

Is the Bankruptcy Code an Adequate Mechanism for Resolving the Distress of Systemically Important Institutions?

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First Draft: January 21, 2009
This Draft: December 30, 2009

Forthcoming in *Temple Law Review*

Abstract

Lehman's bankruptcy has triggered calls for new approaches to rescuing systemically important institutions. This essay assesses and confirms the need for a new approach. It identifies the inadequacies of the Bankruptcy Code and advocates an approach modeled on the current regime governing commercial banks. That regime includes both close monitoring when a bank is healthy and aggressive intervention when it is distressed. The two tasks—monitoring and intervention—are closely tied, ensuring that intervention occurs only when there is a well-established need for it. The same approach should be applied to all systemically important institutions. President Obama and the Congress are now considering such an approach, though it is unclear whether it will establish a sufficiently close connection between the power to intervene and the duty to monitor. The proposed legislation is unwise if it gives the government power to seize an institution regardless of whether it was previously subject to monitoring and other regulations.

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I. Introduction

The President² and members of Congress³ are considering proposals that would give the government broad authority to rescue financial institutions whose failure would threaten market stability. These systemically important institutions include bank and insurance holding companies, investment banks, and other “large, highly leveraged, and interconnected” entities that are not currently subject to federal resolution authority.⁴ Interest in these proposals stems from the credit crisis, particularly the bankruptcy of Lehman Brothers. That bankruptcy, according to some observers, caused massive destabilization in credit markets for two reasons.⁵ First, market participants were surprised that the government would permit a massive market player to undergo a costly Chapter 11 proceeding. Very different policy had been applied to other systemically important institutions such as Bear Stearns, Fannie Mae, and Freddie Mac. Second, the bankruptcy filing triggered fire sales of Lehman assets. Fire sales were harmful to other, non-distressed institutions that held similar assets, which suddenly plummeted in value. They were also harmful to any institution holding Lehman’s commercial paper, which functioned as a store of value for entities such as the Primary Reserve Fund.⁶ Fire sales destroyed Lehman’s ability to honor these claims.

Lehman’s experience and the various bailouts of AIG, Bear Stearns, and other distressed institutions have produced two kinds of policy proposals. One calls for wholesale reform, including creation of a systemic risk regulator with authority to seize and stabilize systemically important institutions. Another is more

² Department of the Treasury, “Financial Regulatory Reform: A New Foundation” (June 17, 2009), available at <http://www.ustreas.gov/>. See also Department of the Treasury, “Title XII-Enhanced Resolution Authority,” proposed legislation available at http://www.financialstability.gov/docs/regulatoryreform/title-XII_resolution-authority_072309.pdf.

³ Senate hearings were held on these policies on May 6, 2009. See, e.g., Statement of Sheila C. Bair, Chairman, Federal Deposit Corporation on “Regulating and Resolving Institutions Considered ‘Too Big to Fail,’” before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate (May 6, 2009). The House Republicans have issued a statement opposing policies favored by the Treasury Department and Ms. Bair. “Financial Services Committee Republican Plan for Reforming the Financial Regulatory System,” available at <http://republicans.financialservices.house.gov/images/stories/fscrepregreformplan.pdf>. They recently proposed legislation that would rely heavily on the bankruptcy system to handle distressed, systemically important institutions. See “A Bill To Reform the Financial Regulatory System of the United States, and For Other Purposes,” available at <http://republicans.financialservices.house.gov/images/stories/consumer%20protection%20and%20regulatory%20enhancement%20act.pdf>. The bill is summarized by a companion document, “Section by Section of H.R. XXXX, the Consumer Protection and Regulatory Enhancement Act of 2009 (July 20, 2009), available at <http://republicans.financialservices.house.gov/images/stories/section%20by%20section%20of%20republican%20plan.pdf>.

⁴ Treasury, “Financial Regulatory Reform,” *supra* note 2, at 23.

⁵ Statement of Sheila Bair, *supra* note 3, at 12-13.

⁶ See Christopher Condon, “Reserve Primary Fund Falls Below \$1 a Share,” Bloomberg (Sept. 16, 2008), available at <http://www.bloomberg.com/apps/news?pid=20601087&sid=a5O2y1go1GRU>.

modest and calls for targeted amendments to the Bankruptcy Code and greater government monitoring of market risks. This approach would retain bankruptcy as the principal mechanism for resolving distress at non-bank institutions, systemically important or not.

Put differently, current debates hinge on one question: Is the Bankruptcy Code an adequate mechanism for resolving the distress of systemically important institutions? One view says “no,” and advances wholesale reform. Another view says “yes, with some adjustments.” This paper sets out and evaluates these competing views on the limits of bankruptcy law. A roadmap for what lies ahead: Section II discusses the current structure of the Bankruptcy Code and its limited ability to protect markets from failing, systemically important institutions. Section III outlines policy responses. In Section IV, I conclude that the Code is indeed inadequate for dealing with failures of systemically important institutions. A systemic risk regulator is needed because a judicially-administered process cannot act with sufficient speed and expertise in response to rapidly changing economic conditions.

