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THE CONTEXT FOR BANKRUPTCY RESOLUTIONS

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I. Introduction

Any process for resolving the affairs of a failed financial institution, whether under Title II of Dodd-Frank or the Resolution Project's proposed new version of a Chapter 14 of the Bankruptcy Code, takes as its starting point a firm whose organizational form and financial structure has been determined by a complex set of statutory and regulatory requirements. At this writing, many of those requirements are still being spelled out, and important aspects are uncertain. Revised Chapter 14 at places makes assumptions about those requirements' final form, and may have to be modified in the light of what is settled on. It also contains recommended changes in the application of stays to QFCs, which will be discussed in a separate paper by Darrell Duffie on central clearing counterparties.

FDIC has proposed that the failure of those US financial institutions that are thought to be systemically important (SIFIs) and not satisfactorily resolvable under bankruptcy law will be handled by (1) placing the parent holding company under the control of FDIC as receiver and (2) transferring to a new "bridge" financial company most of its assets and secured liabilities (and some vendor claims)—but not most of its unsecured debt (exactly what is to be left behind is not defined, but will be here referred to as "capital debt"). The losses that created a fear of insolvency might have occurred anywhere in the debtor's corporate structure, but the takeover would be of the parent company—a tactic described as a "single point of entry" (SPOE).

The desired result would be a new financial company that was strongly capitalized (having shed a large amount of its prior debt), would have the capacity to recapitalize (where necessary) operating subsidiaries, and would have the confidence of other market participants, and therefore be able to immediately continue its critical operations in the financial system without there being any systemic spill-over effects or problems. But all of that depends on a number of pre-conditions and assumptions about matters such as: the size and locus of the losses, the amount and terms of capital debt and where it is held, the availability of short term (liquidity) debt to manage the daily flow of transactions, and agreement on priorities and the dependability of cooperation among regulators in different countries where the firm and its subsidiaries operate, to name some of the most salient.

Not all of these matters are, or can be, determined by Dodd-Frank or in the Bankruptcy Code, but they can be affected for better or worse by regulations yet to be issued. This paper represents an attempt, for readers not unfamiliar with these topics, to highlight some of the problems and to explain why we recommend some measures that would facilitate successful resolutions.

II. Capital Debt

A. Definition

1) In FDIC's proposal, the debt that is not to be transferred (and thus fully paid) is not precisely specified. It is suggested that accounts payable to "essential" vendors would go over, and "likely" secured claims as well (at least as deemed necessary to avoid systemic risk), but not (all?) unsecured debt for borrowed funds. Unless ultimately clarified, this would leave a high degree of uncertainty for creditors of financial institutions, with corresponding costs.

There are some alternatives that have been offered—for example, that capital debt be limited to unsecured debt for borrowed money with an original maturity of over a year. That would imply a regulatory requirement that a SIFI hold at all times a prescribed amount of such debt – in an amount yet to be determined but perhaps even equal to its applicable regulatory capital requirement.

Would that amount be sufficient to cover all losses the firm might encounter, and enough more to leave it still well capitalized? In effect, the debt requirement becomes a new level of required total capital (beyond equity), and severely impaired regulatory capital could trigger resolution (but not necessarily continuance of operations, unless a grace period for restoration of the mandated capital debt was included). Until such requirements are actually specified and instituted, however, the question cannot really be analyzed.

2) A capital debt requirement would function the same way in Ch. 14, but without discretionary uncertainty. Section 1405 provides for the transfer to a bridge company of all the debtor's assets (which should include NOL carry-forwards) and liabilities (*except* for the capital debt and any subordinated debt). And capital debt is given a clear definition: all unsecured debt for borrowed money with an original maturity of one year or more. To be effective, minimum capital debt requirements (outside of bankruptcy law) would again need to be specified.

