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A Guide to The

RESOLUTION OF FAILED FINANCIAL INSTITUTIONS:
DODD-FRANK TITLE II AND PROPOSED CHAPTER 14

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I. Background

The "Resolution Project" began in August 2009, in the midst of the financial crisis, to consider how best to deal with the failure of major financial institutions. The members of the group, assembled from institutions across the country, were Andrew Crockett, Darrell Duffie, Richard Herring, Thomas Jackson, William Kroener, Kenneth Scott (chair), George Shultz, Kimberly Summe and John Taylor, later joined by David Skeel[1]. A number of meetings and discussions led to papers and then a conference in December 2009, followed by a book: *Ending Government Bailouts* (K. Scott, G. Shultz & J. Taylor, eds. 2010).

The heated debate in Congress over the proper response continued until July 2010, culminating in the Dodd-Frank Wall Street Reform and Consumer Protection Act (Pub. L. 111-203). This massive statute runs for 848 pages, contains 16 titles, requires 386 more agency rulemakings, and mandates 67 studies. Most of it was a collection of assorted changes to the financial system that various groups had been advocating for some time, unrelated to the causes of the panic.

1 Biographical information may be found at the end of this volume.

A popular conception, in the press and Congress, of the cause of the panic was that when the investment bank Lehman Brothers failed in September 2008, it had to be put into bankruptcy reorganization because (unlike commercial banks) it could not be taken over by FDIC. Whatever its merits, that view provided much of the impetus for the enactment of Titles I (Financial Stability) and II (Orderly Liquidation Authority) of the Dodd-Frank Act, which were intended to prevent the failure of systemically important (nonbank) financial institutions (SIFIs) and, if that was unsuccessful, provide for a new failure procedure whereby the Secretary of the Treasury could institute the takeover of a SIFI with the FDIC becoming the receiver.

Title I created a new Financial Stability Oversight Council, composed of the heads of various financial regulatory agencies, which is to collect data about financial companies and financial risks, and to identify financial companies that could pose a threat to US financial stability. Such companies would be supervised by the Fed and subjected to a list of more stringent prudential standards and requirements.

Title II authorizes the Secretary of the Treasury, upon recommendation by the Fed and FDIC, to determine that a financial company is in default or danger of a default that would have serious adverse effects on US financial stability, and then to petition the DC district court to appoint the FDIC as receiver to "liquidate" the company. Title II, and not the bankruptcy code, would govern the receivership.

The Resolution Project group turned its focus to the development of a supplemental proposal for a modified bankruptcy law, denominated as a new Chapter 14[2], designed exclusively for major financial institutions. This paper is written for a moderately knowledgeable audience and is intended to identify and compare the major differences in the Dodd-Frank Title II and Chapter 14 procedures, and to outline the reasons why the group believes the latter to be preferable. Sections 202 and 216 of the Dodd-Frank Act (the "Act") called for an inquiry on bankruptcy resolution to be conducted by the GAO, the FRS Board of Governors and the Administrative Office of the

2 The current version (previously entitled Chapter 11F), primarily authored by Tom Jackson following extensive discussion and input from the other members of the Resolution Project, is the next chapter in this volume.

United States Courts, and one of the Resolution Project's goals was to make a contribution to that analysis and its consideration by the Congress.[3]

II. Objectives of resolution law for major insolvent financial firms

Any failure law for business firms has a number of objectives, not always fully consistent. One is to provide a mechanism for collective action by creditors to realize on the assets of the firm in an orderly manner, as opposed an individual scramble for whatever could be seized and sold first, and apply the proceeds to claims in accordance with the contractual priorities for which they had bargained and charged. An efficient procedure for maximizing recoveries, involving notices and hearings, contributes to meeting expectations and reducing losses, and hence to lower costs of capital for the carrying on of all business enterprises.

A second objective, which could be seen as an adjunct to the first, is to retain the "going-concern-value" of any parts of the business which can still be operated at a net profit through a "reorganization" of the firm, as opposed to the liquidation sale of its various assets. This is particularly significant for financial firms, much of whose value lies in the organization, knowledge and services of its personnel and their relationships to clients, rather than in separately saleable assets like inventory, real estate, buildings and machinery.

