth more.

In the case of an ordinary contract, however, the volatility of the price of the component is typically only one part of the picture, and often it is a small part. The debtor delays the breach-or-perform decision, not because it is exploiting price volatility, but rather because it takes time to decide whether the debtor will even continue making the product for which the component is used, and because it takes time to determine whether a higher quality or more suitable substitute can be obtained elsewhere. Here, the costs that the automatic stay imposes on the seller are small and the benefits to the debtor large.

In the case of a financial contract, by contrast, volatility matters much more. Indeed, for the vast majority of debtors it is the *only* feature that matters. A financial contract is, almost by definition, a contract in

¹¹⁵ §210(c)(9)(A). financial contracts could be firm-specific assets. Think of a specialized, OTC hedge: It is a special contract between two parties; it is not a traded instrument.

which the counterparties are trading volatility. The counterparties are bearing opposite sides of the risk that market movements will change the price of some underlying asset, index, or other measure of value. If an automatic stay were applied to these contracts, it would fundamentally alter the terms of trade by giving the debtor the ability to gain from favorable price movements and limit its liability for unfavorable ones (“cherry-picking”). Put differently, an automatic stay would give the debtor the option value associated with the volatility in the underlying price. Moreover, cancelling financial contracts typically presents few problems for firms that are not systemically important. For the most part, the financial contract brings no firm-specific synergy.¹¹⁶ More to the point, as long as the market is liquid, as it should be outside of the times of crisis for which Title II is intended, the debtor can simply recreate the same contract and continue to enjoy whatever benefits the old financial contract provided. To be sure, it may be very costly to recreate the contract. The same market conditions that have rendered the debtor insolvent have also probably raised the price it faces to enter new financial contracts. But the same market discipline faces any troubled business, which will face different terms of trade when it is healthy than when it is distressed.

This line of argument¹¹⁷ is often used to distinguish ordinary contracts from financial contracts and for subjecting only the former to the automatic stay.¹¹⁸ A problem arises, however, in the case of systemically

¹¹⁶ There are, of course, some exceptions. For example, there can be customized contracts between two parties, such as a specialized OTC hedge that is of particular value to the debtor and that cannot be readily replicated.

¹¹⁷ Another line of argument distinguishes ordinary contracts from QFCs on grounds that the latter contracts are systemically important. Exempting QFCs from the automatic stay, it is argued, promotes systemic stability. This argument is controversial and hard to square with the Dodd-Frank legislation, which deviates from the bankruptcy code’s “safe harbors” for QFCs in order to promote systemic stability. See Franklin R. Edwards and Edward R. Morrison, *Derivatives and the Bankruptcy Code: Why the Special Treatment?*, 22 Yale J. Reg. 91 (2005).

¹¹⁸ Although it is easy to identify reasons for offering different treatment to ordinary and financial contracts, it is much harder to say what the appropriate treatment is. Any *ex post* difference in treatment when a company becomes insolvent will have complex *ex ante* effects on credit markets, as explored by Mark J. Roe, *The Derivative Market’s Payment Priorities as Financial Crisis Accelerator*, 63 Stan. L. Rev. 539 (2011).

important companies whose assets consist of large bundles of financial contracts.¹¹⁹ Without the protection of an automatic stay, these companies are torn apart when they become insolvent. Recall Lehman Brothers: It was party to about 1.5 million transactions with over 8,000 counterparties when it filed for Chapter 11. Less than two weeks later, eighty percent of those transactions had been liquidated.¹²⁰ When an institution like Lehman is torn apart, markets can destabilize. As the institution defaults on millions of contracts with thousands of creditors, counterparties and creditors may too suffer distress and fail (as the Primary Reserve Fund did after Lehman's collapse). And as thousands of counterparties rush to sell collateral and re hedge positions that were exposed by the institution's default, market prices will experience wild swings in value. These gyrations, of course, may severely undermine investor confidence, as we saw in "flight to quality" after the Lehman Brothers' bankruptcy and AIG bailout.

