Are Bailouts Inevitable?

Randall D. Guynn†

The "too systemically important to fail" problem is one of the most intractable problems of our time. During the financial panic of 2008, governments around the world decided to use taxpayer funds to rescue their most important financial institutions rather than allow them to be liquidated at fire-sale prices. Policymakers have developed measures to make future failures less likely or severe. If failures nevertheless occur, however, regulators will want to resolve systemically important institutions in a way that provides a credible alternative to taxpayer-funded bailouts. This Essay establishes an economic model for testing when a proposed solution is credible. It applies that test to proposals for a new Chapter 14 to the Bankruptcy Code and to the FDIC's new resolution authority, examining especially the FDIC's possible use of this authority to recapitalize the systemically important and viable parts of a failed institution and liquidate the rest without cost to taxpayers.

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† Partner and Head of the Financial Institutions Group, Davis Polk & Wardwell LLP. J.D., 1984, University of Virginia School of Law. Law clerk, Justice William H. Rehnquist, October Term 1985. This essay is based on a presentation made at the Weil Gotshal & Manges Roundtable on Assessing Dodd-Frank at Yale Law School on April 1, 2011. I would like to thank Donald Bernstein, Priya Bindra, Jordan Costa, John Douglas, Wilson Ervin, Rick Evans, Jonathan Guynn, Marshall Huebner, James Kearl, Gabriel Rosenberg, Reena Sahni, David Skeel, Margaret Tahyar, and James Wigand for their helpful comments on this Essay. I remain responsible for any errors. This Essay does not necessarily reflect the views of Davis Polk & Wardwell LLP or any of my partners.
Introduction

During the global financial panic of 2008, most governments around the world decided that it was better to rescue their most important banks and other financial institutions than to allow them to be liquidated in a “disorderly” manner. The governments shared the concern that a disorderly liquidation could result in a severe destabilization or collapse of the financial system. In other words, some financial institutions were “too systemically important to fail” (TSTF). After the crisis faded, however, these decisions were followed by populist outcries of “never again.” Policymakers have therefore been searching for ways to make taxpayer-funded bailouts of systemically important financial institutions (SIFIs) a thing of the past. This Essay discusses whether taxpayer-funded bailouts are inevitable despite these efforts.

My central thesis is that bailouts of SIFIs need not be inevitable. However, the bailout problem is a difficult one to understand, much less solve. It has significant cross-border dimensions, and its various solutions are not cost-free. Most people tend to oversimplify the problem and its solutions: some think that the problem is mainly a lack of political commitment to free market principles, while others think it is a matter of excessive political influence by Wall Street. Thus, the solution, according to these individuals, is principally a matter of voting the right people into office, dampening the influence of Wall Street, convincing shareholders and creditors that they will bear all the losses.

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1. See, e.g., Barack Obama, President, Weekly Address: President Obama Urges Congress To Complete Work on Wall Street Reform Bill (June 26, 2010), http://www.whitehouse.gov/the-press-office/weekly-address-president-obama-urges-congress-complete-work-wall-street-reform-bill (reflecting populist outcries to ensure that “Main Street is never again held responsible for Wall Street’s mistakes” (emphasis added)).

2. See Debate Between Paul Mahoney, Dean, Univ. of Va. Sch. of Law, and Randall D. Guynn, Partner and Head, Fin. Insts. Grp., Davis Polk & Wardwell LLP, at the University of Virginia Law School (Feb. 28, 2011), http://www.youtube.com/watch?v=yiOvMr5rVMY.


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from the insolvency of their firms or debtors, restricting lender-of-last-resort facilities or debt guarantee programs, or breaking up the largest banks into constellations of smaller banks.

Part I of this Essay discusses the economics of bailouts and explains why policymakers during the fall of 2008 believed that taxpayer-funded bailouts were the lesser of two evils when compared to disorderly liquidations. It concludes that the key to eliminating taxpayer-funded bailouts is to develop a credible alternative that results in lower social costs than a bailout or a disorderly liquidation. Part II examines proposed solutions to the bailout problem, including ex ante solutions that focus on reducing the likelihood of a SIFI failure and ex post solutions that focus on minimizing the social costs of failure. Part III analyzes why attempts to liquidate or reorganize a SIFI under the existing Bankruptcy Code during a financial panic can result in disorderly liquidations, especially if the SIFI has significant cross-border operations. It also explains why a proposed new Chapter 14 of the Bankruptcy Code, which was designed specifically for nonbank SIFIs, does not go far enough to provide a credible alternative to bailouts. Part IV describes how the Federal Deposit Insurance Corporation (FDIC) can use its bank and nonbank resolution authorities, including recapitalization within resolution, to create a credible alternative to taxpayer-funded bailouts of bank and nonbank SIFIs during a financial panic. This Part also discusses the importance of balancing the extraordinary discretion that regulators must enjoy during a crisis with enhanced due process protections, imposed by the FDIC (through rulemaking) and Congress (through legislation).

I. The Economics of Bailouts

FDIC Chairman Sheila Bair described the TSTF problem during the fall of 2008 as a choice between two evils—a taxpayer-funded bailout or a “disorderly liquidation” of a SIFI that would risk a collapse of the financial

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10. See, e.g., JOHNSON & KWAK, supra note 4, at 208.

A severe destabilization of the financial system, in turn, would have resulted in more serious, long-term harm to the wider economy, with potential consequences ranging from higher unemployment, lower output, and excessive regulation, to political instability, riots, increased risk of authoritarianism, and even war. The reason for this linkage between financial crises and broader economic unsettlement is that most of the money and credit in a modern economy is created by commercial banks and other private sector financial institutions, not by public central banks. Through the power of the money multiplier, every dollar, euro, or other unit of central-bank money, is transformed into many times that amount in other forms of money and credit. When depositors and other short-term creditors panic and demand immediate repayment of their funds, the amount of money and credit throughout the system contracts dramatically and sometimes violently in inverse relation to the money multiplier. Such a sudden and severe contraction of money and credit can be compared to a scenario in which the lubricating oil in every car in the United States were vaporized instantly: engines would be permanently damaged and would not run again even if they were subsequently re-lubricated. According to Chairman Bair, then, governments did not choose bailouts because they wanted to offer bailouts: they looked into the abyss and chose bailouts as the lesser of two evils.

In order to develop a credible alternative to these two evils, it is important to define what we mean by “taxpayer-funded bailouts” and “disorderly liquidations.” People have used these terms in different ways, and have often talked past each other as a result. Only when we agree on what the two evils are can we describe a credible alternative.


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A. Taxpayer-Funded Bailouts

A taxpayer-funded bailout can be defined, for present purposes, as an injection of public money into an otherwise insolvent firm that imposes at least some losses on parties other than the non-public shareholders and creditors of the firm. This injection may take the form of equity capital or unsecured debt. The party that is bailed out is not really the firm, but rather the firm’s creditors and shareholders to the extent they are insulated from the losses they otherwise would have borne in a liquidation, reorganization, or private-sector recapitalization. The firm’s managers and employees are also beneficiaries of the bailout to the extent that they otherwise would have lost their jobs or other income or wealth, including equity they hold in the firm.

Under this definition, the injection of public money into the mortgage giants Fannie Mae and Freddie Mac would be treated as a bailout, even though these government-sponsored entities (GSEs) had always been perceived to enjoy an implicit government guarantee. As of October 2011, the government had injected a combined $169 billion into the two GSEs in the form of senior preferred stock and warrants for approximately eighty percent of their common stock in order to prevent their insolvency. Although their common and preferred shareholders were massively diluted, they were not entirely wiped out, and their senior and subordinated creditors were entirely insulated against

17. Compare my proposed definition to the one proposed by Kenneth Scott, who states that “a bailout occurs when some favored claimants on a failed financial firm are given more than what they would receive in a strict bankruptcy, at the expense of others.” Kenneth E. Scott, A Guide to the Resolution of Failed Financial Institutions: Dodd-Frank Title II and Proposed Chapter 14, in Thomas H. Jackson et al., Resolution of Failed Financial Institutions: Orderly Liquidation Authority and a New Chapter 14, at 9-10 (Apr. 25, 2011) (unpublished manuscript), available at http://media.hoover.org/sites/default/files/documents/Resolution-Project-Booklet-4-11.pdf. Professor Scott’s definition is insensitive to whether the costs are borne by taxpayers, the public debt, the shareholders and creditors of the firm, a deposit insurance fund, or the financial industry (through an ex post assessment), and to whether the government’s exposure, if any, is fully secured. His definition appears too sweeping because it would seem to count as “bailouts” not only secured lender-of-last-resort facilities and deposit insurance schemes, but also many ordinary reorganizations under the Bankruptcy Code. Such reorganizations often allow critical vendor creditors whose flow of inputs, and important customer creditors whose flow of purchases, are necessary for the continuing operations of a failed business to receive “more than what they would receive in a strict bankruptcy, at the expense of others,” in the form of immediate payments made without the consent of other creditors. See DOUGLAS G. BAIRD, ELEMENTS OF BANKRUPTCY 225-26 (5th ed. 2010) (describing the availability under Chapter 11 of so-called “critical vendor orders” and other immediate payments to certain unsecured creditors where such payments are “in the interests of the estate as a whole”).

losses.\textsuperscript{19} Many of their senior managers resigned or were replaced, but most of their employees were insulated from losing their jobs, incomes, or wealth.\textsuperscript{20} By contrast, the traditional lender-of-last-resort activities of central banks are not taxpayer-funded bailouts,\textsuperscript{21} even though they expose central banks to a contingent risk of loss and create a certain amount of increased moral hazard.\textsuperscript{22} As outlined by Walter Bagehot in his classic treatise on banking, the traditional lender-of-last-resort function of a central bank is to lend freely to solvent-but-illiquid firms during a financial panic on a fully secured basis and at penalty rates.\textsuperscript{23} Lender-of-last-resort facilities thus provide firms with an emergency source of credit in order to turn assets that have temporarily become illiquid into cash. Bagehot would not have limited this privilege to banks, but rather encouraged such emergency lending to all firms that are solvent and have sufficient collateral. Thus, under Bagehot's conception, both the Federal Reserve's authority to lend to insured depository institutions through its discount window\textsuperscript{24} and its authority to lend to all firms under section 13(3) of the Federal Reserve Act\textsuperscript{25} would qualify as lender-of-last-resort facilities.