II. The Current Bankruptcy-Based Approach

The Bankruptcy Code has, since enactment, taken steps to mitigate systemic risk.⁷ This is the risk that one debtor’s failure will infect other financial market participants, causing a chain-reaction of insolvencies that destabilize markets. The Code attempts to mitigate this risk through “safe harbors” for swaps, repos, and other financial contracts: When a debtor enters bankruptcy, non-debtor counterparties can terminate these contracts, exercise netting and setoff rights, and seize margin to the extent of the debtor’s net obligations to the counterparties.⁸ These safe harbors allow counterparties to extricate themselves quickly from contracts with a failing debtor and thereby minimize their exposure to its distress.⁹

These provisions, however, are largely prophylactic: they aim to reduce the risk of systemic failure, not manage a clear and present danger of a market meltdown. That danger exists when a major institution collapses. With or without the Code’s safe harbors, the institution’s failure will destabilize markets. Its failure infects financial markets through three channels. First, and most obviously, the institution will suspend payments on commercial paper and other debt instruments. This can have profound effects on financial markets because, when an institution is very large, its debt instruments are widely held. This was true of Lehman Brothers. After its failure, we saw important funds “break the buck,” producing losses for investors or fund sponsors.¹⁰ Additionally, major

⁷ See generally Edward R. Morrison & Joerg Riegel, *Financial Contracts and the New Bankruptcy Code: Insulating Markets from Bankrupt Debtors and Bankruptcy Judges*, 13 Am. Bankr. Inst. L. Rev. 641 (2005); Franklin R. Edwards & Edward R. Morrison, *Derivatives and the Bankruptcy Code: Why the Special Treatment*, 22 Yale J. Reg. 91 (2005).

⁸ Morrison & Riegel, *supra* note 7, at 644-52.

⁹ *Id.*, at 642; Edwards & Morrison, *supra* note 7, at 97-98.

¹⁰ These funds include Primary Reserve Fund (the oldest money market fund) and BNY Institutional Cash Reserves (a securities lending fund). See Christopher Condon, “Reserve Primary Money Fund Falls Below \$1 a Share,” Bloomberg (Sept. 16, 2008);

market players may have sold credit default swaps (“CDS”) to holders of a failing institution’s debt.¹¹ As the institution fails, payments under these CDS could destabilize the protection sellers, assuming they have not fully hedged their positions.

Second, the Code’s safe harbors permit premature liquidation of failing institutions.¹² Non-debtor counterparties rush to terminate existing contracts, dismembering the failing institution and preventing an orderly wind-down that might yield greater overall value to counterparties. As these counterparties suffer significant losses, they too may encounter financial distress. When Lehman Brothers entered bankruptcy in September 2008, it was party to about 1.5 million transactions with over 8,000 counterparties. Within two weeks, eighty percent of those transactions had been terminated, netted, and liquidated.¹³ Significant value was lost, some critics allege,¹⁴ because no party—Lehman, a trustee, or a judge—could implement an orderly wind-down process.

Third, and perhaps most important, a rushed liquidation of a failed institution will be accompanied by large-scale efforts to sell off margin and re hedge positions by non-debtor counterparties.¹⁵ A counterparty will enter financial contracts with a financial institution in order to hedge other risky investments on the counterparty’s balance sheet. The financial contract will often be collateralized: the parties will periodically pledge liquid securities (“margin”) to collateralize their expected obligations to each other. When an institution fails, counterparties will net their outstanding contracts with the institution and seize margin to the extent that the institution is a net obligor. As margin is sold en masse, the price of the underlying collateral falls. Because the underlying collateral is typically composed of liquid securities that function as collateral for many market players, these actors will see their assets decline in value. Additionally, as counterparties attempt to re hedge simultaneously, the price of hedging will rise precipitously, creating additional losses for the counterparties. Fear of these effects prompted the Federal Reserve to orchestrate a bailout of Long Term Capital Management (LTCM) in Fall 1998.¹⁶ Some critics believe that

Matthew Keenan & Christopher Condon, “BNY Mellon, Reserve Primary Rattle Fund Investors,” Bloomberg (Sept. 18, 2008).

¹¹ See Serena Ng, Emily Barrett & Jacob Bunge, “Lehman Swap Payments Look Bigger than Expected,” Wall St. J. (Oct. 11, 2008).

¹² Edwards & Morrison, *supra* note 7, at 94, 101.

¹³ Harvey Miller, Discussion at Sixth Annual Deals Roundtable, Columbia Law School (Nov. 24, 2008).

¹⁴ Jeffrey McCracken, “Lehman’s Chaotic Bankruptcy Filing Destroyed Billions in Value,” Wall St. J. (Dec. 29, 2008) (“As much as \$75 billion of Lehman Brothers Holdings Inc. value was destroyed by the unplanned and chaotic form of the firm’s bankruptcy filing in September, according to an internal analysis by the company’s restructuring advisers.”). Also, the close-outs occurred in a market that was weakened as a result of Lehman’s failure and had huge price swings in CDS for names like GMAC, AIG, Morgan Stanley, and Goldman Sachs. See, e.g., “Morgan Stanley’s CDS lead credit spreads wider,” Reuters (Oct. 10, 2008).

¹⁵ This is discussed in Edwards & Morrison, *supra* note 7, at 99-106.

¹⁶ *Id.*, at 100.

Lehman's bankruptcy similarly contributed to a subsequent freezing of credit markets.¹⁷

The failure of a systemically important institution will, therefore, destabilize markets regardless of whether the Bankruptcy Code offers safe harbors for financial contracts. Indeed, these safe harbors may exacerbate the instability by permitting a counterparty "run" on the failing institution. The government's response, thus far, has been to bail out institutions before they fail (AIG, Bear Stearns) or perform triage afterward (Lehman).¹⁸ The government's ability to respond has, according to some officials, been hamstrung by legal constraints. Indeed, one view of Lehman's bankruptcy is that the government was powerless to prevent it. The Federal Reserve can make loans, as it did to Bear Stearns and AIG, if the borrower posts sufficient collateral.¹⁹ Lehman, however, was highly insolvent and lacked adequate collateral, according to government officials,²⁰ which rendered it ineligible for assistance. This account has been questioned,²¹ but has helped fuel proposals that would give the government broad authority to address the limits of bankruptcy law.