In this setting, the ordinary bankruptcy rule for QFCs—exempting them from the automatic stay—is no longer attractive. While we do not want to permit cherry-picking, value exists in the various bundles of contracts that may be impossible to recreate in times of severe economic distress. Title II creates a regime that allows for an intermediate treatment of financial contracts that places them between ordinary executory contracts and financial contracts in the typical Chapter 11. In this sense, it does not turn its back on Chapter 11 as much as it creates a compromise between two positions that are already embedded in existing bankruptcy law.

III. Will it Work?

One way to think about this question is to ask how Lehman Brothers would have benefited from Title II, were it on the books prior to Lehman's distress.¹²¹ Lehman found itself both heavily leveraged and

¹¹⁹ See generally Morrison, *supra* note 1.

¹²⁰ Harvey Miller, Discussion at Sixth Annual Deals Roundtable, Columbia Law School (Nov. 24, 2008).

¹²¹ The FDIC recently performed a similar thought experiment and envisioned a rapid receivership that merely consummated a sale (to Barclays) that was hammered out during the five or six months preceding September 2008. *Orderly Liquidation of Lehman Brothers Holdings Inc. under the Dodd-Frank Act*, 5 FDIC Quart. (forthcoming 2011). As many bloggers have already noted, the

absolutely dependent upon short-term credit markets. It had made large bets on subprime residential real estate, commercial real estate, and loans used to facilitate leveraged buyouts. When all three went sour, it was hopelessly insolvent and, as soon as its sources of credit got wind of this state of affairs, they cut it off. Lehman's bankruptcy filing not only made plain its own sorry condition, but also that of other large financial institutions that were similarly leveraged and with similar wagers on residential or commercial real estate or leveraged loans.

Laws by themselves can do little to fix this state of affairs.¹²² They can do nothing to make an insolvent firm solvent or keep bad news about others from leaking out. Dodd-Frank does provide some liquidity. Limitations on the ability of the FDIC to extend credit may also undermine the ability of the Title II receivership to provide stability. As noted earlier, the liquidation fund is capitalized by borrowings from the Treasury and there is a strict cap on total borrowing per receivership.¹²³

Regardless of whether the fear of bailouts justifies such limits, they necessarily constrain the Treasury, Federal Reserve, and FDIC. Title II applies only when there are systemic risks to the economy as a whole. During the financial crisis of 2008, the federal government committed \$8 trillion to the financial sector, essentially converting short-term financing of the largest financial institutions into long-term financing.¹²⁴ Ex post, the cost to the taxpayer will likely be small, perhaps even less than the cost of the savings and loan debacle of the 1990s. But the resources deemed necessary far, far exceed the modest resources that Title II make available to the FDIC.

FDIC report assumes (among other things) that the Corporation would have been able to identify Lehman's distress many months before its failure, muster the political will to intervene prior to the firm's collapse, obtain cooperation of managers in investigating the firm's options, investigate Lehman's finances and orchestrate an auction without sparking destabilizing rumors among financial market participants, and secure cooperation from foreign financial officials. Our analysis in this paper entertains the possibility that the FDIC receivership might have been more complex and time-consuming.

¹²² For a different version of the same argument, see DAVID SKEEL, *THE NEW FINANCIAL DEAL: UNDERSTANDING THE DODD-FRANK ACT AND ITS (UNINTENDED) CONSEQUENCES* 19–33 (2011).

¹²³ See §210(n)(6).

¹²⁴ See Comments of Jim Millstein, Education Session, American College of Bankruptcy (March 19, 2011).

The Lehman bankruptcy proved unusually complicated and hard because its affairs were so tightly linked with its many off-shore affiliates. It underscored the way in which the affairs of giant banks transcend national borders and implicate many different and sometimes competing regulatory regimes. The regulator of a related entity in another country will typically put a ring around that entity when a related entity fails. This act alone can hugely disrupt the operations of a financial institution that is completely dependent upon cash flowing continuously throughout the entire system.