Of course, it requires considerable judgment to distinguish between an insolvent firm and a fundamentally sound firm whose assets are merely illiquid during a financial panic. The requirement that any emergency lending be done on a fully secured basis at penalty rates, however, provides a certain amount of protection against mistakes and moral hazard. Assuming that the central bank properly applies a "haircut," or discount, to the collateral value of any assets accepted as security, the amount of credit that an insolvent firm can incur will be limited by its unencumbered assets, and the central bank will be insulated against losses. At the same time, if the penalty rate is stiff enough, the disincentive to use these facilities should minimize any moral hazard.

\begin{footnotes}
\footnote{21. Milton Friedman, for example, considered lender-of-last-resort facilities to be appropriate governmental functions consistent with free market principles, rather than bailouts. Indeed, Friedman largely blamed the Great Depression on the Federal Reserve’s failure to exercise its lender-of-last-resort powers aggressively enough. See FRIEDMAN & SCHWARTZ, supra note 16, at 407-19. Friedrich von Hayek also recognized that lender-of-last-resort facilities are necessary in a free market economy whose core monetary base consists of central bank money, although this recognition led him to the conclusion that central bank money should be abolished. See F.A. HAYEK, DENATIONALISATION OF MONEY—THE ARGUMENT REFINED: AN ANALYSIS OF THE THEORY AND PRACTICE OF CONCURRENT CURRENCIES 105-06 (3d ed. 1990), available at http://mises.org/books/denationalisation.pdf.}
\footnote{22. Moral hazard refers to the phenomenon by which individuals and firms engage in riskier behavior if someone else, such as an insurance company or the government, bears the cost of that risk in their stead. See MARK S. DORFMAN, INTRODUCTION TO RISK MANAGEMENT AND INSURANCE 5 (5th ed. 1994).}
\footnote{23. WALTER BAGEHOT, LOMBARD STREET: A DESCRIPTION OF THE MONEY MARKET 97 (Richard D. Irwin, Inc. 1962) (1873).}
\footnote{25. Id. § 343.}
\end{footnotes}
In addition, deposit insurance or other similar credit insurance schemes should not be treated as taxpayer-funded bailouts, even though they insulate insured depositors or creditors from loss, and therefore increase moral hazard. The insured parties pay premiums for their insurance, allowing the costs of such government interventions to be borne by members of the insured community, rather than by the taxpaying public.

B. Disorderly Liquidations

The term "disorderly liquidation" has nothing to do with the orderliness of the liquidation proceeding. A liquidation under the Bankruptcy Code is indisputably orderly. Instead, the term is used as shorthand for value-destroying liquidations of financial assets at the bottom of the market during a financial panic, or for value-destroying reorganizations that take so long to consummate that the firm, like a melting ice cube, has lost most of its value by the time the reorganization is approved. A more descriptive term might be "fire-sale liquidations" or "value-destroying reorganizations." Such liquidations and reorganizations minimize the value of a distressed firm and maximize the losses borne by its shareholders and creditors. During a financial panic, they also minimize the perceived value of similar assets throughout the financial system and maximize the incentives of depositors and other short-term creditors to stage a "run"—that is, to pull their cash out of the system. This, in turn, increases the risk of a severe destabilization or collapse of the financial system.

C. When a Bailout Is the Lesser of Two Evils

A bailout is the lesser of two evils whenever the social costs of a bailout are less than those of the next best alternative. For example, consider a situation in which the only alternative to a bailout is the sort of disorderly fire-sale liquidation that Chairman Bair described. Assume that a particular SIFI becomes insolvent during a financial panic. Assume further that the SIFI has $1 trillion in liabilities and a going-concern value, before liabilities, of $950 billion. This gross going-concern value can only be realized if the firm is immediately recapitalized with $150 billion in return for all of the firm's common equity, leaving the firm with a net firm value of $100 billion and a tangible common equity leverage ratio of approximately ten percent. The net cost of recapitalizing this firm would be $50 billion—the gross cost of $150


billion, less the $100 billion value of the new common equity issued to the taxpayers. Furthermore, even after this recapitalization, the firm will need a temporary source of secured funding, until it can regain its footing and its access to general credit markets.

By contrast, if the firm's assets are immediately liquidated in a fire sale at the bottom of the panic-affected market, the assets may generate as little as $400 billion in cash.28 Thus, the firm's "going-concern surplus"—the difference between its gross going-concern value and its liquidation value—is $550 billion.29 Moreover, much of the potential loss represented by this going-concern surplus is a "deadweight" loss in the social value of the assets, rather than a "mere" transfer of wealth from the firm's unlucky and potentially imprudent creditors to the "lucky" and potentially more prudent purchasers of the assets at the fire-sale prices.30 Such a dramatically large going-concern surplus may emerge very suddenly during a financial panic, when the market experiences extreme uncertainty and excessive pessimism about the value of a SIFI's assets and its future earnings, and nearly every financial institution—fearing a cascade of withdrawals and terrified about its own survival—starts pleading: "Cash, cash, my kingdom for some cash."31
Under these circumstances, the social cost of a taxpayer-funded bailout would include the following: the sum of the net cost of recapitalizing the insolvent institution ($50 billion); the cost of providing it with a temporary source of secured funding; and the increased moral hazard created by the bailout. This cost might be offset by any contribution collected from the firm’s bailed-out creditors, or by any proceeds from the eventual sale of the equity received in exchange for the recapitalization in excess of the equity’s initial $100 billion value. The social cost of the fire-sale liquidation, by contrast, would be the portion of the going-concern surplus that is a deadweight loss in the social value of the assets, which is likely to be close to $550 billion,\(^3\) plus the increased risk of a severe destabilization or collapse of the financial system, with corresponding immediate and long-term harm to the wider economy and society.\(^3\) This back-of-the-envelope calculation suggests that, under many circumstances, a bailout would be less costly to society than a fire-sale liquidation of the SIFI. Regardless of their commitment to free-market principles or to restraining the relative influence of Wall Street, many policymakers will choose the bailout option because it minimizes net social costs.

Of course, in a world of perfect information and with no collective action problems or other transaction costs,\(^3\) the SIFI’s creditors would be willing to reimburse the taxpayers for their bailout and to pay for the temporary secured funding at penalty rates. However, they would be willing to do so only if their sole alternative were to forfeit the going-concern surplus and receive their pro-rata shares of the firm’s immediate liquidation value. Alternatively, the creditors would be willing to have $150 billion of their claims written down and exchanged for $100 billion of common equity in the firm, eliminating the need for a taxpayer-funded bailout. In reality, however, the federal government typically emerges as the only actor with both the capacity and the motivation to organize a timely intervention, leaving it in the position of negotiating with the creditors for their contributions in a high-moral-hazard environment.

D. Toward a Credible Alternative to Bailouts

Taxpayer-funded bailouts will remain inevitable during financial panics as long as their social costs are perceived to be less than the social costs of the available alternatives. To avoid future bailouts, it is not enough to reduce the influence of Wall Street or ensure that public officials express a renewed commitment to free-market principles. Rather, policymakers must develop a

\(^{32}\) See supra note 30.

\(^{33}\) See POSNER, supra note 13, at 115-16 (explaining the consequences of a depression as including high inflation, increases in the national debt, and political instability); Hall, supra note 13, at 3 (noting that the financial crisis that began in 1929 led to the Great Depression, and that the financial crisis of 2008 led to the “Great Recession”).

credible alternative to both taxpayer-funded bailouts and disorderly liquidations. For an alternative to be credible, both policymakers and the market must be confident that it will result in lower social costs than either a bailout or a disorderly liquidation.

II. Proposed Solutions

Several solutions have been proposed to this dilemma. Some focus on making financial failures less likely or less severe. Such ex ante solutions include the following: better risk management and supervision, more frequent stress-testing, more effective early remediation measures, higher capital and liquidity requirements, breaking up the largest banks into constellations of smaller banks, early-trigger contingent capital or bail-in mechanisms, and recovery and resolution plans. Other solutions focus on reducing the social costs of resolving SIFIs at the point of nonviability or even afterwards. Such ex post solutions include a proposed new Chapter 14 of the Bankruptcy Code;

42. Jackson et al., supra note 17.
bail-in at the point of nonviability; and recapitalizations or bail-in within resolution, including use of the FDIC’s bank and nonbank resolution authorities to recapitalize the systemically important operations of a bank or nonbank SIFI.

This Part proceeds in two stages. Section II.A reviews the leading proposals for ex ante solutions and finds that none of these proposals is fail-safe, that some may be counterproductive or ineffective, and that all involve trade-offs that could result in excessive social costs. Section II.B then briefly outlines the leading proposals for ex post solutions. Parts III and IV will explore in detail two of the mechanisms that underlie these proposed ex post solutions—a revamped Bankruptcy Code and the Dodd-Frank Wall Street Reform and Consumer Protection Act’s orderly liquidation authority.