III. Non-Bankruptcy Options

Two options are now being considered by Congress and regulators: enact insolvency legislation for non-bank institutions or modify Chapter 11 to accommodate these institutions. The former is favored by President Obama,²² the latter by Republicans in the House of Representatives.²³

A. Insolvency Legislation for Non-Banks

Under this approach, the federal government would have power to seize systemically important institutions and dictate their future—reorganization, sale,

¹⁷ Carrick Mollenkamp, Mark Whitehouse, Jon Hilsenrath & Ianthe Jeanne Dugan, "Lehman's Demise Triggered Cash Crunch Around Globe—Decision to Let Firm Fail Marked a Turning Point in Crisis," *Wall St. J.* (Sept. 29, 2008).

¹⁸ See, e.g., Ben S. Bernanke, "Federal Reserve Policies in the Financial Crisis" (Dec. 1, 2008), available at <http://www.federalreserve.gov/newsevents/speech/bernanke20081201a.htm>; Michael D. Bordo, *An Historical Perspective on the Crisis of 2007-08*, NBER Working Paper No. 14569 (Dec. 2008), available at <http://www.nber.org/papers/w14569.pdf>.

¹⁹ See generally David H. Small & James A. Clouse, *The Limits the Federal Reserve Act Places on the Monetary Policy Actions of the Federal Reserve*, 19 *Ann. Rev. Banking L.* 553, 560-565 (2000).

²⁰ See, e.g., Joe Nocera & Edmund L. Andrews, "Struggling to Keep Up as the Crisis Raced On," *N.Y. Times* (Oct. 22, 2008); Ben S. Bernanke, *Federal Reserve Policies in the Financial Crisis*, speech (Dec. 1, 2008) (available at <http://www.federalreserve.gov/newsevents/speech/bernanke20081201a.htm>); Timothy F. Geithner, *Finance Committee Questions for the Record*, U.S. Senate Committee on Finance, at 82-83 (Jan. 21, 2009); Michael McKee & Vivien Lou Chen, "Yellen Signals Letting Lehman Collapse was a Mistake," *Bloomberg* (Apr. 17, 2009), available at <http://www.bloomberg.com/apps/news?pid=20601087&sid=aycrixRelVc0>.

²¹ See, e.g., Editorial, "Questions for Mr. Geithner," *N.Y. Times* A34 (Dec. 15, 2008).

²² Department of the Treasury, "Financial Regulatory Reform: A New Foundation" *supra* note 2, at 76-79.

²³ See references cited in note 3, *supra*.

or liquidation—in order to minimize effects on financial markets and costs to taxpayers.²⁴ These institutions would be barred from filing a bankruptcy petition, or the government might be given the right to intervene in a bankruptcy case, stripping court jurisdiction.²⁵

To be effective, this approach to systemic risk *should* have three elements: (i) a clear definition of “systemically important institutions,” (ii) transparent procedures for rescuing these institutions, and (iii) a broad regulatory framework that guides the relevant federal agency and the financial institutions *before* the institutions hemorrhage.

1. Definitions

A “systemically important institution” would likely be one that (i) falls within a category of institutions that have an important presence in financial markets and (ii) whose failure would threaten market stability. Category (i) almost surely includes any institution subject to prudential regulation, including investment banks, money market funds, and mutual funds. Although hedge funds currently sit outside the scope of most regulations—a situation that will likely change in the near future²⁶—the LTCM bailout suggests that they too form a class of institutions that is systemically important.

An institution falls within category (ii) if it is sufficiently large, leveraged, complex, and capitalized by illiquid assets that its failure would destabilize markets.²⁷ Even if an institution does not achieve a massive scale, it can still be systemically important if it is behaving similarly to a large number of institutions that are “systemic as part of a herd.”²⁸

Legislation could establish the types of institutions within category (i). Category (ii) requires judgment from a regulator, who must decide whether an institution’s scale or comovement with other firms renders it systemically important. That judgment could be given to the relevant regulator for the industry, or it could be given to a single decision-maker such as the Federal Reserve. If discretion is given to industry regulators, the benefits are industry-

²⁴ See, e.g., Department of the Treasury, “Financial Regulatory Reform: A New Foundation,” *supra* note 2, at 76-79.

²⁵ A similar right of intervention is possessed by the Securities Investor Protection Corporation (SIPC) in stockbroker liquidations under Chapter 7. 11 U.S.C. § 742. See generally Daniel J. Morse, *When a Securities Brokerage Goes Broke*, 25 Am. Bankr. Inst. J. 34 (Feb. 2006).

²⁶ See, e.g., Treasury, “Financial Regulatory Reform,” *supra* note 2, at 37-38.

²⁷ Along these lines, the Treasury has proposed three factors that may help identify systemically important institutions: “the impact the firm’s failure would have on the financial system and the economy; the firm’s combination of size, leverage (including off-balance sheet exposures), and degree of reliance on short-term funding; and the firm’s criticality as a source of credit for households, businesses, and state and local governments and as a source of liquidity for the financial system.” Treasury, “Financial Regulatory Reform,” *supra* note 2, at 23.

²⁸ Markus Brunnermeier, Andrew Crockett, Charles Goodhart, Avinash D. Persaud & Hun Shin, *THE FUNDAMENTAL PRINCIPLES OF FINANCIAL REGULATION* 25-26 (Geneva Reports on the World Economy 2009)

specific expertise and regulatory competition; the costs are regulatory capture and politically-charged exercise of discretion. If discretion is given to a single regulator, the benefits are greater (but still incomplete) political insulation and centralized decision-making; the cost is a lack of industry-specific expertise.²⁹ These are theoretical cost-benefit tradeoffs; in practice, the comparison is very muddy, leaving no obvious basis for preferring a single regulator over multiple regulators.