A third objective, perhaps uniquely so for "systemically important financial institutions", is to avoid a breakdown of the entire financial system. What this means, and what it entails, will be considered toward the end of this paper. So we turn next to an examination of the differences between the Act and Chapter 14, necessarily limiting it to central concepts and omitting a host of (not at all unimportant) details.[4]

III. Financial institutions covered

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3 The agency reports when submitted did not make recommendations but surveyed the principal issues and arguments. The Project's proposals are reviewed at some length in the FRB's "Study on the Resolution of Financial Companies under the Bankruptcy Code" (July 2011).

4 Broker-dealers and insurance companies have special separate provisions in the Act.

A. Dodd-Frank

The Act excludes from its coverage banks and (notably) government-sponsored entities (such as Fannie Mae and Freddie Mac)[5], and includes in its coverage companies predominately (on the basis of either assets or revenues) engaged in financial activities. From the large universe of financial companies, the Federal Reserve Board ("Fed") is supposed to give especially intensive supervision to all bank holding companies with over $50 billion in consolidated assets and those financial companies that the Financial Stability Oversight Council has selected as potentially posing a threat to US financial stability in the event of its financial distress[6]. But whether or not so pre-designated or supervised, *any* financial company that the Secretary of the Treasury determines to be in danger of default with serious adverse effects on financial stability[7] may be seized and put into FDIC receivership by petition to the DC district court[8]. Financial companies that are not so chosen would remain under the existing Bankruptcy Code. In other words, application of Title II of the Act is left to administrative discretion, defined only by 'findings' that the agency itself makes at the time of action.

B. Chapter 14

The new Chapter applies to all financial companies and their subsidiaries with more than $100 billion in consolidated assets. Counterparties would generally not be left in doubt as to what companies will be subject to a special resolution procedure and what ones will be dealt with under the present Bankruptcy Code provisions. Uncertainty in financial transactions increases risk and costs for everyone, and is to be minimized wherever possible.

5 The latter is a major omission, since the CBO estimated back in August 2009 that their losses would cost taxpayers more than $290 billion, far more than the cost of assistance to all other financial companies combined.

6 §113(a)(1). All section references are to the Dodd-Frank Act, Pub. L. 111-203 (July 21, 2010).

7 §203(b).

8 §202(a).

IV. Commencement of proceedings

A. Dodd-Frank

The Act creates an elaborate, and potentially cumbersome, bureaucratic process for triggering seizure of a financial company. The Fed and FDIC (or other primary federal regulator) jointly make a recommendation to the Treasury Secretary, based upon consideration of a list of factors that includes the reason why proceeding under the Bankruptcy Code is not appropriate. The Treasury Secretary then determines, among other things, that the firm is a financial company projected to be in danger of a default (because of insufficient capital or ability to pay its obligations when due) that, if handled under the Bankruptcy Code, would have serious adverse effects on US financial stability[9].

The Secretary thereupon files a petition in the DC district court to appoint the FDIC as its receiver (unless the company's board consents). The statute mandates that within 24 hours (1) there is a closed and secret hearing in which the Secretary presents all the accumulated documentation underlying the agency recommendations and his conclusions, (2) the company can try to present a rebuttal as to its portfolio asset valuations and capital or access to liquidity, (3) the judge considers all the conflicting evidence, and (4) the court issues either an order authorizing the receivership, or a written opinion giving all reasons supporting a denial of the petition. If the district court can not accomplish all that within 24 hours, the petition is granted by operation of law[10]. Apart from the obvious impossibility of an effective rebuttal by the company, much less of findings of fact and a reasoned decision by the court, within such a truncated time frame, any appeal to a higher court would be limited to that one-sided, one day record, and any stay of the liquidation is prohibited.[11] This summary procedure raises substantial

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9 §203(b).

10 §202(a)(1)(A)(v).

11 §202(a)(1)(B).

Constitutional problems under the Due Process Clause which could invalidate the entire Title II mechanism[12].