Of course, there may be no single best solution for all SIFIs under all circumstances. Rather, every firm faces a range of alternative or complementary solutions appropriate to the structure of the firm, the cross-border component of its operations, the substance of the laws governing the insolvency of its various parts, and a variety of other factors. In the wake of the 2008 crisis, many SIFIs have been required to identify the best solutions for themselves under various scenarios and to prepare and maintain living wills—that is, contingency plans designed to assist in avoiding or recovering from a financial disaster, or if those efforts fail, to be resolved in the least-costly way.46

A. Ex Ante Solutions

The ex ante solutions that focus on reducing the likelihood and severity of failure are not cost-free. They all involve tradeoffs, including the supply and


cost of credit in the wider economy. As a result, they may be too socially costly or politically unpopular to succeed.\footnote{See Coffee, supra note 40, at 821 (arguing that most ex ante solutions are insufficient due to the “regulatory sine curve,” which leads to deregulation when memories of a financial crisis fade and the public becomes convinced that the cost of regulation exceeds the benefits).}

To take one extreme example, the risk of taxpayer-funded bailouts could be virtually eliminated by banning maturity transformation—the process by which financial institutions fund themselves with demand deposits or other short-term borrowings and use these funds to make long-term loans or invest in other illiquid assets.\footnote{See Ricks, supra note 14, at 98.} It is this core activity that makes financial institutions vulnerable to runs and correlated waves of failure.\footnote{See Sandra C. Krieger, Executive Vice President, Fed. Reserve Bank of N.Y., Remarks at the Global Association of Risk Professionals 12th Annual Risk Management Convention: Reducing the Systemic Risk in Shadow Maturity Transformation (Mar. 8, 2011), http://www.ny.frb.org/newsevents/speeches/2011/kri110308.html (explaining the role of maturity transformation in the tendency of “runs [to] spread from unhealthy to healthy institutions,” especially when lender-of-last-resort facilities are unavailable); see also FDIC, RESOLUTIONS HANDBOOK 2-3 (2003), available at http://www.fdic.gov/bank/historical/reshandbook (demonstrating the correlated nature of U.S. bank failures, with nearly 10,000 failures during the Great Depression and 3000 during the savings-and-loan crisis, and with almost no significant failures during the intervening fifty years); Gorton, supra note 14, at 3 (illustrating the correlated waves of U.S. bank failures during the Depression, the savings-and-loan crisis, and the global financial panic of 2008); Douglas & Guynn, supra note 11, at 317 (same); Historical Statistics on Banking, FDIC, http://www2.fdic.gov/hsoh/SelectRpt.asp?EntryTyp=30 (select “Geographic Area: United States and Other Areas,” “Effective Date(s): Between 1934 and 2011,” and “Type of Report: Detail,” and follow “Produce Report” button) (last visited Dec. 5, 2011) (listing all FDIC bank interventions since 1934, by year, and showing the same pattern of intermittent waves of correlated failures).} By banning maturity transformation, policymakers could virtually eliminate bank failures and thus end taxpayer-funded bailouts. Of course, the problem with this “solution” is that maturity transformation is the mechanism that creates most of the money and credit in a modern economy.\footnote{See Kearl, supra note 15, at 422-25 (explaining the “money multiplier” effect, by which retail banks’ borrowing and lending activity dramatically increases the supply of money in the economy).} Without it, our economy would screech to a halt.

Similar tradeoffs arise when we try to eliminate the risk of taxpayer-funded bailouts through other ex ante solutions. For example, SIFIs would almost certainly be more resilient to failure during a financial panic if they were subject to higher core capital requirements and required to have more liquid balance sheets. But if they were, the wider economy would have access to less credit, and at a higher price. Alternatively, SIFIs could be required to contribute to a credit insurance program, similar to the FDIC’s program for insured banks; this bank tax would increase the cost of creating money and supplying credit, though, leaving the financial system with less of both. More troublesome, the fund created by such a tax could be so large that it might create an irresistible temptation for policymakers to divert it to other social uses...
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during the long periods between waves of bank failures, which would make it unavailable when needed during a financial crisis.

Banks could also be made less vulnerable to failure if they were limited in their ability to engage in high-risk activities. The most extreme version of this proposal is the utility or narrow bank—a bank that is required to invest all of its funds in very safe, highly liquid instruments, such as U.S. government securities. The Glass-Steagall Act, the Volcker Rule, and the proposed ring-fencing of retail banks in the United Kingdom, all impose activity or investment restrictions that have been justified by this premise, even though some of the activities or investments they restrict may in fact be less risky and just as socially useful as traditional lending. Unless similar restrictions are imposed throughout the financial system, the role of creating money and credit would simply shift from regulated banks to either the largely unregulated shadow banking system or offshore. In the end, the bailout risk might be as large in the shadow and foreign banking systems as it had been in the regulated domestic banking system. The idea that we can create a divided financial system and eliminate the bailout risk in the regulated banking system without giving rise to similar bailout pressures in the shadow or foreign banking systems is an illusion.

Finally, consider a solution in which the largest banks are broken up into constellations of smaller banks. As long as the smaller banks engage in maturity transformation and invest in assets that are correlated with each other, their risks of failure during a financial panic will remain similarly correlated.


Unless each constellation of banks faces risks that are less correlated than those faced by the original bank, or manages these risks more effectively, each constellation could fail in a correlated wave\footnote{Such waves of failure are copiously attested in the historical record. Nearly 10,000 small and medium-sized banks and thrifts failed in a correlated wave between 1930 and 1933, see Gorton, supra note 14, at 14, contributing to the turmoil of the Great Depression. Another wave in the late 1980s and early 1990s, associated with the savings-and-loan crisis, brought down nearly 3000 small and medium-sized banks and thrifts. See Douglas & Guynn, supra note 11, at 317. Finally, virtually all of the banks and thrifts that have failed during the most recent financial crisis or found themselves unable to repay their obligations under the Troubled Asset Relief Program (TARP) have been small and medium-sized institutions. See SPECIAL INSPECTOR GEN. FOR THE TROUBLED ASSET RELIEF PROGRAM, EXITING TARP: REPAYMENTS BY THE LARGEST FINANCIAL INSTITUTIONS (Sept. 29, 2011), available at http://www.sigtarp.gov/reports/audit/2011/Exiting_TARP_Repayments_by_the_Largest_Financial_Institutions.pdf; Kevin Wack, For Many Small Banks, TARP Becomes Trap, AM. BANKER (Sept. 29, 2011), http://www.americanbanker.com/issues/176_190/tarp-community-banks-small-business-lending-fund-1042686-1.html?zkPrintable=true; Failed Bank List, FDIC, http://www.fdic.gov/bank/individual/failed/banklist.html (last visited Dec. 5, 2011).}—with the same consequences to the financial system as the failure of the original bank. Furthermore, the social costs of such a “solution” would be significant. Smaller banks are likely to be less diversified and have fewer resources to devote to effective risk management. They are not subject to the Dodd-Frank Act’s enhanced prudential standards, which are reserved for large and systemically important institutions.\footnote{See Dodd-Frank Act § 165(a), 124 Stat. at 1423-24 (codified at 12 U.S.C. § 5365(a)).} They may also be less competitive internationally, lacking the balance sheets necessary to compete with larger foreign banks in satisfying the borrowing needs of large U.S. corporations. Indeed, the break-up solution would resemble a return to the sort of “unit” banking that was one of the alleged causes of bank failures during the Great Depression,\footnote{See Charles W. Calomiris, The Political Lessons of Depression-Era Banking Reform, 26 OXFORD REV. ECON. POL'Y 540, 542 (2010); see also 76 CONG. REC. 1405 (1933) (remarks of Sen. Carter Glass) (“But when I tell you of the nearly 11,000 banks that have failed in recent years, 80 per cent of them were banks whose capitalization did not exceed $25,000, you may have some conception of the menace they are to sound banking and the curse to their depositors.”); 75 CONG. REC. 9892, 9896-97 (1932) (remarks of Sen. Carter Glass) (“It is, therefore, obvious that the problem is largely one of small rural bank failures.... [T]here are thousands of country banks that have failed.... because those banks are so inadequately supplied with capital that they can not afford to employ expert bank managers and skillful bank officials.... [W]e have in this country hundreds of 1-crop banks, so to speak. The diversity of their business is inappreciable; and if that one crop fails, the bank fails.... Two fundamental causes are at the root of the small bank failures—lack of diversity and necessarily lack of earning power. Most of the small banks are what may be termed, as I have stated, 1-crop or 1-enterprise banks.”).} which led policymakers to promote the modern system of branch banking and consolidated banks.\footnote{See Mark Carlson & Kris James Mitchener, Branch Banking, Bank Competition, and Financial Stability (Fin. & Econ. Discussion Series, Working Paper No. 2005-20, 2005), available at http://ssrn.com/abstract_id=725021; see also 76 CONG. REC. 1413 (1933) (remarks of Sen. Jesse H. Metcalfe) (“Branch banking means diversification, and diversification means decrease in failures as the result of strictly local occurrences”); 75 CONG. REC. 9892, 9896 (1932) (remarks of Sen. Carter Glass) (predicting that weaknesses that caused country banks to fail “would not apply to larger banks having branches in a community where the unit bank is so weak”). This view was not unanimous. See, e.g., 75 CONG. REC. 10,056 (1932) (remarks of Sen. John J. Blaine) (“[The argument in favor of branch banking] implies that bigness and volume mean strength. The probabilities are that bigness and volume mean weakness instead of strength, at least, there is some persuasive evidence that bigness and volume do not mean strength in banking.”).} It appears that the physicians of the financial system...
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prescribe consolidation when banks are small and break-ups when banks are large, even though the fundamental problems (and solutions) are largely independent of size.