2. Rescue Procedures

The relevant agency must be given fairly broad power to wind down, reorganize, or sell off a distressed institution. Commercial banking law provides a useful template. The FDIC has authority to seize control of a commercial bank that is approaching (or has entered) insolvency³⁰ or has engaged in conduct signaling fraud or unsound risk management practices.³¹ Once it intervenes, the FDIC has broad power to succeed to the institution, operate it, revoke its charter, remove management, and choose whether to liquidate the bank or reorganize it.³² The FDIC's decisions are not subject to court oversight or notice-and-hearing requirements.³³ The FDIC's mandate is to resolve bank insolvencies in ways that achieve the "lowest cost" to federal deposit insurance funds.³⁴

Five broad strategies are available:

(1) *Purchase and Assumption*. The FDIC may transfer the failing bank to a solvent institution.³⁵ This is a rapidly executed strategy: a bank may be seized on Friday and its balance sheet transferred to a solvent bank before the opening of business on Monday.³⁶ To make the transaction attractive to the acquiring bank, the FDIC may agree to share losses from risky assets or to compensate the acquirer if transferred liabilities exceed the value of assets.³⁷ Of course, this payment often functions as full insurance for creditors of the failed bank; they

²⁹ On the costs of centralized decision-making, see Peter Wallison, Testimony Before the House Financial Services Committee 5-9 (Mar. 17, 2009).

³⁰ Intervention is necessary, for example, when a bank is "critically undercapitalized," defined as equity capital representing two percent or less of total assets. 12 U.S.C. § 1831o(c)(3). If an institution becomes critically undercapitalized, the FDIC is required to restrict its activities in certain statutorily prescribed ways. § 1831o(i). The FDIC may appoint a receiver at any time, but it must appoint a receiver within 90 days. This rule prevents federal regulators from gambling on bank resurrection. §1831o(h).

³¹ § 1821(c)(5).

³² See generally Jonathan R. Macey, Geoffrey P. Miller, & Richard S. Carnell, *BANKING LAW AND REGULATION* ch. 8 (2d ed. 2001).

³³ Judicial review is available for the decision to impose a receivership or conservatorship, but not for subsequent decisions by the federal agency. See, e.g., *James Madison Ltd. by Hecht v. Ludwig*, 82 F.3d 1085 (DC Cir. 1996).

³⁴ § 1823(c)(4).

³⁵ §§ 1821(d)(2)(G); 1823(c)(2)(A)(iii).

³⁶ For a useful, oft-quoted, but somewhat outdated summary of the process, see *Gunter v. Hutcheson*, 674 F.2d 862, 865-66 (11th Cir. 1982).

³⁷ 12 U.S.C. 1823(c)(2), (c)(4); see also FDIC, *RESOLUTIONS HANDBOOK* 29-35 (2003), available at <http://www.fdic.gov/bank/historical/reshandbook/ch3pas.pdf>.

may suffer no haircut as a result of the bank's failure. Critics therefore argue that "purchase and assumption" transactions can generate excessive cost (borne by the federal deposit insurance funds) as well as moral hazard (because creditors are insensitive to a bank's riskiness).³⁸

Strategies analogous to "purchase and assumption" were applied to Bear Stearns and WaMu, both sold to JPMorgan.³⁹ In the first case, however, the sale was orchestrated by the Federal Reserve, not the FDIC.

(2) *Bridge Banks and New Banks.* The FDIC may capitalize a new bank that assumes the balance sheet of a failed institution.⁴⁰ The new bank may be a temporary measure (a "bridge bank") that exists only while the FDIC identifies the best resolution of the failed bank's operations, a process that can take up to two years. Or the new bank may be a permanent institution—a new bank—whose stock the FDIC will eventually sell to investors (the stock can be sold to private investors, such as private equity firms).⁴¹ In either case, the FDIC can transfer all or part of a failed institution's balance sheet.⁴² Creditors cannot object, but are entitled to recoveries at least as large as they would receive in a liquidation.⁴³ This year, the FDIC chartered a bridge banks to salvage the operations Silverton Bank.⁴⁴

(3) *Receivership and Liquidation.* The FDIC can assume the role of receiver, marshal and liquidates bank assets, pay depositors or transfers their accounts to another institution, and then distribute the remaining value in the estate to other claimants.⁴⁵ The procedure is typically used when no healthy institution is willing to acquire the failing bank's balance sheet.⁴⁶ Critics argue that a version of

³⁸ These critiques are summarized in *id.*, at 20-21.

³⁹ The WaMu purchase and assumption agreement is available online at http://www.fdic.gov/about/freedom/Washington_Mutual_P_and_A.pdf. See generally Robin Sidel, Dennis K. Berman, & Kate Kelly, "J.P. Morgan Buys Bear in Fire Sale, As Fed Widens Credit to Avert Crisis," *Wall St. J.* (Mar. 17, 2008); Andrew Ross Sorkin & Landon Thomas Jr., "JPMorgan Acts to Buy Ailing Bear Stearns at Huge Discount," *N.Y. Times* (Mar. 16, 2008); Robin Sidel, David Enrich & Dan Fitzpatrick, "WaMu is Seized, Sold Off to J.P. Morgan, in Largest Failure in U.S. Banking History," *Wall St. J.* A1 (Sept. 26, 2008).

⁴⁰ 12 U.S.C. §§ 1821(m), (n). See generally FDIC, RESOLUTIONS HANDBOOK, *supra* note 37, at 35-40.

⁴¹ If an IPO of the bank's stock fails, the FDIC must arrange a purchase and assumption transaction or liquidate the new bank within two to five years of its origination. New banks must be wound up within two years, but the FDIC has discretion to extend the life of a bridge bank for three additional one-year periods. § 1821(n)(9).

⁴² FDIC, RESOLUTIONS HANDBOOK, *supra* note 37, at 37.