Whether it will be defined in that way in the forthcoming regulations, as we would recommend, remains to be seen. The definition would mean that short term unsecured creditors (such as commercial paper) are fully protected, and the rationale is that they play an important role in the payments system and as a source of liquidity (a subject discussed below). But they are also sophisticated and well-informed institutions, and in a position to quickly exert effective market discipline on a financial company's decisions to take on risk. It can be argued, therefore, that the exclusion from transfer (and full protection) should on balance apply to them as well. At this time it is another open issue.

3) What is the locus of the capital debt? The question is central to whether subsidiaries necessarily continue in operation. The FDIC proposal seems to contemplate that it is issued by parent holding company (or, in the case of a foreign parent, its intermediate US holding company), and thus removed from the capital structure of the new bridge company, which is thereby rendered solvent.

But what if the large losses precipitating failure of the US parent were incurred at a foreign subsidiary? There have been suggestions that the new bridge parent would be so strongly capitalized that it *could* recapitalize the failed sub – but who makes that decision, and on what basis? The supervisory authorities of foreign host countries have understandably shown a keen interest in the answer, and it is high on the agenda of various international talks.

A core attribute of separate legal entities is their separation of risk and liability. Under corporate law, the decision to pay off a subsidiary's creditors would be a business judgment for the parent board, taking into account financial cost, reputational cost, future prospects, and the like – and the decision could be negative. In a Title II proceeding, perhaps the FDIC, through its control of the board, would override (or dictate) that decision – and perhaps not.

The clearest legal ways to try to ensure payment of subsidiary creditors would be (1) to require parents to guarantee all sub debt (which amounts to consolidation), or (2) to have separate and hopefully adequate capital debt (presumably to the parent) requirements for all subsidiaries. Again, at time of writing it is an issue still unresolved, and perhaps better left to the firm's business judgment in the specific circumstances.

B. Coverage

1) The FDIC's SPOE bridge proposal applies only to domestic SIFIs (currently, 8 bank and 3 non-bank holding companies are so designated, although more may be added, even at the last minute), not to all the (potentially over 1000) "financial companies" covered by Dodd-Frank's Title I definition (at least 85% of assets or revenues from financial activities) or the next 95 bank holding companies with more than $10 billion in consolidated assets. Will the capital debt requirement be limited to designated SIFIs, or will it be extended to bank holding companies with more than (say) $50 billion in consolidated assets? That will determine how failure resolutions may be conducted under the Bankruptcy Code, as they must be for all but that small number of SIFIs that Title II covers.

2) Resolution under Chapter 14 (in its original version) can take the form essentially of a familiar Chapter 11 reorganization of the debtor firm (often at an operating entity level) or, where systemic risk considerations dictate no interruptions of business operations, it may (in its current revised version) take the form of transfers to a new bridge company (usually at the holding company level—thus leaving operating subsidiaries out of bankruptcy). Therefore, any capital debt requirement should apply explicitly to both situations – being left behind in a transfer case, or being converted to equity (such as a new class of preferred stock) in a reorganization case. The latter form, under the label of "bail-in" or "convertible" debt, seems to be becoming the method in favor in Europe. Chapter 14 would accommodate both options.

III. Liquidity

A. Significance

Banks perform vital roles in intermediating transactions between investors and businesses, buying and selling risk, and operating the payments system. They have to manage fluctuating flows of cash in and out, by short term borrowing and lending to each other and with financial firms. Bank failures often occur when creditors and counterparties have lost confidence and demand full (or more) and readily marketable collateral before supplying any funds. Even if over time a bank's assets could cover its liabilities, it has to be able to have sufficient immediate cash, or it cannot continue in business. For that reason, the Basel Committee and others have adopted and are in the process of implementing regulations governing "buffer" liquidity ratios that global systemically important banks (G-SIBs) would be required to maintain.