B. Chapter 14

To the involuntary procedure in current bankruptcy law, initiated by unpaid creditors, there is added authority for the financial institution's primary regulator to commence a case both on the grounds applicable to other involuntary petitions as well as on the ground of "balance-sheet" insolvency: its assets are less than its liabilities, or it has unreasonably small capital. This is analogous to the "in default or in danger of default" concept in Dodd-Frank[13], but the company has an actual opportunity in a court to challenge the assertion (in closed and secret hearing, should the judge deem appropriate), without a truncated time-frame, if it really disputes the adverse judgments on its financial soundness or believes the administrative valuations of its illiquid (non-traded) assets are demonstrably erroneous.

Chapter 14 retains the ability of the management of a firm to itself initiate a voluntary proceeding in lieu of having to go into FDIC receivership. If the management sees the firm's financial position as becoming untenable, it does not have to wait for balance-sheet insolvency or default on obligations, but can inaugurate a reorganization to try to salvage in part its business and retain its jobs. Much recent history indicates the tendency of banking regulators for various reasons not to take over prior to complete insolvency (as the FDIC Improvement Act of 1991 authorized them to do) but to wait until losses to the deposit insurance fund have become substantial despite its supervisory powers and stake as the primary creditor. The Dodd-Frank seizure procedure was designed to require a consensus of a set of government agencies before taking action. The history of voluntary bankruptcy, on the other hand, is replete with examples of pre-emptive action in which asset values are written down, there is a negotiation to allocate losses among claimants (with stockholders being the first to go), and a reduced business continues in successful operation, sometimes under existing management (which as

12 For discussion, see K. Scott, "Dodd-Frank: Resolution or Expropriation?" in this volume.

13 §203(c)(4).

explained below Dodd-Frank makes very unlikely). Incentives for management to act in a more timely fashion than receivership liquidation are socially valuable.

V. The resolution procedure

A. Dodd-Frank: FDIC as receiver

One of the reasons stressed in Congress for enactment of Title II was FDIC's long experience in liquidating failed commercial banks. But the SIFIs with which the Act is primarily concerned are giant firms—hundreds of billions or even trillions of dollars in size, with any commercial bank as only one part of the complex. FDIC's experience has been in dealing with numerous small and medium-sized banks, in which it is by far the biggest creditor through the deposit insurance fund, and for which there are often obvious—and larger—institutions ready to take over; only in the last several years has it encountered a few very large ones, with a wider variety of assets and claimants[14]. And in the case of a common reassessment type of systemic event (see part VI.A), it might have to take on a number of such institutions at the same time—a situation for which no one has experience or existing capacity.

The Act mandates[15] that the seized financial company shall be liquidated; it may not be reorganized, and the management "responsible" must be immediately removed[16]. It is evident that the mandate was intended to be more punitive than value enhancing. There may be indirect ways to avoid its needless value destruction, but it is certainly not conducive to efficient resolution, a process which the Act recognizes could take more than 5 years to complete.[17]

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14 For a fuller discussion, see D. Skeel, *The New Financial Deal* 117-27 (2011).

15 §214.

16 §206.

17 §202(d).

More troubling is the power of the receiver to operate without transparency and not observe standard bankruptcy rules intended to adhere to absolute priority of claims and equal treatment of claimants in the same category. (Although many of the relevant Title II provisions have been imported from the Bankruptcy Code, all provisions for hearings and creditor votes were not.) The Act authorizes the FDIC to transfer assets *and liabilities* as it sees fit to a "bridge" institution where they are fully protected[18], and depart from equal treatment of unsecured receivership claimants if it decides that would be good for the receivership estate[19]. If those dealing with a large financial institution have to calculate the risk they are assuming not only on the basis of business assessments but on the basis, not of reasonably settled legal rules, but of predictions of the exercise of legally unreviewable political discretion, a major cost and burden is imposed on the operation of financial markets.

B. Chapter 14

Bankruptcy judges have been handling the liquidation and reorganization of very large and complicated companies for decades. Nonetheless, it should be recognized that giant financial firms pose some particular issues. Therefore, Chapter 14 contemplates the development of a small (since hopefully cases will be few and infrequent) and specialized panel of district and bankruptcy court judges and special masters that would oversee these cases. Like FDIC, they would have to develop some special expertise with giant SIFIs over time. The details are spelled out in the full paper on Chapter 14 next.