⁴³ §§ 1821(d)(2)(G)(i)(II), (i)(2).

⁴⁴ See "FDIC Creates Bridge Bank to Take Over Operations of Silverton Bank, National Association, Atlanta, Georgia," press release (May 1, 2009), available at <http://www.fdic.gov/news/news/press/2009/pr09061.html>,

⁴⁵ See generally FDIC, RESOLUTIONS HANDBOOK, *supra* note 37, at 41-46.

⁴⁶ *Id.*, at 41.

Receivership and Liquidation should have been applied to Lehman, to ensure an orderly wind-down.⁴⁷

(4) *Conservatorship and Government Assistance.* The federal government has authority to appoint itself as a conservator of a bank—without revoking its charter—and operate it with a view toward rehabilitation.⁴⁸ Until recently, the strategy was rarely employed by the FDIC.⁴⁹ In mid 2008, the Corporation was designated conservator for IndyMac, a federal savings bank.⁵⁰ About two months later, another federal agency—the Federal Housing Finance Agency (FHFA)—became conservator for the government-sponsored entities (GSEs) Fannie Mae and Freddie Mac.⁵¹ This conservatorship was the product of The Housing and Economic Recovery Act of 2008,⁵² which created the FHFA to regulate the GSEs.⁵³ The statute grants the FHFA authority to appoint a conservator after determining that a GSE is critically undercapitalized.⁵⁴ Pursuant to this authority, the FHFA appointed itself conservator of Fannie Mae and Freddie Mac on September 7, 2008. Having arrogated to itself all powers possessed by shareholders, directors, and officers, it implemented a plan under which the Treasury Department will provide up to \$100 billion in financing in exchange for warrants to purchase up to 79.9% of the GSE's common stock (at a price of \$0.00001 per share).⁵⁵ The Housing and Economic Recovery Act places no limit on the length of the conservatorship.⁵⁶

(5) *Open Bank Assistance.* The FDIC can inject liquidity into troubled banks if the transfer will prevent a likely receivership or conservatorship, the transfer will

⁴⁷ The “disorderly failure” of Lehman was, in part, the motivation for President Obama’s proposal for “the creation of a resolution regime to allow for the orderly resolution of failing” institutions “in situations where the stability of the financial system is at risk.” Department of the Treasury, Financial Regulatory Reform, *supra* note 2, at 76. See also Statement of Sheila Bair, *supra*; Nouriel Roubini, “We Need a New Insolvency Regime for Banks,” *Forbes* (Mar. 26, 2009), available at <http://www.forbes.com/2009/03/25/banks-nationalization-fdic-bankruptcy-opinions-columnists-insolvency-roubini.html>.

⁴⁸ 12 U.S.C. § 1821(d)(2)(D).

⁴⁹ FDIC, RESOLUTIONS HANDBOOK, *supra* note 37, at 69 n 2 (“[t]he FDIC has never been appointment conservator by the OCC or a state regulatory authority and may decline the appointment if tendered; the FDIC was appointed conservator once by the Office of Thrift Supervision [in the case of IndyMac]”).

⁵⁰ Information about the conservatorship is available on the FDIC website at <http://www.fdic.gov/bank/individual/failed/IndyMac.html>. See also Damian Paletta, Lingling Wei & Ruth Simon, “IndyMac Reopens, Halts Foreclosures on Its Loans,” *Wall St. J.* C1 (July 15, 2008).

⁵¹ See generally, Mark Jickling, “Fannie Mae and Freddie Mac in Conservatorship,” CRS Report for Congress (Sept. 15, 2008), available at <http://fpc.state.gov/documents/organization/110097.pdf>.

⁵² Pub. L. 110-289, 122 Stat. 2654, codified at 12 U.S.C. §§ 4501, et seq.

⁵³ 12 U.S.C. § 4511.

⁵⁴ § 4617.

⁵⁵ Jickling, *supra*.

⁵⁶ 12 U.S.C. § 4617; see also FHFA Fact Sheet, “Questions and Answers on Conservatorship,” available at http://www.treas.gov/press/releases/reports/fhfa_consrv_faq_090708hp1128.pdf (Sept. 7, 2008).

prevent the bank from breaching capital reserve requirements, and the bank's managers are competent and have not violated any laws or regulations.⁵⁷ This strategy is, of course, controversial because it protects both creditors and shareholders from the bank's financial distress.⁵⁸

A version of Open Bank Assistance was applied to AIG, with the federal government injecting \$85 billion in return for equity participation notes.⁵⁹

Strategies along these lines could be among the powers available to a systemic risk regulator. Instead of minimizing the cost to federal deposit insurance funds, which is the goal of the FDIC, the regulator would minimize the cost to creditors, financial markets, and the public fiscal from the failure of a systemically important institution. Affected parties might be given a right of appeal, but the regulator would have discretion to select the appropriate strategy without prior court approval.

3. Regulatory Framework

Rescue legislation cannot exist in isolation. Because it vests the federal government—the Treasury, the Fed, or an agency—with enormous discretion, the legislation must be tied to a broad regulatory framework that limits government discretion and gives clear guidance to institutions that are subject to a potential takeover.

Again, commercial banking law provides a useful analogy. Long before it fails, a bank is subject to ongoing, prudential regulation by state or federal regulators.⁶⁰ This regulation includes capital reserve requirements,⁶¹ limits on lending⁶² and other investment activities,⁶³ and periodic reports⁶⁴ and audits.⁶⁵ The relevant state or federal regulator is charged with the responsibility for initiating any conservatorship or receivership.⁶⁶ Similarly, the GSEs and FHLB are subject to regulations governing their capitalization and business practices, and their regulator (FHFA) is the decision-maker with respect to initiation of any conservatorship or receivership proceedings.⁶⁷

Prudential regulation serves three critical functions. First, it reduces the moral hazard caused by deposit insurance or any other form of government insurance. Insurance dulls the incentives of the insured parties—the bank and its creditors

⁵⁷ 12 U.S.C. § 1823(c)(8).