B. Ex Post Solutions

Three principal ex post solutions have been proposed in recent years. The first proposal recognizes that the current Bankruptcy Code is not a credible alternative to taxpayer-funded bailouts and seeks to resolve this problem by introducing into the Code a new Chapter 14 designed specifically for liquidating or reorganizing SIFIs. The second proposal features so-called “bail-in at the point of nonviability.” This approach would recapitalize a struggling SIFI without receivership or other insolvency proceedings by converting enough of the claims against the SIFI into common equity, in accordance with the priorities of such claims, at some defined point of nonviability. The third proposal involves a so-called “recapitalization within resolution,” which is similar to a bail-in at the point of nonviability, except that it is effected only after an institution is closed and placed into a resolution or insolvency proceeding. This technique could be used, for example, by the FDIC, exercising its new orderly liquidation authority under Title II of the Dodd-Frank Act in combination with its bank resolution powers under the Federal Deposit Insurance (FDI) Act, to recapitalize the systemically important and other viable operations of a bank or nonbank SIFI within the resolution proceeding. The mechanisms underlying these three proposed solutions are discussed in greater depth in the Parts that follow.

III. The Problem with Bankruptcy

A. The Strength of the Bankruptcy System in Ordinary Times

For all the talk about the Bankruptcy Code’s weaknesses in resolving a global SIFI like Lehman Brothers during a financial crisis, the Bankruptcy Code has some important advantages in reorganizing and liquidating most

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61. See Jackson et al., supra note 17.
62. See CLIFFORD CHANCE LLP, supra note 43.
63. See FIN. STABILITY Bd., supra note 44; SIFMA & Clearing House Comment Letter, supra note 45.
nonbank financial institutions most of the time. As a result, the Bankruptcy Code continues to apply unless the Dodd-Frank Act's orderly liquidation authority (OLA) is invoked.

Foremost among the Bankruptcy Code's advantages is what it offers in terms of transparency and due process safeguards for creditors and other stakeholders. All creditors and other stakeholders have substantial input into structuring a liquidation or reorganization under the Bankruptcy Code, thus ensuring that the value of the failed company is allocated in a fair manner for the benefit of the creditors and other stakeholders as a group. The equal-treatment and absolute-priority rules under the Bankruptcy Code are generally more protective of pre-insolvency property rights and interests than their counterparts under the OLA or the FDIC's bank resolution authority, which


67. See Douglas & Guynn, supra note 11, at 317. Activating the OLA requires the concurrence of the so-called "triple keys"—the Secretary of the Treasury, acting in consultation with the President; two-thirds of the Board of Governors of the Federal Reserve System; and two-thirds of the FDIC Board. See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 203(a), 124 Stat. 1375, 1450-51 (2010) (codified at 12 U.S.C. § 5383(a)). In the case of a broker or dealer, or a financial company whose largest U.S. subsidiary is a broker-dealer, the consent of two thirds of the Securities and Exchange Commission is required in lieu of the FDIC. Id. In the case of an insurance company, or a financial company whose largest U.S. subsidiary is an insurance company, the consent of the Director of the Federal Insurance Office is required instead of the FDIC. Id.

In order to activate the OLA, the three entities must agree that a particular nonbank financial institution has failed or is in danger of failing; that resolving it under the Bankruptcy Code would have serious adverse effects on the financial stability of the United States; and that invoking the OLA would avoid or mitigate those effects. Id. § 203(b), 124 Stat. at 1451 (codified at 12 U.S.C. § 5383(b)). Although this determination could theoretically be invoked for any nonbank financial institution at any time, these standards are unlikely to be met except with respect to nonbank SIFIs under the most destabilizing financial conditions.

68. See 11 U.S.C. § 1122(a) (2006) (requiring that all substantially similar claims and interests be included within same class); id. § 1123(a)(4) (requiring that bankruptcy plan provide same treatment for each claim or interest in same class); id. § 1129 (requiring that a court confirm a bankruptcy plan only if it complies with the aforementioned provisions). Although these rules are more protective than their counterparts under the OLA, they are not as "absolute" as the common terminology would imply. Under the "cramdown" power, a plan of reorganization can be imposed on a class of impaired claims and interests that did not consent to the plan as long as at least one impaired class has accepted the plan and the plan does not "discriminate unfairly" against, and is "fair and equitable" with respect to, the non-consenting class. Id. § 1129(b)(1). If the plan meets these standards, under the "best interests of creditors" rule, it can also be imposed on any non-consenting individual holder of a claim or interest as long as the holder will receive or retain a value that is not less than the amount that such holder would receive or retain if the debtor were liquidated under Chapter 7. Id. § 1129(a)(7)(A)(ii).

69. See Dodd-Frank Act § 210(a)(7)(B), 124 Stat. at 1468 (codified at 12 U.S.C. § 5390) (entitling creditors to receive not less than the amount they would have received in Chapter 7 liquidation); id. § 210(b)(4), 124 Stat. at 1476-77 (requiring that similarly situated claimants be treated in similar manner unless certain conditions are satisfied, including that all claimants receive not less than what they would have received in Chapter 7 liquidation); id. § 210(d)(2), 124 Stat. at 1494 (establishing maximum entitlement of any claimant as claimant's share in Chapter 7 liquidation); id. § 210(b)(4), 124 Stat. at 1499 (requiring FDIC, in exercising power to transfer assets and liabilities to bridge company, to
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treat similarly situated creditors in similar manner unless certain conditions are satisfied; see also 12 U.S.C. § 5390 (Supp. 2010) (codifying Dodd-Frank Act § 210); id. § 1821(i)(2) (setting FDIC’s maximum liability to any creditor equal to creditor’s share in liquidation); Douglas & Guynn, supra note 11, at 346-47 (discussing maximum and minimum recovery rights).

70. See 11 U.S.C § 1129(a)(7)(A)(ii) (2006) (describing the “best interests of creditors” rule); Baird, supra note 17, at 62-66 (describing the procedures for railroad reorganizations under the law of equitable receivership and under the Bankruptcy Act of 1898 and the “best interests of creditors” rule under the current Bankruptcy Code); see also Fleischmann & Devine, Inc. v. Saul Wolfson Dry Goods Co., 299 F. 15, 18 (5th Cir. 1924) (noting that, under the Bankruptcy Act of 1898, the offered plan must be “for the best interests of the creditors” and that a plan is “manifestly not for the best interests of the creditors if it would pay them considerably less than they might reasonably expect to realize in the administration of the assets in due course”).


are more akin to the “best interests of creditors” rule under the current Bankruptcy Code and those under the law of equitable receiverships or the Bankruptcy Act of 1898.70

The Bankruptcy Code also allows creditors to assess in advance with greater certainty how they will be treated in a resolution proceeding. The bankruptcy process is more rule-based than its alternatives and has produced an extensive body of case law, commentary, and other guidelines. In contrast, the FDIC has extremely broad discretion to structure any resolution under the OLA, with only a limited body of regulations and other legal guidance to constrain its discretion. While the FDIC is required to issue regulations to provide better legal guidance about the OLA than it has historically provided about bank resolutions, it has only had time to clarify a few issues to date. As two former government officials wrote more than twenty years ago regarding the bank resolution process:

This is a confusing area. The challenge arises less because of the complexity of the rules than because of their ambiguity and obscurity. The Bankruptcy Code generally constitutes the starting point for rules governing the failure of companies in the United States. It contains a detailed set of rules that fill three volumes of U.S. Code Annotated, volumes of West’s Bankruptcy Reporter, and over four linear feet of Collier’s [on Bankruptcy]. But the statutes governing conservatorships and receiverships of federally insured banks and thrifts fill, at most, about 111 pages of the U.S. Code Annotated.71

B. The Weakness of the Bankruptcy Code During a Panic

The weaknesses of the Bankruptcy Code become apparent, however, when it is the only available option for resolving a global SIFI during a financial panic.72 First, bankruptcy is a slow and deliberate process that is not designed for preserving systemically important operations critical to the
functioning of the economy as a whole. This same deliberateness makes bankruptcy a poor fit for preserving or maximizing the value of institutions whose assets have a liquidation value that rapidly approaches zero during a financial panic, and whose going-concern value may melt away by the time the reorganization process is complete.\(^\text{73}\) Although bankruptcy’s due process safeguards are an important feature, they need to be balanced against other considerations during a financial crisis when justice delayed can be justice denied, and a failure to act promptly can result in a severe destabilization or collapse of the financial system.

Second, bankruptcy lacks certain tools that are necessary during a financial panic to preserve the systemically important and other viable operations of a global SIFI and to prevent severe harm to the financial system. For example, it does not provide for the creation of bridge entities or authorize the transfer of certain critical operations to a bridge without the consent of counterparties or a court, as may be required during a fast-developing financial panic.\(^\text{74}\) Nor do its equal-treatment and absolute-priority rules, as beneficial as they are in quieter times, provide much flexibility in a crisis. Although bankruptcy judges routinely permit debtors to pay critical vendor creditors and important customer creditors with little or no notice to other creditors in order to maximize the value of the bankruptcy estate, they lack the power to do so for reasons beyond the impact on the estate. Bankruptcy judges are therefore barred from favoring short-term creditors, who are likely to stage a run at the expense of long-term creditors who cannot run, unless that would maximize the value of the estate—even if doing so would prevent further harm to the financial system while still leaving the disfavored creditors with more than they would have received in a liquidation. Nor does bankruptcy provide access to any public lender-of-last-resort funding facility if debtor-in-possession (DIP) financing is not available from the private sector. Since no private sector bank is likely to be healthy or confident enough to provide a sufficient amount of emergency funding during a panic, such an emergency source of short-term government funding is as crucial for the continuing operations of a financial institution as raw materials are for the continuing operations of a manufacturing business.\(^\text{75}\)

\(^\text{73}\) See Baird & Morrison, supra note 28, at 33. Judge Peck, in explaining the exigencies driving his approval of the sale of Lehman Brothers to Barclay’s Capital under section 363 of the Bankruptcy Code, emphasized this potential for value destruction. See In re Lehman Bros. Holdings Inc., No. 08-13555 (JMP), 2008 WL 4902202 (Bankr. S.D.N.Y. Sept. 19, 2008).