In a typical Bankruptcy Code proceeding, management (as the "debtor-in-possession" or "DIP") remains in control of ordinary business operations, and has an exclusive period in which to file a plan of reorganization. Upon creditor petition, the bankruptcy court may turn control over to a bankruptcy "trustee." Under Chapter 14, the financial company's primary federal regulator could initiate the proceeding, and could petition to have the FDIC appointed as a trustee. FDIC would then function under

18 §210(h)(1).

19 §210(b)(4). The FDIC has adopted a rule stating that it will not use its authority to depart from equal treatment for holders of long-term senior debt, or subordinated debt, or shareholders. 12 C.F.R. §380.27.

Chapter 14 and therefore have the option (lacking in Title II of the Act) to pursue openly a traditional reorganization to maximize the business's value for benefit of creditors, rather than being forced to liquidate it in a formal sense to satisfy §214. In addition, there would be no period of exclusivity in Chapter 14 in which only management could propose a plan of reorganization; both the FDIC and a creditor's committee would be given concurrent rights to file such a plan.

Whoever was in charge, resolution under Chapter 14 would be conducted under established (Chapters 11 and 7) bankruptcy rules about absolute priority, avoiding powers, transfers and preferences (except as noted in part VI.C below). Dispositions of cash and of assets outside the ordinary course of business require creditor notice and opportunity for hearing, particularly on the value being received. Plans of reorganization, with their allocation of losses among claimant classes, are subject to approval votes and judicial oversight. The resolution would proceed in the open, unlike present FDIC practices.

These requirements constitute safeguards against, not only erroneous administrative judgments, but also political manipulation and favoritism of selected interests. That such concerns are not merely speculative is illustrated by the way the Government managed the Chrysler bankruptcy under the current bankruptcy code to avoid creditor voting rights[20]. This defect is partially addressed in the new Chapter 14, through the provisions entrusting this category of cases to Article III judges with life tenure. In addition, other broader safeguards are included to ensure that sales under Section 363 of the Bankruptcy Code don't, sub rosa, avoid the safeguards of voting under plans of reorganization and protection of dissenting creditors.

VI. Systemic risk – breakdown of the financial system

A. Concepts of systemic risk – what exactly is the scenario?

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20 M. Roe & D. Skeel, "Assessing the Chrysler Bankruptcy," 108 Mich. L. Rev. 727 (2010).

Systemic risk is much referred to but typically not defined operationally or modeled in any generally accepted form[21]. At least three different (if at times overlapping) notions can be found[22]. All describe paths to the failure, or failure to function, of a large number of major financial institutions and a breakdown of the system for allocating financial credit.

Type 1: Macro shocks—massive losses or disruptions simultaneously affecting many key institutions in the economy. Suppose the 9/11 al Qaeda attack had not been aimed at creating the dramatic psychological shock of the collapse of the WTC towers but instead at destroying the records and transactional capacity of the Federal Reserve Bank of NY and the New York and Nasdaq stock exchanges. Or suppose, for a more recent example, the Japanese earthquake, tsunami and nuclear power failure had all been centered on Tokyo instead of 150 miles to its north.

Type 2: Chain reactions—"domino" effects from the unexpected failure of a single giant institution. Losses from the initial collapse could cause some counterparties to become insolvent in turn, and the process could keep going outward from there. Some have seen the Lehman failure in this light, although in fact no significant counterparty was rendered insolvent.

Type 3: Common reassessments—affecting institutions with similar asset portfolios, whether or not directly linked. Thus the rescues or collapses in a ten day period in September 2008 of important institutions with large holdings of, or exposure to, (especially subprime) mortgage-backed securities (MBS)—from the giant mortgage firms Fannie and Freddie to Merrill Lynch to Lehman Brothers to AIG—led banks and financial institutions throughout the world to become uncertain of each other's solvency, and discontinue or sharply raise the price of extensions of credit. With credit flows greatly reduced, the crisis spread from the financial to the real economy, and a severe recession was underway.

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21 J. Taylor, "Defining Systemic Risk Operationally," in K. Scott, G. Shultz & J. Taylor eds., *Ending Government Bailouts* (2010).