Title II, however, does little, if anything, to promote international cooperation in the event of a financial meltdown. Section 202(f) calls for a study “regarding international coordination.” In the meantime, Section 210(a)(1)(N) exhorts the FDIC to “cooperate, to the maximum extent possible, with the appropriate foreign financial authorities regarding the orderly liquidation of any covered financial company that has assets or operations in a country other than the United States.” Without treaties or other multilateral agreements, this exhortation offers little comfort.

One can also doubt the competence of government regulators to handle the problems of a financial company that suddenly poses a systemic risk to the economy. The FDIC’s success in the past may derive in large measure from its having regulated the failed bank closely in the past and being already intimately familiar with its operation. The assets consist largely of deposits that the FDIC has insured, and hence its own money is at risk. Neither the FDIC nor any other government regulator will be in a similar position if a toxic hedge fund appears in the next meltdown.

To be sure, we live in a world of the second best. To say that the FDIC will be badly equipped is not to say that anyone else will be better equipped. Even so, we must be sanguine about the likely success of Title II proceedings: If the Federal Reserve does an adequate job regulating systemically important institutions under Title I of the Act, we will see receiverships under Title II only when pervasive fraud or a seismic shift in market conditions catch the Federal Reserve unawares (as the Great Recession seems to have). These receiverships will be massively complex and deeply threatening to the economy (as were the failures of Lehman and AIG). It is hard to be confident that any regulator will be able to contain the fallout. Perhaps only another massive government bailout will help.

There is, however, one aspect of Lehman's failure for which Title II has something to offer that existing bankruptcy law does not. This concerns the treatment it provides for a systemically important financial institution's book of derivative trades.¹²⁵ At the time of Lehman's bankruptcy, its derivatives book as a whole appeared to be a net asset to the estate worth tens of billions of dollars. Because of the way that the Bankruptcy Code treats qualified financial contracts, this asset disappeared in a puff of smoke the moment that bankruptcy was filed.

Moreover, Lehman's derivative book was so large—consisting of 900,000 positions—that other players in the market had to rush to re-hedge their positions. This in turn destabilized prices. Unscrambling and sorting out these transactions will likely take many years. Everyone would have been better off if Lehman's entire book of derivatives could have been preserved. Because it was a net asset, in principle someone would have been willing to pay a positive price to acquire it if it were an asset that could have been sold.

Effecting the transfer of a derivatives book, however, will not be always be easy when the systemically important institution is in distress. It is one thing to contemplate assuming an entire derivatives book when one can be confident that it is a net asset, which may well have been the case in *Lehman*. But it will be much harder in cases in which the book is a net liability or simply too hard to assess, as was likely the case in *AIG*. Taking the entire book may not be an option, and evaluating tens or hundreds of thousands of open contracts and picking and choosing among the various counterparties simply will not be possible within the two-day window of Dodd-Frank. Moreover, only by assuming the entire book does one minimize disruptions to counterparties. (If an entire book is assumed or transferred, the receivership becomes completely transparent to counterparties. They have same positions afterwards as before.)

Of course, allowing entire positions to be transferred does not itself require replacing the Bankruptcy Code with another regime. Indeed, one could imagine importing Title II's provisions on qualified financial contracts into Chapter 11. This does not mean that Title II is bad, as it

¹²⁵ For background on Lehman's derivatives book, see Report of Anton R. Valukas, Examiner, In re Lehman Brothers Holdings, Inc., vol. 2, at 568-83, Chapter 11 Case No. 08-13555 (Bankr. S.D.N.Y. 2008).

suggests that its most obvious purpose is much narrower and more modest than commonly supposed.