\(^\text{74}\) While transfers are possible under section 363, they typically cannot be made without counterparty consent and court approval, which can take substantial time to obtain.

\(^\text{75}\) See Thomas F. Huertas, Barriers to Resolution 1 (Feb. 22, 2011) (unpublished manuscript), available at www2.lse.ac.uk/fin/event/conferences/2011/DBWorkshop_14Mar2011/11-ThomasHuertas.pdf (“The very essence of banking is the ability to make commitments to pay—depositors at maturity, sellers of securities due to settle, borrowers who wish to draw on lending commitments, derivative counterparties who contracted with the [financial institution] for protection from interest rate, exchange rate or credit risks. Putting a stay on payments to creditors is equivalent to stopping the [institution’s] operating business. Unlike airlines, retailers or automobile companies,
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Third, bankruptcy has certain features that can reduce and potentially minimize the value of a global SIFI during a financial panic. For example, the automatic stay provision\textsuperscript{76} would force such a firm into liquidation unless it were lifted with respect to short-term creditors, because a moratorium on paying depositors and other short-term creditors is effectively a moratorium on the firm’s core operations.\textsuperscript{77} In contrast, the unqualified exemption from the automatic stay for financial contracts,\textsuperscript{78} and the failure to suspend close-out rights (even if the contracts are transferred within one business day to a creditworthy third party or bridge entity), can result in value-destroying close-outs during a financial panic.\textsuperscript{79} Moreover, the Code’s failure to suspend cross-defaults at affiliates based on the insolvency of a parent or other affiliate—which is provided for in the OLA\textsuperscript{80}—can destabilize and reduce the value of an entire family of otherwise solvent financial companies.

Fourth, the Bankruptcy Code does not require taking into consideration the public’s confidence in the financial system or the effects of a bankruptcy on systemic risk. In addition, bankruptcy judges have no experience or special expertise in preserving or restoring public confidence or minimizing systemic risk. Financial regulators, who have such experience and expertise, have neither the power to trigger a bankruptcy proceeding nor any significant role to play once such a proceeding begins.

Finally, the Bankruptcy Code does not include the tools necessary to conduct or facilitate a cross-border resolution of a global SIFI. Chapter 15 of the Code\textsuperscript{81} implements the Model Law on Cross-Border Insolvency,\textsuperscript{82} but that chapter reflects the same slow and deliberate judicial process as the rest of the Bankruptcy Code. It is not designed for a global SIFI that can lose value rapidly or threaten the national or global financial system. All of the disadvantages it has in resolving SIFIs in general are magnified when applied to global SIFIs with branches, subsidiaries, assets, liabilities, and contracts, outside the United States. Even if all of the impediments to a cross-border

\textsuperscript{77} See Huertas, supra note 75.
\textsuperscript{80} Dodd-Frank Act § 210(c)(16), 124 Stat. at 1461 (codified at 12 U.S.C. § 5390(c)(16)).
resolution could be identified, judges would lack the capacity to address those impediments effectively, such as by reviewing and evaluating living wills, seeking international law reform to empower host countries to facilitate cross-border resolutions by home-country authorities, or entering into bilateral or multilateral cooperation and coordination agreements with foreign bankruptcy courts or resolution agencies.

C. Advantages and Disadvantages of the Proposed Chapter 14

Of course, the Bankruptcy Code could be amended to address most of these weaknesses. Indeed, a working group at Stanford University's Hoover Institution has proposed just that—a new Chapter 14 of the Bankruptcy Code designed specifically for financial institutions with $100 billion or more in assets. The proposed new Chapter 14 would attempt to address the weaknesses of the existing Bankruptcy Code in several ways. Perhaps most strikingly, it would grant an institution's primary regulator standing to be heard as a party or to raise motions relevant to its regulations in a Chapter 14 proceeding. The regulator would be empowered to do the following: to commence an involuntary case against the institution (including on the basis of mark-to-market balance sheet insolvency or unreasonably small capital); to file motions, in conjunction with the DIP or any trustee, for the use, sale, or lease of property of the estate under section 363, subject to court review; and to file a plan of reorganization for the debtor at any time after the order for relief. The chapter would also allow DIP financing, whether provided by the government or the private sector, to be used to make partial or complete payouts to certain liquidity-sensitive creditors in advance of final distribution, once again subject to court approval. Finally, the new chapter would attempt to reduce the destruction of value in the form of close-out of financial contracts by making certain amendments to the safe harbor for financial contracts.

83. For the latest version of this proposal, see Jackson et al., supra note 17, at 2-3 to -4. The authors define the scope of Chapter 14 to include domestic and foreign insurance companies, stockbrokers, and commodity brokers, but not insured depository institutions. Id. at 2-7 to -9. It is not clear whether its authors view this proposal solely as a supplement to the OLA and the FDIC's bank resolution authority, or whether they are advocating it as a superior replacement for the OLA. Compare id. at i (“The purpose of this short collection of papers is to demonstrate why the 'orderly liquidation authority' . . . should be supplemented with a new and more predictable bankruptcy process designed specifically for large financial institutions.” (emphasis added)) with id. at ii (referring to the OLA—and implicitly the bank resolution provisions on which it is modeled—as a "discretionary bailout option" that is vulnerable to constitutional challenge on due process grounds, and to the proposed Chapter 14 as "a credible alternative to [such] a bailout").

84. Id. at 2-11 to -12.
85. Id. at 2-9 to -11.
86. Id. at 2-12 to -13.
87. Id. at 2-16 to -17.
88. See id. at 2-13 to -16.
89. These proposed amendments are exceedingly complex and will be difficult for the market to understand and for judges to apply, as the authors acknowledge. See id. at 2-18.
The Hoover Institution proposal would also address some of the perceived cultural and constitutional shortcomings of traditional bankruptcy proceedings. It would address the lack of experience and expertise of bankruptcy judges, as well as the limits on their political independence, by requiring Chapter 14 cases to be adjudicated by a panel of Article III district judges in the Second and D.C. Circuits.  

This proposed new Chapter 14 could be a useful supplement to the OLA and the bank resolution provisions, but as currently proposed, it falls considerably short of being a credible alternative to taxpayer-funded bailouts. First, even the failure of a financial institution with less than $100 billion in assets could destabilize the financial system if the market believed its failure signaled widespread vulnerability, if other financial institutions were dependent on any of its operations, such as payment or settlement system, or if other institutions had substantial credit or liquidity exposures to the firm. Banks and other financial institutions have historically failed in correlated bunches or waves, but Chapter 14 would not apply to the simultaneous failure of multiple medium-sized financial institutions that may collectively have assets far in excess of $100 billion. 

Second, although Chapter 14 would give financial regulators a greater role in the SIFI bankruptcy process, it does not expand the goals of the Bankruptcy Code to consider public confidence or systemic risk. Furthermore, it does not give either the regulators or the panel of pre-selected Article III judges any additional power to balance these holistic goals against the existing goals of bankruptcy. In particular, it fails to provide any of the essential tools necessary to preserve the systemically important operations of a global SIFI, such as the powers to create bridge entities, transfer assets and liabilities to a bridge without counterparty consent, depart from the equal treatment and absolute priority rules when necessary to prevent a systemic meltdown (subject to a minimum recovery right tied to liquidation value), or provide government emergency funding. 

Third, although Chapter 14 would provide authority for making very conservatively-estimated payouts to liquidity-sensitive creditors near the beginning of a case despite the automatic stay, that power is likely to be too slow and limited to stem the cascade of demands for cash withdrawals. These withdrawals could be induced by the fear that an automatic stay could be imposed on other institutions throughout the system. Such a cascade of withdrawal demands—a bank run—could spiral out of control and lead to a severe destabilization or collapse of the financial system. At the same time, the proposed amendments to the safe harbor for financial contracts are too complex to be workable. They could therefore do substantially more harm than good in

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90. *Id.* at 2-5 to -7. These Article III judges would be authorized to appoint special masters from a pre-designated panel of masters to hear and administer the cases. *Id.*
91. *See supra* note 49 and accompanying text.
furthering the goals of maximizing the value of a derivatives book for the benefit of the creditors or minimizing the impact of a value-destroying close-out on the financial system or the economy.

Fourth, there is no reason to believe that a panel of pre-selected Article III judges or special masters is likely to have any more experience or expertise with financial institution failures than the average bankruptcy judge. Indeed, bankruptcy judges have more specialized experience with insolvencies than Article III judges, who are generalists by nature. Although a pre-selected panel of judges and masters may be more competent than the average bankruptcy judge, it would not necessarily have more expertise than a pre-selected panel of bankruptcy judges, the FDIC, the Federal Reserve, the Secretary of the Treasury, or the Security Investors Protection Corporation.\(^9\) Indeed, such a panel of Article III judges and special masters would suffer from the same fundamental weakness that any resolution authority has with respect to financial institution failures: because financial institutions tend to fail in waves, with decades between each wave, whatever expertise and human capital a panel builds during one wave is likely to be lost by the time the next wave hits. Furthermore, the proposed chapter does little to address the generally glacial pace of the judicial bankruptcy process.