⁵⁸ FDIC, RESOLUTIONS HANDBOOK, *supra* note 37, at 47.

⁵⁹ Matthew Karnitschnig, Deborah Solomon, Liam Plevin & Jon E. Hilsenrath, "U.S. to Take Over AIG in \$85 Billion Bailout; Central Banks Inject Cash as Credit Dries Up," *Wall St. J.* (Sept. 16, 2008).

⁶⁰ *See generally* Macey, Miller & Carnell, *supra* note 32, at 70-73.

⁶¹ 12 USC § 1818.

⁶² § 84(a)

⁶³ § 24 (restricting equity investments in corporations).

⁶⁴ § 161.

⁶⁵ § 1820(d).

⁶⁶ *See generally* Macey, Miller & Carnell, *supra* note 32, at 725-26.

⁶⁷ *See* 12 U.S.C. §§ 4511, *et seq.* *See also* text accompany notes 48-54, *supra*, and the FHFA's description of itself at <http://www.fhfa.gov/Default.aspx?Page=4>.

or depositors—to monitor and, if necessary, reduce the riskiness of the bank’s activities.⁶⁸ This moral hazard problem necessitates vigorous monitoring by the insurer. We see this in the detailed reporting and auditing requirements of bank regulations.

Second, prudential regulation ensures that both the regulator and the public receive timely information about a commercial bank’s condition long before distress occurs.⁶⁹ When the FDIC does intervene to rescue a bank, there will be a long paper trail that justifies the intervention.

Third, prudential regulation establishes rules that guide both banks and the FDIC. These rules constrain banks and discourage unnecessarily risky transactions. They also serve as objective, often quantifiable, standards for determining whether conservatorship or receivership are justified. These rules, therefore, constrain the FDIC by placing limits on the Corporation’s discretion in regulating and rescuing failing banks.⁷⁰

Laws governing failing banks, then, have always been tied to a framework regulating healthy banks. Without a framework, rescue legislation would be deeply troubling. It would give the federal government authority to rescue financial institutions that are subject to little or no prudential, federal regulation prior to failure, and such action would be based on amorphous subjective determinations. There is, for example, much discretion in any judgment whether a financial company is distressed or in danger of default and therefore worthy of rescue. That discretion can be misused, especially if it is not tied to an existing regulatory framework imposing prudential regulation on systemically important financial companies. An agency might delay a rescue, for fear of adverse political or public reaction. A timely rescue will often be one that occurs when an institution has not yet defaulted or entered distress. The rescue may seem premature to outsiders, even if the agency believes that the company is in danger of default.⁷¹ And there will indeed be a real risk of premature rescue. Because reasonable minds can disagree whether an institution is “in danger of

⁶⁸ Stuart I. Greenbaum & Anjan V. Thakor, *CONTEMPORARY FINANCIAL INTERMEDIATION* 446 (2d ed. 2007) (noting that “LLR [lender-of-last-resort] facility, deposit insurance, protection of the payments system, and the too-big-to-fail policy . . . create moral hazards that shift costs and risks from the private banks to the public (central bank) and, therefore, elicit restrictions on bank behavior designed to limit such exploitation”).

⁶⁹ Inadequate information seems to have been a contributor to the current crisis. See Richard A. Posner, *A FAILURE OF CAPITALISM: THE CRISIS OF '08 AND THE DESCENT INTO DEPRESSION* 146 (2009) (“[A]lthough the housing bubble began to leak air in 2005, it was not until the fall of 2008 that the government discovered that the banking industry was in dire straits.”).

⁷⁰ See, e.g., Robert R. Bliss & George G. Kaufman, *U.S. Corporate and Bank Insolvency Regimes: A Comparison and Evaluation*, 2 Va. L. & Bus. Rev. 143, 152 (2007) (noting that statutory minimum capital-reserve requirements are designed in part to “reduce[] the discretion of bank regulators to decide when to appoint receivers”).

⁷¹ See Posner, *supra* note 69, at 51-52 (“it is very difficult to receive praise, and indeed avoid criticism for preventing a bad thing from happening unless the probability of the bad thing’s happening is known”).

default,” politics can enter the decision-making process (consciously or subconsciously).⁷²

Additionally, without a regulatory framework, the relevant federal agency might have insufficient information to make timely rescue decisions. And, as noted before, rescue legislation could even increase systemic risk, because it would dampen the monitoring incentives of creditors, investors, and other private actors.⁷³ Prudential regulation is needed to address this moral hazard problem.

To be sure, prudential regulation will not eliminate concerns about regulators abusing their discretion. Even though the FDIC and FHFA operate within a comprehensive regulatory framework, their rescue decisions are not immune to criticism.⁷⁴ But the goal of legislation is not to remove discretion from federal actors—that is impossible. The goal is to constrain it in ways that limit ill-informed or biased decisions. That is possible, but only through legislation that channels the decision-making of systemically important institutions and the government actors empowered to rescue them.

B. Modifying Chapter 11

The rescue powers of the FDIC—receivership, conservatorship, purchase and assumption, creation of a bridge bank, etc.—are similar to those of a judge in a Chapter 11 case. Once an institution files for bankruptcy, it enjoys insulation from creditors (the “automatic stay”).⁷⁵ The bankruptcy judge can then approve gradual liquidation (akin to a receivership),⁷⁶ reorganization (conservatorship),⁷⁷

⁷² The response to the current financial crisis has been widely criticized for inconsistency. See Steve Mathews & Viven Lou Chen, “Hoenig Hits Treasury for Lack of ‘Decisive’ Action,” Bloomberg (Mar. 9, 2009) (reporting senior Federal Reserve official criticizing Treasury’s “ad-hoc” approach to bank crisis). The proposed legislation provides little guidance to regulators to reduce inconsistent responses, however.