Whether Title II can serve a broader purpose may be doubted. The goal of Title II is to provide a stabilizing force when systemic institutions crater, but several features undermine that goal. It is not obvious that Title II will even provide certainty to any creditors. Creditors are entitled to a minimum recovery equal to what they would have received if both (i) the institution had been liquidated under Chapter 7 and (ii) the FDIC had not been appointed as receiver.¹²⁶ But the FDIC is appointed as receiver only if the institution's failure "would have serious adverse effects on financial stability in the United States."¹²⁷ Thus, to determine the minimum recovery to creditors, we must imagine the liquidation value of the institution in an economy that is suffering an economic collapse. That liquidation value is likely to be close to zero.

The minimum recovery is particularly uncertain for creditors with rights of setoff. The legislation permits the FDIC to sell assets, free and clear of rights of setoff.¹²⁸ Affected creditors receive minimal compensation in the form of priority above general unsecured claims, but below administrative claims and certain other high-priority unsecured claims (e.g., wage claims of ordinary employees).

Creditors can, of course, receive more than this minimum recovery if the FDIC determines that a higher recovery is necessary to maximize the value of the institution's assets or facilitate continued operations.¹²⁹ But these higher recoveries may eventually be clawed back by the FDIC. Again, the legislation mandates that the Title II receivership be self-funding or at least not publicly funded. Section 210(o) allows the FDIC to impose "assessments" on claimants to the extent that they received amounts greater than "the value the claimant was entitled to receive from the Corporation on such claim solely from the proceeds of the liquidation of the covered financial company under this title."¹³⁰ It is un-

¹²⁶ §210(d)(2),(3)

¹²⁷ §203(b)(2).

¹²⁸ §210(a)(12)(F).

¹²⁹ See §210(b)(4), (d)(4), (h)(5)(E).

¹³⁰ §210(o)(1)(D)(i). Some Creditors are not vulnerable to assessment. The FDIC cannot claw back payments that were "necessary to initiate and continue operations essential to implementation of the receivership or any bridge financial company." §210(o)(1)(D)(i). See Interim Rules, 12 CFR Part 38, p. 4212 (Jan. 25, 2011) ("A possible example of payments not subject to the "claw-back" pro-

clear whether “proceeds of the liquidation of the covered financial company under this title” is equivalent to the minimum payment guaranteed to unsecured creditors described above.

That particular creditors receive nothing in the event of a Title II receivership is not necessarily a problem per se, but the ambition of the law and the justification for government intervention in the first instance is to provide stability when the failure of the company threatens the United States economy as a whole. If payments are uncertain and if it is not clear that payments can be kept even after they are made, one can question how much stability the law in fact provides.

A common complaint against Title II—that it puts government regulators to solve a problem that existing bankruptcy law or a new chapter of the Bankruptcy Code might solve—may miss the point. To a large extent, Title II is consistent with the basic principles of bankruptcy law. The terminology is different, but this is not a matter of substance. Its basic features and ambitions are the same. The striking differences—the eligibility rules, the minimal judicial involvement, and the consolidation of many different roles in a single government regulator—derive from its underlying premise. A Title II receivership can begin only when private solutions and ordinary judicial processes fail and it does provide a resource that existing law lacks.

In short, Title II, like the Bankruptcy Code, provides a safety net. The argument against it may be not so much that this safety net is likely a modest one. Additional safety nets, however modest, would seem to be things. One can take the view that working without a safety net might be a good thing. People tend to be much more careful when there is no safety net in place at all, poor or not. The absence of a safety net concentrates the mind wonderfully. Cooler heads may have prevailed in the case of LTCM and held its derivatives book together precisely because there was no one for the investment banks to fall back on. There was nothing analogous to Title II to come to the rescue of LTCM if they did not. But this line of reasoning assumes that the relevant actors will

visions might be payments to trade creditors, such as a payment necessary to ensure that a vendor is able to continue to provide the failed company with essential software or hardware that could not be replicated, or payments to a utility with a local monopoly.”). In other words, “critical vendors” avoid clawback. Additionally, if proceeds from liquidation of a covered financial company are sufficient to repay any funds received from the Treasury, the FDIC will not exercise its clawback authority. §210(o)(1)(B).

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act rationally when left to fend for themselves. This path contains risk as well.