22 G. Kaufman & K. Scott, "What is Systemic Risk…", VII Independent Rev. 371 (2003).

The September 2008 panic thus seems to belong mostly in the third category. Inadequacy of disclosure of specifics of hundreds of billions in loan and securities holdings, and skepticism as to their valuations on balance sheets, contributed greatly to the problem. Growing anxieties in 2007 about valuations led over time to MBS becoming nearly untradeable, which the Fed apparently perceived initially as due mainly to insufficient liquidity in the financial system, though it had tried to address that issue with a host of new lending facilities beginning in late 2007 and extending through 2008 into 2009[23]. But the September crunch had jolted financial institutions into critically reassessing their counterparties' potential economic insolvency, and more liquidity did not remove that concern. In October 2008 the Treasury converted the TARP program into capital investments of $10 to $25 billion in the six largest banks, which were more a signal of implied Government guarantees against their failure than clearly sufficient by themselves to ensure their capital solvency against adverse portfolio outcomes.

B. Dodd-Frank

The concept of systemic risk underlying the Title II machinery is not clear in either the Act or its legislative history, but it seems to correspond most closely to trying to prevent a Type 2 chain reaction, in accordance with the often asserted myth that Lehman going into bankruptcy, because the Treasury lacked the power to seize it, was the cause of the panic. Lehman's failure was certainly one of the events that contributed to the September 2008 loss of confidence and panic, as discussed above, but just why would subsequent receivership by the FDIC, instead of the bankruptcy court, have made a difference in that regard? No one would have been reassured about the composition and valuations of MBS in others' portfolios, and the Act does nothing to cure the informational and valuation deficiencies that played a critical role in the credit crisis, beyond authorizing the SEC to require some additional disclosure from issuers of asset-backed securities[24].

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23 See St. Louis Fed events timeline, available at http://timeline.stlouisfed.org.

24 §942.

The Act requires SIFIs to prepare detailed resolution plans or “living wills” to facilitate their wind-downs, but on the basis that it occurs under the Bankruptcy Code and not a Title II receivership[25]. (And if the problem is actually one of liquidity pressure on an otherwise solvent institution, the Act makes the problem worse by abolishing the Fed’s §13(3) emergency authority to act as a lender of last resort to a non-bank financial company.)[26]

Everyone proclaims that they are opposed to bailouts, but most seem to find it unnecessary to define what they are talking about. For my purposes, a bailout occurs when some favored claimants on a failed financial firm are given more than what they would receive in an ordinary bankruptcy, at the expense of others. The additional money might come from several different sources:

- It might come from the Government: authorized expenditures by the Treasury (as in the Orderly Liquidation Fund), guarantee payments from the FDIC, or non-recourse “loans” by the Fed.
- It might come from an “assessment” on prudent financial companies which did not fail.
- It might come from the receivership estate at the expense of disfavored creditors.

But whatever the source, moral hazard is created: the favored creditors have reduced or no reason to pay attention to the behavior of the debtor (now failed) firm, and the likelihood of such failures is increased.

Title II gives FDIC power to obtain immediately from the Treasury financing funds equal to 10% of the (book) value of the seized firm[27], and much more thereafter.

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25 §165(d)(4).

26 §1101.

27[2]5 §210(n)(6).

Those funds may be made available to a “bridge” institution[28], which can use them to pay liabilities transferred to it from the receivership. Therefore, perhaps the unstated premise is that the FDIC under Title II would include all those significant financial counterparties that it thought might be endangered and immediately transfer their claims (and sufficient assets or advances to cover them in full), together with other liabilities, to a bridge bank, if it felt that necessary to prevent a potential chain reaction of insolvencies. (That did not occur in the actual Lehman bankruptcy case, but put that aside.)