⁷³ Tyler Cowen, “Why Creditors Should Suffer Too,” N.Y. Times (Apr. 4, 2009) (“Even as they focus on firms deemed too big to fail, the new proposals immunize the creditors and counterparties of such firms by protecting them from their own lending and trading mistakes.”).

⁷⁴ E.g., Francis X. Diebold & David A. Skeel, Jr., “Geithner is Overreaching on Regulatory Power,” Wall St. J. (Mar. 27, 2009) (“IndyMac, for example, was not taken over by the FDIC until long after it was obvious that it should be closed . . .”).

⁷⁵ 11 U.S.C. § 362(a).

⁷⁶ A firm can file a bankruptcy petition under Chapter 7 (“Liquidation,” §§ 701 *et seq.*) or Chapter 11 (“Reorganization,” §§ 1101, *et seq.*). Liquidation can be accomplished under either Chapter. See generally Douglas G. Baird, *The Elements of Bankruptcy* ch. 1 (2003). Circuit City, for example, underwent liquidation in Chapter 11 earlier this year. See Miguel Bustillo, “Retailer Circuit City to Liquidate—Consumer-Electronics Pioneer Closing; 34,000 Workers Will Lose Jobs,” Wall St. J. B1 (Jan. 17, 2009).

⁷⁷ 11 U.S.C. §§ 1101, *et seq.*

or sale of all or part of the institution's assets, together with financing provided by the government or another lender (purchase and assumption).⁷⁸

These features make bankruptcy a potentially attractive mechanism for rescuing distressed institutions, including systemically important ones.⁷⁹ One obvious problem is the safe harbors for financial contracts, discussed in Section II. Financial contracts are the primary (often the only) assets of financial institutions, and the safe harbors permit a "run" on these assets.

One solution is to eliminate the safe harbors, at least when a systemically important institution files for bankruptcy. Some members of Congress, for example, advocate creation of a new chapter of the Bankruptcy Code for financial institutions.⁸⁰ Presumably this chapter would closely resemble Chapter 11, but the automatic stay would apply to all financial contract counterparties in order "to prevent runs on troubled institutions, thereby helping to alleviate the panic that could strike the financial system if a large institution finds itself facing difficulties."⁸¹ Other details remain to be worked out. The debtor would probably be limited in its ability to "cherry pick" or otherwise use the benefit of hindsight to gamble at the expense of financial contract counterparties. The debtor might also be given strict deadlines for disaffirming contracts. In this way, bankruptcy judges could be given the same authority—with respect to financial contracts—as the FDIC possesses when a commercial bank becomes distressed.⁸²

Even with these fixes, however, the Bankruptcy Code would remain a poor fit for systemically important institutions. By the time an institution becomes obviously distressed, and its managers finally consider a bankruptcy filing, counterparties will have commenced a "run" on its assets and confidence in the financial system will have deteriorated. It seems unlikely that troubled institutions will seek bankruptcy protection *before* they exhibit signs of distress. The incentive to "gamble for resurrection"—to delay bankruptcy as long as possible—will be very strong, particularly because equityholders generally receive nothing and managers often lose their jobs after a bankruptcy filing.

To be sure, a distressed institution can be forced into bankruptcy via an involuntary petition. Under current law, only a group of unpaid, unsecured

⁷⁸ Sales are often conducted in Chapter 11 using § 363(b), which permits sales of assets outside the ordinary course. *See generally* Ayotte & Morrison, *supra* (documenting the frequency of "363 sales" in large corporate bankruptcy cases); Douglas G. Baird & Robert K. Rasmussen, *Chapter 11 at Twilight*, 56 *Stan. L. Rev.* 673 (2003) (same). Chrysler and General Motors, for example, were recently sold as going-concerns, with financing provided by the federal government. *See generally* Mark J. Roe & David A. Skeel, "Assessing the Chrysler Bankruptcy," working paper (Aug. 12, 2009), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1426530.

⁷⁹ *See* Kenneth M. Ayotte & David A. Skeel, Jr., "Bankruptcy or Bailouts?," working paper (Mar. 2, 2009).

⁸⁰ "Financial Services Committee Republican Plan for Reforming the Financial Regulatory System," *supra* note 2, at 3.

⁸¹ *Id.*

⁸² 12 U.S.C. § 1821(e)(8). *See generally* Bliss & Kaufman, *supra* note 70.

creditors can file such a petition.⁸³ That could be changed. Perhaps the federal government could be given broad authority to file involuntary petitions against systemically important institutions, regardless of whether it is a creditor. But this power would be as troubling as proposals for a systemic risk regulator. Would the government possess sufficient information and proper incentives to file an involuntary petition at the appropriate time against the appropriate institutions? A broad regulatory framework would be needed to ensure that this happens. Of course, a bankruptcy judge could dismiss a premature involuntary bankruptcy petition, but the filing itself conveys negative information to the market and undermines confidence in the systemically important institution.

A second problem is that the bankruptcy process is managed by a judge. Though federal regulators are subject to political pressure, they possess expertise that is generally beyond the ken of judges. When a systemically important institution suffers distress, rapid decision-making is necessary. Federal law permits this kind of speed when the FDIC seizes a bank. Most of the corporation's decisions, for example, are not subject to judicial review. Speed is less likely in a bankruptcy case because the judge must offer due process to objectors.⁸⁴ Though the Lehman bankruptcy was handled very quickly—the North American operations were sold to Barclay's within a week⁸⁵—it seems overly optimistic to expect that every bankruptcy judge would act with the same dispatch as the judge did there.⁸⁶

These problems can be overcome, provided the government is willing to pay enough. It can intervene before a bankruptcy occurs by bailing out the troubled institution (as in AIG and Bear Stearns). It can also intervene afterwards by offering financing tied to strict covenants that force a quick reorganization or liquidation (as in Chrysler and GM).⁸⁷ These measures are costly, but the costs

⁸³ 11 U.S.C. § 303(b).