Fifth, although Chapter 14 would apply to insurance companies, stockbrokers and commodity brokers, it would continue to exclude insured depository institutions. This is a serious and possibly fatal limitation, since the vast majority of assets in many global SIFIs are attributable to bank affiliates.\(^9\) Having two entirely different processes for the resolution of the bank and nonbank components of a SIFI group will create impediments to the effective resolution of the group, increasing the risk that such a process will continue to impose greater social costs than a taxpayer-funded bailout. Moreover, if the due process protections and other advantages of proposed Chapter 14 are superior to the OLA, it is not clear why they are not superior to the bank resolution provisions in the FDI Act, which served as the model for the OLA.

Finally, the proposed Chapter 14 does not include any new tools for contingency planning, such as the preparation of recovery and resolution plans, or for conducting a cross-border resolution of a global SIFI. Indeed, it is difficult to envision a judicial process engaging in contingency planning or having the speed and flexibility necessary to carry out an effective value-


maximizing and systemic-risk minimizing resolution of a global SIFI during a financial panic.

In short, while the proposed Chapter 14 could be a useful supplement to the OLA and the bank resolution provisions, as currently proposed it would not be a credible alternative to taxpayer-funded bailouts. If this chapter were the only option, taxpayer-funded bailouts would remain inevitable because the social costs of bailing out global SIFIs during a panic would remain significantly lower than those of reorganizations under the proposed Chapter 14.

IV. The FDIC’s Resolution Powers as a Credible Alternative

The new orderly liquidation authority included in the Dodd-Frank Act94 has been described as an important new tool in the regulatory toolkit.95 It is modeled on the bank receivership provisions in the FDI Act96 but has been harmonized with the Bankruptcy Code to make it less disruptive for the creditors of financial companies that would otherwise be liquidated or reorganized under the Bankruptcy Code.97 The FDIC has promised that this new tool, combined with the old tool of bank resolution, will end the TSTF problem and make taxpayer-funded bailouts a thing of the past.98

In early 2011, the FDIC released a report describing how it could have used the OLA to resolve Lehman Brothers in a more orderly fashion than in the way in which it was resolved under the Bankruptcy Code.99 Before this report was released, the FDIC’s public statements regarding the resolution of nonbank SIFIs had focused mainly on how it would use the OLA to minimize moral hazard and maintain market discipline by ensuring that shareholders and creditors of nonbank SIFIs would bear all of the losses in the event of failure.100 These early statements failed to distinguish the OLA from a fire-sale liquidation under the Bankruptcy Code; some therefore questioned whether the

94. See supra note 11 and accompanying text.
96. These are contained mainly in sections 11 and 13 of the FDI Act, which are codified at 12 U.S.C. §§ 1821, 1823 (2006).
97. For a comprehensive discussion of the FDIC’s resolution powers under the Federal Deposit Insurance Act and title II of the Dodd-Frank Act, see Douglas & Guynn, supra note 11.
99. See FDIC, supra note 65.
statutory conditions for invoking the OLA would ever be satisfied, and thus whether the OLA could provide a credible alternative to a taxpayer-funded bailout. In its Lehman report, however, the FDIC clarified how the OLA could be used to provide liquidity or even loss-sharing support to the critical parts of a SIFI’s business, while imposing all losses on a firm’s pre-existing shareholders and creditors, with the goal of maximizing the firm’s value, minimizing its losses, and preserving or restoring financial stability during a crisis.

As important as the FDIC’s new powers are, though, even more important is the FDIC’s ability to combine its old and new resolution powers to resolve a global SIFI with both bank and nonbank operations. Banking operations are typically the largest components of the financial groups that are expected to be designated as global SIFIs. As a result, the credibility of any proposed alternative to taxpayer-funded bailouts depends on the FDIC’s ability and willingness to use its combined powers, in coordination with other U.S. and non-U.S. resolution agencies, to resolve all of the components of a global SIFI.

The remainder of this Part summarizes the FDIC’s combined resolution authority in the wake of the Dodd-Frank Act and discusses one particularly noteworthy way in which this authority might be used. The Part then sets out some considerations that should guide the agency in the use of its newfound powers, including the importance of prudence, international cooperation, and respect for traditional concepts of due process.

A. The FDIC’s Combined Resolution Authority

The FDIC’s resolution powers give it enormous discretion to structure a liquidation, reorganization, or recapitalization, of a bank or nonbank SIFI. Upon appointment as conservator or receiver of an institution, the FDIC immediately succeeds by law to all of the rights and powers of the institution’s shareholders, directors, and managers. Unlike the Bankruptcy Code, the FDIC Act imposes no general automatic stay on an institution’s payment obligations


102. See FDIC, supra note 65.


or a creditor's exercise of any contractual rights aside from termination rights based on the appointment of a conservator or receiver or the insolvency of the institution. Even the limited prohibition on enforcing such close-out rights does not apply to qualified financial contracts (QFCs), although the close-out rights in these contracts are subject to a temporary stay of one business day.

In place of an automatic stay, however, the FDIC has the power to take a broad range of actions to maximize the value of the institution and protect the larger financial system, without seeking consent from creditors, counterparties, or courts. The FDIC is not obliged to seek input from any creditors and is subject to judicial review only to scrutinize the validity and size of any denied claims after the administrative claims process has been completed.

The FDIC's powers to resolve a bank under the FDI Act are slightly broader than its powers to resolve a nonbank SIFI under the OLA, even though the OLA was modeled on the bank receivership provisions of the FDI Act. The FDIC may be appointed as either the conservator or receiver of a bank but may only be appointed as receiver of a nonbank SIFI. Under a conservatorship, the FDIC has the power to take temporary control of a bank SIFI, with the goal of rehabilitating, reorganizing or recapitalizing it, and then returning it to the private sector. There is no requirement to liquidate the institution, and the FDIC normally would not do so without converting the conservatorship to a receivership. Creditors are permanently stayed from exercising close-out rights on QFCs based solely on the insolvency of the bank or the appointment of the FDIC as conservator.

In contrast, the FDIC's job in a receivership is to liquidate the failed institution. The Treasury Department's original proposal included a provision allowing the FDIC to take a nonbank SIFI into conservatorship, which the House of Representatives relabeled as a "qualified" receivership. However, Congress ultimately stripped this provision from the Dodd-Frank Act.

The FDIC’s obligation to liquidate an institution placed in receivership is nonetheless far less significant than it is sometimes made out to be. This obligation is only binding in the most technical sense; before liquidating the institution, the FDIC has almost unfettered discretion to transfer any or all of the firm’s assets and liabilities to a third party or bridge entity, without the need to obtain counterparty or judicial consent. It has the power to operate a bridge entity as if it were the bridge’s conservator while leaving only an empty carcase subject to the liquidation obligation.

Assuming that a bank or nonbank SIFI has sufficient unencumbered assets to pledge to the Federal Reserve or transfer to a bridge, the bank or bridge would be eligible for any of the Federal Reserve’s emergency liquidity facilities that are properly established under its discount window or section 13(3) authorities. In addition, the FDIC has authority to provide almost unlimited funding to a bridge bank or a bank in conservatorship, subject only to the least-cost-alternative test. The FDIC also has the authority to provide emergency funding to either a nonbank SIFI in receivership or a bridge entity established under the OLA, subject only to the limits in the OLA.

Although the FDIC is generally subject to equal-treatment and absolute-priority rules similar to those contained in the Bankruptcy Code, it has more discretion than a bankruptcy judge to make exceptions to those rules if necessary to maximize the value of a SIFI or avoid severe harm to the financial system. Thus, it has the discretion to transfer all of the deposits and other short-term liabilities of a bank or nonbank SIFI in receivership to a creditworthy third party or bridge entity, if necessary to achieve those goals. The FDIC has this discretion even if the transfer results in more favorable treatment for the transferred creditors than for similarly situated creditors who are left behind, or if it destroys setoff rights, subject to certain conditions. These conditions include the following: that the FDIC must transfer either all or none of the QFCs with a particular counterparty and its affiliates; that left-behind creditors must receive their minimum recovery right (similar to their


114. Id. §§ 1821(n)(7), 1823(c).

115. Dodd-Frank Act § 210(n), (o), 124 Stat. at 1463 (codified at 12 U.S.C. § 5390(n), (o)).

116. See supra note 68.


right under the Bankruptcy Code’s “best interests of creditors” rule),¹¹⁹ that under the OLA, holders of destroyed setoff rights must have priority over general creditors,¹²⁰ and that under the OLA, transferred creditors must be subject to having “excess benefits” clawed back if the FDIC is saddled with any losses from the receivership.¹²¹

The FDIC, the Federal Reserve, and certain other federal financial agencies, have the collective power to facilitate cross-border resolutions of a global SIFI. One or more of them can require bank and nonbank SIFIs to prepare living wills and to otherwise engage in contingency planning.¹²² The regulators have the authority to determine the credibility of these living wills¹²³ and to enter into bilateral or multilateral cooperation and coordination agreements with foreign bankruptcy courts or resolution agencies. This framework for cooperation and coordination with foreign courts and agencies represents one of the landmark advantages of the administrative resolution process over an Article III or bankruptcy court process.