B. FDIC's SPOE proposal

It is intended that the new bridge company will be so well-capitalized, in the sense of book net worth, that it will have no difficulty in raising any needed funds from other institutions in the private market. But this is an institution that despite all regulations has just failed, and there may be limited cash on hand and substantial uncertainty (or controversy) about the value of its loans and investments. So if liquidity is not forthcoming in the private market, Dodd-Frank creates an Orderly Liquidation Fund (OLF) in the Treasury, which the FDIC as receiver can tap for loans or guarantees (to be repaid later by the bridge company or industry assessments) to assure the necessary cash. Critics fear that this will open a door for creditor bailouts or ultimate taxpayer costs.

C. Chapter 14

As with the FDIC proposal, under favorable conditions there may be no problem. But what if cash is low or collateral value uncertain, and there is a problem? It depends on which type of resolution is being pursued.

In a standard Chapter 11 reorganization, the debtor firm can typically obtain new ("debtor in possession" or DIP) financing because the lenders are given top ("administrative expense") priority in payment. In a bridge resolution, the new company is not in bankruptcy, so the existing Code priority provision would not apply. Therefore, Chapter 14 provides that new lenders to the bridge would receive similar priority if it were to fail within six months after the transfer.

In addition, it would be possible to give the new financial institution the same access to the Fed's discount window as its competitors would have, and in a time of general financial crisis it could be eligible to participate in programs established by the Fed under its §13(3) authority. If all that is not enough assurance of liquidity in case of need, skeptics might support allowing (as a last resort) the supervisor of the failed institution (as either the petitioner or a party in the bankruptcy proceeding) the same access to the OLF as under Title II.

IV. Due Process

A. Title II of Dodd-Frank Act

Section 202 of the Act prescribes a procedure to take over a SIFI that the Secretary of the Treasury has determined to be in danger of default, with FDIC as receiver instructed to immediately proceed to liquidate it. The Secretary's determination, if not consented to, is filed in a petition in the DC federal district court to appoint the receiver. Unless in 24 hours the district court judge has held a hearing, received and considered any conflicting evidence on the financial condition of a huge firm, and either (1) made findings of fact and law, concluded that the determination was arbitrary and capricious, and written an opinion giving all the reasons for that conclusion, or (2) granted the petition, then (3) the petition is deemed granted by operation of law.

Obviously, the pre-seizure judicial hearing is an empty formality, and it is quite possible that most judges would prefer to simply let the 24 hour clock run out. The company can appeal (although the record may be rather one-sided), but the court cannot stay the receiver's actions to dismantle the firm (or transfer operations to a bridge), pending appeal. So in the unlikely event that there is a successful appeal, an adequate remedy would be hard to design. The whole procedure invites constitutional due process challenge.

B. Chapter 14

Most non-SIFIs are likely to go through a straight-forward, one-firm reorganization, which entails claimant participation, public hearings, and well-defined rules, all presided over by an Article III (life tenure) judge. Criteria of due process and fundamental fairness are observed in a procedure developed over many years.

In the case of a SIFI going through the bridge route in order to promote continuity of essential services, the transfer motion is subjected to a somewhat more substantial hearing, in terms of both time and content. If the Fed is filing the motion, it has to certify (and make a statement of the reasons) that it has found (1) that a default by the firm would have serious adverse effects on US financial stability, and (2) that the new bridge company can meet the transferred obligations. If the Treasury Secretary asserts authority to put the proceeding into Title II, he would be required in addition to certify and make a statement of the reasons for having found that those adverse effects could not adequately be addressed under the Bankruptcy Code.

Nonetheless, the court would not be in a position, given the time constraints, to conduct a genuine adversary hearing and make an independent judgment. To overcome the serious due process shortcomings attached to the Title II section, Chapter 14 provides for an ex-post remedy under §106 of the Bankruptcy Code: an explicit damage cause of action against the United States. And rather than the very narrow judicial oversight possible under the "arbitrary and capricious" standard of review (such as the APA provides where there has already been a full administrative hearing), there is the standard of whether the relevant certifications are supported by "substantial evidence on the record as a whole."