⁸⁴ See, e.g., § 1109(b) (“A party in interest ... may raise and may appear and be heard on any issue in a case under this chapter”); Fed. R. Bankr. Proc. 6004 (requiring notice and hearing before a court approves a motion to sell assets). See generally Eric S. Richards, *Due Process Limitation on the Modification of Liens Through Bankruptcy*, 71 Am. Bankr. L. J. 43, 44-51 (1997).

⁸⁵ Lehman Brothers Holdings, Inc., the parent company, filed its Chapter 11 petition on September 15, 2008. Bankruptcy Judge Peck approved the sale of Lehman Brothers Inc., a subsidiary, to Barclays on September 19, 2008. See “Order Under 11 U.S.C. §§ 105(a), 363, and 365 and Federal Rules of Bankruptcy Procedure 2002, 6004, and 6006 Authorizing and Approving (A) The Sale of Purchased Assets Free and Clear of Liens and Other Interests and (B) Assumption and Assignment of Executory Contracts and Unexpired Leases,” *In re Lehman Brothers Holdings Inc., et al.*, Case No. 08-13555 (Bankr. SDNY September 19, 2008).

⁸⁶ A third problem is the international scope of most, if not all, major financial institutions. Any rescue will require extensive coordination with foreign governments, something bankruptcy courts are not well-equipped to handle.

⁸⁷ See, e.g., the Treasury Department's press release regarding its role in Chrysler's restructuring, available at <http://www.treas.gov/press/releases/tg115.htm>, and GM's 8-K describing the “U.S. Treasury 363 Sale Proposal”, available at <http://www.sec.gov/Archives/edgar/data/40730/000119312509119940/d8k.htm>. See also Roe & Skeel, *supra*.

impose a salutary break on over-eager regulators, particularly because they face public scrutiny when they use public funds to bail out failing institutions.

Put differently, little in the current regime prevents the federal government from conducting quick rescues and pursuing other measures to mitigate a systemic collapse.⁸⁸ The current regime is just more costly for taxpayers when systemically important institutions fail than one that permits immediate federal takeover. These costs must be weighed against the costs of a system that permits federal takeovers. That system requires a massive regulatory apparatus to constrain agency discretion.⁸⁹

IV. Conclusion

Returning to the key question: Is the Bankruptcy Code an adequate mechanism for resolving the distress of systemically important institutions? No. The government needs a process with more flexibility and speed than what the Code offers. Although the government can avoid the Code's constraints by bailing out or extending loans to failing institutions, the cost to taxpayers is too large.

President Obama has proposed a plausible alternative to the Code. It would vest the Federal Reserve—working with the Secretary of the Treasury, FDIC, and other federal regulators—with authority to act as a systemic risk regulator that monitors, regulates, and rescue any foreign or domestic financial institution⁹⁰ whose “material financial distress ... could pose a threat to United States financial stability or the United States economy.”⁹¹ The proposed legislation combines close monitoring of institutions before they enter distress⁹² and FDIC-style resolution procedures⁹³ when the institution craters. Importantly,

⁸⁸ *Almost* nothing stops the government from acting to protect markets. Recall that, according to various government officials, the Fed was powerless to stop Lehman's failure, due to statutory constraints on its lending abilities. *See* text accompanying notes 19-21, *supra*. This suggests that we might want to expand the Fed's lending powers to include unsecured loans. With greater power, the Fed would be better poised to prevent a costly bankruptcy filing.

⁸⁹ The current regime also imposes discipline on financial institutions, which cannot expect conservatorships or bailouts in the event of distress. They instead face, as Lehman did, the prospect of rapid liquidation in Chapter 11. This prospect induces troubled institutions (pressured by creditors) to contact federal regulators and share information before a meltdown.

⁹⁰ *See* Department of the Treasury, “Title II—Consolidated Supervision and Regulation of Large, Interconnected Financial Firms Treasury” § 203, proposed legislation available at <http://www.financialstability.gov/docs/regulatoryreform/07222009/titleII.pdf>.

⁹¹ *Id.*, at § 204(a). *See also* Department of Treasury, “Division D—Improvements for Financial Crisis Management, Title XII—Enhanced Resolution Authority” § 1203, proposed legislation, available at http://www.financialstability.gov/docs/regulatoryreform/title-XII_resolution-authority_072309.pdf.

⁹² Department of the Treasury, “Financial Regulatory Reform: A New Foundation,” *supra* note 2, at 20.

⁹³ *Id.*, at 76.

it gives the federal government authority to place institutions into conservatorship or receivership only when their distress imperils the overall economy. If an institution is “critically undercapitalized” but its distress does not create threaten market stability, the institution will be forced into bankruptcy instead of receivership or conservatorship.⁹⁴ President Obama’s proposal, therefore, invokes alternatives to bankruptcy only when economic conditions necessitate them. Plus, these alternatives are invoked by the same regulators that monitor systemically important institutions long before they fail. These features render the President’s plan a viable, targeted approach to protecting financial markets and the overall economy from a financial institution’s failure.

⁹⁴ Department of the Treasury, “Title II—Consolidated Supervision and Regulation of Large, Interconnected Financial Firms Treasury”, *supra* note 90, at § 204(a), p. 32 (“Mandatory bankruptcy petition for critically undercapitalized Tier 1 financial holding companies”).