B. Recapitalizations Within Resolution

Under the FDI Act, the FDIC’s technique of choice in resolving banks has been to sell a whole bank to a third party through a purchase and assumption transaction, with or without loss-sharing, in a competitive bidding process.¹²⁴ This technique was used to resolve Washington Mutual and almost all of the insured depository institutions that have failed since 2007.¹²⁵ This structure works well with small and medium-sized banks, but it could have serious limitations when applied to bank and nonbank SIFIs during a financial panic. For one thing, it may be difficult to find any third parties that are large enough and confident enough to purchase a SIFI at the bottom of the market during a financial panic, much less to find enough such suitors to conduct an effective auction. As a result, there is a serious risk that any bid for all or part of a SIFI’s

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¹¹⁹. Under both title II of the Dodd-Frank Act and the FDI Act, the minimum recovery right is what the left-behind creditors would have received in a liquidation. Title II further specifies that this hypothetical liquidation is a Chapter 7 liquidation. See supra note 69; cf. 11 U.S.C. § 1129(a)(7)(A)(ii) (providing the “best interests of creditors” rule in bankruptcy).


¹²³. Dodd-Frank Act § 165(d), 124 Stat. at 1426-27 (codified at 12 U.S.C. § 5365(d)).


business will be at a fire-sale price that does not maximize the value of the SIFI’s business for the benefit of its creditors and the financial system as a whole. At the same time, such a sale could also result in greater concentration in a market. The FDIC’s purchase and assumption method may therefore result in higher social costs than a taxpayer-funded bailout when used to resolve a SIFI during a financial panic.

One promising alternative is for the FDIC to use its resolution powers to recapitalize the systemically important and otherwise viable portions of a failed SIFI’s business. A detailed version of this proposal was submitted to the FDIC in a joint comment letter that I drafted on behalf of the Securities Industry and Financial Markets Association and The Clearing House Association. The comment letter was based on a discussion I had with two of my law-firm partners following a meeting with the U.S. Department of the Treasury to discuss the proposed OLA and various European bail-in proposals, and on a model subsequently developed by J.P. Morgan and certain other U.S. and non-U.S. banks. The proposed technique calls on the FDIC to use its powers to transfer the systemically important and viable part of a SIFI’s business to a bridge entity and exchange any remaining claims against the SIFI for equity in the bridge, in accordance with the priority of the remaining claims. In effect, the FDIC would divide the failed SIFI into a “good bank” and a “bad bank,” transfer the good bank to a bridge, and leave the bad bank behind. The business transferred to the bridge bank would be recapitalized by exchanging claims against the bad bank for equity in the bridge bank, and the bad bank would be liquidated.

This technique should provide a means for resolving SIFIs in a way that produces lower social costs than either a taxpayer-funded bailout or a fire-sale liquidation. If the FDIC’s bank and nonbank resolution powers can be used to achieve such a result, then a credible alternative will exist to these two evils. To

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126. SIFMA & Clearing House Comment Letter, supra note 45.

127. They are Donald Bernstein, Head of Davis Polk’s Insolvency and Restructuring Practice, and John Douglas, Head of Davis Polk’s Bank Regulatory Practice and former General Counsel to the FDIC.

128. The power to do so arises out of the provisions that grant to the FDIC, as receiver, all of the rights and powers of the shareholders, directors and management of the institution in receivership, and grant the FDIC the power to establish bridge entities, transfer any and all assets and liabilities of the institution in receivership to such bridge entities, administer the claims process against the receivership, and provide claimants with interests in a bridge entity in partial or full satisfaction of their claims against the receivership, in accordance with the priority of claims set forth in the statute. See 12 U.S.C. § 1821(d), (n) (2006); Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 210(a), (h), 124 Stat. 1375, 1460, 1462 (2010) (codified at 12 U.S.C. § 5390(a), (h)).

129. As a practical matter, this process would not take place overnight. Once the “good bank” has been stabilized and is operating in the ordinary course of business—a step that could take weeks or months—the FDIC would begin to determine how and when distributions should be made to creditors of the old bank. Like a bankruptcy judge in a Chapter 11 reorganization proceeding, the FDIC would conduct an orderly process for submitting claims, allowing claims, resolving disputed claims, and making interim distributions. The process might include the creation of a distribution reserve to hold distributable cash and equity pending the resolution of disputed claims.
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show that this technique should be capable of achieving this result, consider the example introduced in Section I.C of this Essay.

Faced with the failure of the SIFI described in this example, the FDIC would establish a bridge and transfer all of the assets of the SIFI to the bridge. The bridge would therefore receive $950 billion worth of assets, valued at their going-concern value. The FDIC would only transfer $850 billion worth of liabilities, however, in order to ensure that the business transferred to the bridge is properly recapitalized with tangible common equity equal to approximately ten percent of total assets. The FDIC would replace those senior managers, if any, who were responsible for the failure, but retain or attract the managers best suited to help operate the business going forward.

The FDIC would exchange the $150 billion in claims left behind for all of the common equity in the bridge in accordance with their pre-insolvency priorities. That equity would provide an ownership interest to the former creditors with a value of $100 billion. If necessary to preserve or restore public confidence in the financial system and avoid harm to the financial system, the FDIC might choose to transfer to the bridge all of the failed SIFI’s short-term creditors who are in a position to run. A sufficient portion of the subordinated debt and other long-term or intercompany creditors who are not in a position to run would be left behind, and would have their claims exchanged for equity in the bridge. As long as the value of the equity provided to these creditors in exchange for their claims is equal to or greater than their pro-rata share of the liquidation value of the firm’s assets, these long-term creditors would receive their statutorily-required minimum recovery.

Finally, a combination of the FDIC and the Federal Reserve would provide temporary emergency funding on a secured basis at penalty rates to the bridge until it was able to replace this funding with permanent funding at market rates from the private sector. Because the bridge would be capitalized at a tangible common leverage ratio of approximately ten percent and would be paying for the emergency funding at penalty rates, it would be able and highly

130. A rule requiring equity to be distributed in accordance with pre-insolvency priorities would require the FDIC to value the equity being distributed, if an absolute priority rule were followed as would normally be the case in a corporate reorganization. Under such a rule, if the value of the equity being distributed is not sufficient to satisfy all left-behind claims in full, only the most senior $100 billion of claims would receive any equity, and the rest of the claims would be wiped out. This could lead to serious disputes about valuations if made during a financial crisis when valuations are very difficult to determine. One way to avoid the need to value the equity and to preserve the potential for recovery by the most junior classes would be to follow a relative-priority rule instead of the traditional absolute priority rule. Under a relative-priority rule, instead of distributing a single class of common equity in the bridge, the FDIC would cause the bridge to issue equity in different classes of seniority, such as senior preferred stock, junior preferred stock, common stock, and warrants. The more senior equity securities would be distributed to the more senior claimants and the more junior equity securities would be distributed to the more junior claimants. See Douglas G. Baird & Donald S. Bernstein, Absolute Priority, Valuation Uncertainty, and the Reorganization Bargain, 115 YALE L.J. 1930 (2006); James C. Bonbright & Milton M. Bergerman, Two Rival Theories of Priority Rights of Securities Holders in a Corporate Reorganization, 28 COLUM. L. REV. 127 (1928).
motivated to obtain private sector funding at market rates as soon as the financial panic recedes or the market regains confidence that the new firm has a viable business going forward.

The social costs of this recapitalization would be $50 billion (the gross write down of $150 billion, less the $100 billion value of the new common equity received in satisfaction of the debt claims), plus the costs of the emergency funding at the penalty rate. If implemented properly, this procedure would avoid the catastrophic social costs of a fire-sale liquidation, both in terms of lost value to the SIFI’s creditors and in terms of the risk of severe harm to the financial system. At the same time, it would avoid the social costs associated with increased moral hazard from a taxpayer-funded bailout: senior managers responsible for the failure will have lost their jobs, and the firm’s shareholders and creditors will have borne all of the SIFI’s losses and paid the penalty rate for the emergency funding. In short, by using its resolution powers in this manner, the FDIC would have resolved the institution in a manner that produced lower social costs than either a taxpayer-funded bailout or a fire-sale liquidation. Thus, recapitalization within resolution should be a credible alternative to taxpayer-funded bailouts.

C. Important Considerations: Prudence, Wisdom, and Skill

While these powers should be among the most useful tools in the regulatory toolbox if properly used, they could also become the most dangerous new tools through unwise or unskillful use. To illustrate this potential, compare the FDIC’s resolution authorities to a power tool such as a table saw. When used properly, a table saw is much more efficient than a manual saw. In the wrong hands, however, its saw-toothed blade, spinning at over 3000 rotations per minute, can be exceptionally dangerous. What makes particular hands the wrong hands? Among other factors, a lack of practice and a failure to consider the differences in the type of wood being worked. A beginner who is accustomed to working with white pine—a soft, dry wood—would not necessarily be prepared to work with cedar—a hard, gummy wood.