That would create two classes of general unsecured creditors of equal priority but different treatment: those transferred to the bridge company with full payment, and those left behind in the receivership with partial recovery.[29] The Act requires that “similarly situated” creditors be treated in a “similar manner” *except* if the FDIC “determines” that preferences would increase net proceeds and the disfavored creditors would get at least what they would have received in a Chapter 7 liquidation.[30] (That determination and the selection of creditors to be favored are based upon unreviewable agency discretion.[31])

That is possible, of course, only if liquidation under Title II would always yield enough more than under the Bankruptcy Code to cover the preferential payouts. Justifying that premise gives rise to an incentive – indeed, perhaps a necessity – for the FDIC in ‘determining’ how much unsecured general creditors would have gotten in a hypothetical Chapter 7 liquidation to utilize unfavorable assumptions and produce a low figure, thereby increasing the scope of its ability to choose creditors to be paid the face value of their claims.

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28 §210(h)(2)(G)(iv).

29 §§210(h)(5)(E), 210(d)(4).

30 §§210(b)(4), 210(d)(2).

31 A creditor can file suit to have a court determine the validity or amount of a claim against the failed institution (§210(a)(4)), but judicial review of FDIC’s decisions on claim transfers is prohibited. §210(a)(9)(D)(ii).

If the final result of asset liquidations and (if needed) certain creditor payment recoupments [32] is insufficient for the receiver to fully repay its Treasury advances, then a scheme is to be devised to assess the loss on the entire universe of SIFIs[33], whether or not the causes of the initial failures lay in large part on government policies, as was true in 2008.[34]

The intention, stressed throughout the Congressional consideration, is that taxpayers are not to bear the cost of a "bailout" of a financial company. But the real problem with bailouts comes from the protection of creditors, not stockholders (who are significantly or wholly wiped out in most bankruptcies). Shifting losses from taxpayers to an entire industry does not solve the problems arising from weakening or destroying the incentives of a firm's creditors to watch and restrain its risk taking.

A particular set of creditors deserves special attention in this regard: those who have entered into "Qualified Financial Contracts" (QFCs) with a failed firm. QFCs include repo's, interest rate and currency swaps, credit default swaps, and other derivatives; their notional amount has reached the hundreds of trillions of dollars. Title II of the Act carries forward most of their preferential treatment under current bankruptcy law. For these creditors, there is now an automatic one day stay on collecting debts by terminating contracts and seizing and selling collateral , but they need not return prior (within 90 days) preferential payments or additional collateral, they have broader setoff rights, and so on. The complexity and legal status of Lehman's derivatives book—930,000 transactions—would be much the same under Title II as it was under the present Bankruptcy Code, where derivatives were terminated swiftly and efficiently but after three years claims are still being valued and settled[35].

32 The FDIC has 5 years or more to levy assessments on favored claimants to recover the excess they previously received over liquidation amounts. §210(o)(1)(D)(i).

33 §210(o)(4) contains a long list of 'factors' to be taken into account in coming up with an actual plan.

34 See K. Scott, "The Financial Crisis: Causes and Lessons," 22 J. App. Corp. Fin. 22 (2010).

35 K. Summe, "An Examination of Lehman Brothers' Derivatives Portfolio Post-Bankruptcy: Would Dodd-Frank have made a Difference?" in this volume.

These provisions make the covered channels of short term financing of a firm's operations much safer, and hence cheaper, but they also make its counterparties (who constitute the most sophisticated and best informed of all creditors) much more tolerant of its management's indulgence of risky strategies. There is an inherent trade-off at stake, and current QFC law leans heavily toward encouraging risk and discouraging market discipline[36].

C. Chapter 14

As compared to the present Bankruptcy Code, limited creditor advances are facilitated if needed to reduce perceived contagion concerns, but on the basis of a court hearing and approval (which can be quite speedy when justified) of the claimed need. Since reorganization is a permitted option, rather than a formally prohibited one, DIP financing is expressly authorized to continue operations and can be given the priority of "administrative expenses".

There is a popular conception that there cannot be a successful reorganization of a failed SIFI, because counterparties would stop dealing with it. But post-petition creditors' unsecured claims, unlike their pre-petition ones, go near the top of the payment priority ladder as 'administrative expenses'. If the Government believes that systemic concerns are at stake, it could be authorized to provide subordinated DIP financing (along the lines of the Title II Orderly Liquidation Fund) in amounts more than adequate to cover all new claims and all assumed existing contracts, as explained next.