V. International Coordination

Most SIFIs are global firms (G-SIFIs), with branches and subsidiaries in many countries. To resolve them efficiently and equitably would require cooperation and similar approaches by regulators in both home and host nations. Optimally, that would mean a multilateral treaty among all the countries affected—a daunting undertaking that would take years at best. The Financial Stability Board, in its Key Attributes paper, has outlined a framework for procedures and cooperation agreements among resolution authorities, but they are in general not legally binding or enforceable in judicial proceedings.

To make a modest legal beginning, a binding international agreement just between the US and UK would cover a large fraction of total transactions. The FDIC and Bank of England in a 2010 Memorandum of Understanding agreed to consult, cooperate and exchange information relevant to the condition and possible resolution of financial service firms with cross-border operations. It specifically, however, does not create any legally binding obligations.

A treaty, or binding executive agreement, could go further to determine how a resolution would proceed between the US and UK as home or host countries. To get that process underway, the Resolution Project would provide in Chapter 15 (added to the Code in 2005 to deal with cross-border insolvencies) new substantive provisions dealing with US enforcement of foreign home country stay orders and barring domestic ring-fencing actions against local assets, provided that the home country has adopted similar provisions for US proceedings. Our unilateral action, conditioned on such a basis of reciprocal treatment, would be desirable on its merits and might contribute to much broader multilateral efforts.

VI. The Problem of Systemic Risk

The reason for all the special concern with the failure of a systemically important financial institution is the fear that it may lead to a collapse of the financial system which transfers savings, loans and payments throughout the economy and is essential to its functioning. There are several different ways in which this might occur.

A. Knock-on chains

In this scenario, a giant and "interconnected" financial firm incurs very large losses (from poor investment decisions or fraud or bad luck) and defaults on its obligations, inflicting immediate losses on its counterparties, causing some of them to fail in turn. As a wave of failures spreads, the whole financial system contracts and so does the real economy.

Thus some attribute the panic of 2008 to losses caused by the failure of Lehman Brothers, and that belief powered much of the Dodd-Frank Act and in particular its Title II mechanism for taking over a SIFI and putting it into a government receivership. It is not clear how a government receivership per se (without any bailout) is supposed to prevent spillover losses, other than that they will be more "orderly" than was the case for Lehman. (The fact that Lehman had done absolutely zero planning for a bankruptcy reorganization makes that a low standard, and the Dodd-Frank §165 requirement for firms to have resolution plans can't help but be an improvement, however limited their usefulness in an actual case may turn out to be.)

In any event, Title II and FDIC's SPOE proposal are all focused on a new procedure for handling an impending failure of an individual SIFI, and accordingly so is the Chapter 14 proposal for bankruptcy reform.

B. Common shocks

In this scenario, a very widely-held class of assets or investments turns out to perform unexpectedly poorly, and becomes increasingly hard to value and trade. The example in 2007 and 2008 was asset-backed securities, and in particular over $2 trillion in residential (and commercial) real estate mortgage-backed securities that had been promoted as a matter of government policy and were held by financial institutions and investors around the world.

Until December 2006 subprime mortgages had been sustained by ever increasing house prices, but then that bubble burst and delinquencies and foreclosures started rising, adversely affecting the tranches of complex securitizations. Rating agencies downgraded hundreds of subprime mortgage bonds; financial firms became concerned about the solvency of counterparties with large but opaque holdings, and they responded by reducing or cutting off extensions of credit.

It came to a head in early September 2008: Fannie and Freddie were put into conservatorships, Merrill Lynch was forced into acquisition by Bank of America, Lehman filed for bankruptcy, and the Fed made an $85 billion loan to AIG—all in a 10 day period. With such unmistakable signals of the scope and severity of the problem, the flow of funds through the financial system dried up, and business firms in general were being forced to contract operations. A severe recession in the real economy was underway.

This kind of common problem affecting a great many firms is not directly prevented or cured by the early resolution of an individual SIFI. It should be understood to be beyond the reach of Title II or Chapter 14, though they remain relevant to the extent the two categories of systemic risk overlap and some SIFIs have to be resolved.