Although the FDIC has considerable experience resolving community and medium-sized banks under its bank-receivership authority, it has no experience resolving a global SIFI. The businesses and balance sheets of global SIFIs are very different from and more complex than those of community and regional banks. For example, among the large community and regional banks and thrifts that failed between 2008 and 2010, approximately ninety-seven percent of liabilities on average consisted of domestic deposits and secured borrowings from the Federal Reserve or the Federal Home Loan Bank System. In

131. See DAVIS POLK & WARDWELL LLP, SIMPLIFIED BALANCE SHEETS FOR ALL BANKS AND THRIFTS WITH ASSETS GREATER THAN $500 MILLION THAT FAILED FROM JANUARY 1, 2008 THROUGH
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contrast, among the six largest bank holding companies in the United States at the end of 2009, the corresponding figure was less than forty-five percent.\textsuperscript{132} Not only have foreign deposits typically been excluded from FDIC deposit insurance, they do not enjoy the same depositor preference as domestic deposits unless they are payable at a domestic office.\textsuperscript{133} Instead, they are generally ranked equally with the claims of general creditors.\textsuperscript{134}

Because bank and nonbank financial institutions tend to fail in large bunches or waves, with decades between each wave, there is a substantial risk that the FDIC will find itself in the role of an amateur carpenter who does not use his table saw often enough to retain his skill. In addition, because of the substantial differences between the balance sheets and operations of a global SIFI and a community or regional bank, the FDIC may be like a carpenter working with unfamiliar wood. If so, these otherwise useful tools would be dangerous instruments in the hands of a well-intentioned but unskilled craftsman, a menace to himself and to his work.

\textbf{D. Important Considerations: Cross-Border Cooperation}

A full discussion and analysis of the impediments to cross-border resolutions are beyond the scope of this Essay. It is worth noting, however, that the resolution model should be more effective than the bankruptcy model in identifying and addressing impediments to cross-border resolutions. Financial regulatory agencies are in a better position than judges to identify and design solutions for any impediments through the living will process or through bilateral discussions with foreign resolution authorities.

One obvious impediment, which has already been identified above, is the need for host-country authorities to have the discretionary power to cooperate with home-country resolution authorities to facilitate a cross-border resolution. Although U.S. law authorizes the FDIC to transfer all of the assets and liabilities of a bank or nonbank SIFI to a bridge without counterparty or judicial consent, that authority cannot override the conditions for a valid transfer of assets, liabilities, or contracts located in foreign countries, or the foreign change-in-control requirements for foreign branches or affiliates. Those conditions and requirements are governed by foreign law, and U.S. law cannot override them extraterritorially. In addition, U.S. law cannot prevent a foreign regulatory authority or court from ring-fencing local assets to satisfy local

\textsuperscript{132} See \textsc{Davis Polk} \& \textsc{Wardwell LLP}, supra note 93, at 1. Specific figures ranged from a low of under 26% for the Goldman Sachs Group to a high of 70% for Wells Fargo \& Co. \textit{Id.} Among the holding companies' bank subsidiaries, domestic deposits and secured liabilities accounted for an average of 67% of liabilities, with a low of 34% for Citibank and a high of 96% for Morgan Stanley. \textit{Id.}


\textsuperscript{134} See \textit{id.}
liabilities, even if this is an impediment to a value-maximizing, systemic-risk-minimizing cross-border resolution. Thus, the FDIC and other U.S. regulatory agencies have no choice but to coordinate and cooperate with foreign regulators, legal bodies, and courts to facilitate a cross-border resolution of a global SIFI with its headquarters in the United States.

The recapitalization-within-resolution model should facilitate such cross-border cooperation by helping the FDIC to persuade foreign authorities that it is in their interest to cooperate with the cross-border resolution and not to ring-fence foreign assets. This is because cooperating with a well-run recapitalization of the viable part of the SIFI’s business should produce substantially more value for all creditors than a fire-sale liquidation pursuant to local ring-fencing. Once again, then, a well-designed recapitalization-within-resolution should mitigate the potentially catastrophic collateral consequences to the global financial system that could result from a fire-sale liquidation.

E. Important Considerations: Enhanced Due Process Safeguards

Advocates of the proposed new Chapter 14 of the Bankruptcy Code have criticized the OLA (though not the FDI Act’s bank receivership provisions on which it was modeled) for giving the FDIC a dangerous amount of discretion; they claim the FDIC is insufficiently constrained by due process safeguards designed to protect against incompetence, political manipulation, favoritism, and other potential problems. These criticisms reflect a legitimate concern that the extraordinary discretion provided to the FDIC might permit a future FDIC to turn its resolution authorities into a sort of financial Star Chamber. At the extreme, leaders in authoritarian countries have sometimes used discretionary powers to nationalize the financial system for political reasons, in order to punish political enemies and reward favorites. While such an abuse of discretion is far less likely in a democratic country like the United States,

135. See, e.g., SKEEL, supra note 65, at 122; Wallison, supra note 111; Jackson, supra note 17, at i-i, 1-6 to -7, 1-13.

136. The Court of Star Chamber was established during a war-torn period in medieval England to ensure the fair enforcement of laws against nobles who were able to escape justice in the ordinary courts. Its proceedings were closed to the public and many of the traditional due process protections were suspended for the sake of efficiency and to avoid allowing the guilty to go free based on legal technicalities. It was initially well-regarded because of its speed and flexibility, but over time, it evolved into a political weapon used by the monarch to punish enemies and favor friends. See generally Emory Washburn, The Court of Star Chamber, 12 AM. L.R. 21 (1877) (describing the history of the Court of Star Chamber). The court has come to symbolize “a system of arbitrary measures, where the forms of judicial proceedings are made the means of perpetrating acts of injustice, or of consummating schemes of oppression and wrong.” Id. at 21.

137. For example, the Soviets nationalized the Soviet banking system in 1918, see GEORGE GARVY, MONEY, FINANCIAL FLOWS, AND CREDIT IN THE SOVIET UNION 24 (1977), and Benito Mussolini nationalized the Italian banking system in 1933, see ALEXANDER J. DE GRAND, FASCIST ITALY AND NAZI GERMANY 52 (2d ed. 2007).
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with built-in checks and balances, appropriate due process protections—at least on an *ex post* basis—can further insulate the process against abuse or error.\footnote{138}{One possible model for such *ex post* safeguards is the process by which Congress compensated creditors who were affected by the reorganization of bankrupt northeastern railroads into the Consolidated Rail Corporation in the early 1970s. See Note, *Valuation of Conrail Under the Fifth Amendment*, 90 HARV. L. REV. 596, 596-97 (1977) (describing statutory compensation mechanism).}

As discussed in Section III.A, one of the principal advantages of the Bankruptcy Code is its superior due process safeguards. Unfortunately, these same safeguards prevent the Code from providing a credible alternative to taxpayer-funded bailouts during a financial panic. This necessarily results in certain compromises regarding *ex ante* due process, which are justified on the basis of the principle that justice delayed can be justice denied when a SIFI’s liquidation value rapidly approaches zero during a financial crisis.

Just because some *ex ante* due process safeguards may need to be sacrificed in favor of speed and flexibility, however, does not mean that they should be discarded unnecessarily, or that substitute *ex post* protections should not be provided. Nor does it mean that Congress has struck the right balance between discretion and due process in the OLA or the FDI Act. Certain measures that could improve the balance involve the traditional due process safeguard of judicial review. These include subjecting the administrative claims process to full, contemporaneous judicial review, without interfering with the FDIC’s power to exercise its “core” resolution powers with greater dispatch by transferring a firm’s assets and liabilities to a bridge, recapitalizing the business transferred to the bridge, and providing temporary funding to the bridge. In addition, these may include establishing an efficient judicial process for claimants to bring individual actions against the FDIC in a single collective proceeding.

Other measures would impose greater oversight over the FDIC. Congress might choose to create a systemic resolution board consisting of representatives from the Federal Reserve, Treasury, and the FDIC to direct and oversee the FDIC’s bank and nonbank resolution powers; require the FDIC to make an annual report to Congress, describing how it has used its resolution powers and how it would plan to use them in the event of a future financial panic; and mandate that it disclose publicly all material information related to the sale of any financial institution, including material agreements and statistical information about the number of bidders, types of bidders, range of bidding prices, winning price, and other material terms and conditions. Yet other measures would alter in subtle but important ways the FDIC’s statutory authorities. For example, Congress might require the FDIC to issue comprehensive regulations clarifying the rights of stakeholders of bank SIFIs, as it must now do for nonbank stakeholders under the OLA; extend the OLA’s due process protections to the FDI Act, including clarified equal treatment and absolute or relative priority rules, minimum recovery rights, setoff rights, and...
suspension of cross-affiliate defaults; and confirm the FDIC’s duty to maximize the value of an institution in receivership for the benefit of its creditors, subject only to actions deemed necessary to prevent severe harm to the financial system. Finally, other measures would improve the FDIC’s procedures, such as by providing secured creditors with the right to credit bid for their own collateral as a protection against valuation disputes with the FDIC,139 or by establishing standards and procedures for determining hypothetical liquidation value that defines each creditor’s minimum recovery entitlement.

Conclusion

The FDIC’s new and traditional resolution powers have the potential to provide a credible alternative to the choice between the two evils of taxpayer-funded bailouts and a disorderly liquidation or value-destroying reorganization under the Bankruptcy Code. Because most failures of banks and other financial institutions come in waves during financial panics, with almost no failures during the decades between these extraordinary events, the FDIC will not have the opportunity to use these tools very often. In addition, the balance sheets and businesses of SIFIs are very different from those of the community or regional banks with which the FDIC has the most experience. As a result, the bank and nonbank orderly resolution authorities will be like power tools that are used only rarely, on new and unfamiliar objects. If used properly to effect a value-maximizing recapitalization of the systemically important and other viable part of a SIFI’s business, they should provide a credible alternative to taxpayer-funded bailouts. If used unwisely, unskillfully, or unscrupulously, however, they have the potential to be the most dangerous tools in the regulatory toolkit. The risk of these potential dangers can be mitigated by enhanced due process safeguards.

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139. That is, a secured creditor would be allowed to use a portion of its claim equal to the FDIC’s valuation of the collateral to bid for possession and control of the collateral, resulting in the claim being reduced by the amount of the credit bid.