Chapter 14 makes a distinction in the treatment of QFCs. Repo's would be treated as secured loans, and the counterparty given the right to immediately sell the collateral *if* highly-marketable securities (but not, for instance, MBS as the 2005 law authorized). This would preserve the use of repo's as nearly risk-free short term financing, but only under conditions where the sale of collateral would not have drastic

36 M. Roe, "The Derivatives Market's Payment Priorities as Financial Crisis Accelerator," 63 Stan. L. Review 539-90 (2011); D. Skeel & T. Jackson, "Transaction Consistency and the New Finance in Bankruptcy," Penn. ILE Research Paper No. 11-06 (Feb. 2011), available at htpp:/ssrn.com/abstract=1773631, forthcoming in 112 Columbia L. Review 152 (2012).

market price effects. All other swaps and derivatives with a counterparty would be subject to a three day stay, giving the debtor a window to assume (for example, if 'in the money') or reject them all (or transfer them all in bulk to a new counterparty), and also to some preference limits. The objective is to make a somewhat different trade-off between efficient institutional financing and creditor monitoring incentives[37].

VII. Conclusions

A. Dodd-Frank

The Act places heavy reliance on agency discretion, not only in the hundreds of regulations yet to be issued under Title I dealing with the operation of financial firms and markets, but more specifically in the coverage of Title II resolution jurisdiction and the seizure and administration of 'failed' firms. To be effective, regulators will somehow have to have better judgment and foresight into an always uncertain future than was in evidence over the last decade.

Along with the reliance on discretion come low transparency and few checks on errors or abuses of authority. The agencies are supposed to make 'findings' to support their actions, but there is no opportunity for meaningful judicial review and legal accountability. Bailouts of the failed firm (that is, its stockholders) are prohibited, but bailouts of creditors are not; there is discretion over the allocation of losses among creditors. Ironically, proponents of Dodd-Frank always refer to its resolution procedure as "orderly," unlike bankruptcy resolution which is always referred to as "disorderly," although in what respect is not elucidated. In reality, both procedures are highly structured, albeit along different lines and with different degrees of predictability.

All of this produces uncertainty, and the associated costs to financial institutions and transactions. The role of market discipline by informed counterparties with financial stakes is diminished.

B. Chapter 14

37 For fuller discussion, see Skeel & Jackson, op. cit. supra n. 36, and Duffie & Skeel, "A Dialogue on the Costs and Benefits of Automatic Stays for Derivatives and Repurchase Agreements" in this volume.

There is less reliance on unexplained agency decisions reached in private, and more on judicial hearings and reasoned public opinions. Greater emphasis is placed on preserving or creating private incentives to monitor and check firms accepting risks that outsiders view as excessive or misinformed.

Failure losses are allocated to creditors based on known claim priorities. It is true that a government can always intervene, if believed justified on economic (or political) grounds, to protect chosen creditors—for example, by acquiring or guaranteeing their claims and thus bearing their losses. But the action becomes transparent, may require Congressional authorization, and is open to electoral accountability.

C. Policy choices

1. Repeal Dodd-Frank, but such a turnaround seems politically unlikely. Or Title II could be extensively amended—conceivable, but complicated.

2. Enactment along the lines of Chapter 14 of an alternative resolution process.

a. For a case of voluntary bankruptcy: management would have an opportunity to take early reorganization action, including "pre-packaged" filings, under a new chapter drafted for a SIFI's use.

b. In a case of involuntary bankruptcy: the primary regulator could be required to justify to a district court (in a real, if closed, hearing with a rapid—but realistic—timetable for opposition and decision) its preference for an FDIC receivership. Even without enacting a legally binding requirement, a rejection of the new alternative would at least have to be explained in the agency's recommendation[38] and Treasury Secretary's determination[39] to seize the firm under Title II of the Act, and therefore might make resort to that action less automatic. And the detailed "living wills" that all SIFIs

38 §203(a)(2)(F).

39 §203(b)(2).

have to design for a Bankruptcy Code resolution would become directly relevant, facilitating reorganizations

3. Do nothing: Leave Title II of the Act as it is, assume it is not unconstitutional, and just hope it never has to be used. But its mere existence would continue to produce uncertainty and related costs. And an opportunity to make bankruptcy law more effective would have been lost.