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DODD-FRANK: RESOLUTION OR EXPROPRIATION?

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Much of the impetus for the financial reform legislation came from the view, correct or not, that when Lehman Brothers failed and had to go into bankruptcy, disaster ensued because it could not be taken over like a failed bank. Therefore, the Dodd-Frank Act in Title II created a new procedure ("Orderly Liquidation Authority") to seize even nonbank financial companies whose default would, in the view of the Secretary of the Treasury, have serious adverse effects on US financial stability. This procedure gives unprecedented power and discretion to an administrative official, going far beyond banking law to the point of posing serious Constitutional problems.

The Fifth Amendment provides that "No person shall…be deprived of life, liberty or property without due process of law…", a clause that is at the heart of the rule of law which is the central pillar of our legal system. The meaning of "due process" in different contexts is something that English and American courts have developed over time to a reasonable degree of clarity. Usually administrative action to take someone's property must be preceded by notice and opportunity for a hearing[1]. If a court finds that summary action can be warranted by urgent circumstances, as the Supreme Court has held in the case of a regulator appointing a receiver or conservator for banks[2], it has been premised on the availability of a prompt post-seizure hearing. Thus if the Comptroller of the Currency appoints a receiver or conservator to take over a national bank, the bank may go to district court for a full and open hearing "on the merits" of the asserted grounds.[3]

The Dodd-Frank Act squeezes pre-seizure due process down to the vanishing point. Consider how its resolution procedure is supposed to work. Companies "predominantly engaged" in financial activities are to be regulated and supervised by the Fed if they are systemically important. If the Treasury Secretary (upon recommendation by the Fed, and FDIC or SEC) makes a determination that (among other things) a financial company is in danger of default which would have serious adverse effects on US financial stability, he informs the company that he intends to appoint the FDIC as receiver. If the company does not consent, he petitions the district court of the District of Columbia (regardless of the location of the company's headquarters) for an order of authorization—and now the squeeze is on.

Under Section 202(a) of the Act, the district court judge is given 24 hours from the moment of filing to (1) notify the company and hold a closed hearing, (2) review all the hearing evidence, (3) authorize the receivership or determine that the Secretary's action was "arbitrary and capricious", and (4) if the latter, provide a written statement of each reason supporting its opinion. If the judge can't accomplish all that in 24 hours, then the petition is deemed "granted by operation of law" and the receiver is to immediately begin liquidating the company

1 The factors to be considered are discussed in Mathews v. Eldridge, 424 U.S. 319 (1976): the impact on the private party affected, the risk of administrative error, the governmental interest involved, and the value of additional procedural safeguards.

2 See Fahey v. Mallonee, 332 U.S. 245, 253-4 (1947).

3 12 U.S.C. §§191(b), 203(b), and also see §1464(d).

(reorganization is prohibited by §214). The decision and liquidation is not subject to any stay or injunction during the exclusive avenue of review: an appeal to the DC Circuit Court of Appeals or Supreme Court, whose scope of review is likewise limited to whether the Secretary's determination was arbitrary and capricious.

How would this work in practice? A financial company covered by the Act is by definition a large and complex institution, probably with hundreds of billions of dollars in assets. A large portion of those assets would consist of corporate or hedge fund loans, derivatives contracts, complex securities and other financial contracts—much of them illiquid and thinly traded at best. That makes their valuation difficult and judgmental, as the argument over collateral[4] between AIG and Goldman Sachs in January 2008 vividly illustrated. The key determination by the Secretary is that the financial company is in danger of default. If a company has assets less than its obligations, or is unable to pay its obligations in the normal course of business, or is likely to incur losses that will deplete substantially all of its capital, then it meets the definition of "default".[5] Asset valuations are likely to be at the heart of any dispute, and they will not be clear cut.

Judicial review of administrative actions is a central safeguard against both error and abuse of power. Here the judicial hearing before the seizure is designedly just about meaningless. Suppose the Secretary takes his action at the close of a business day, as has become customary in banking. He files with the petition an extensive set of documents prepared by the Fed and FDIC or SEC for their recommendations and by Treasury staff for his determinations. By the next morning the company has to have received and analyzed them, prepared its own counter valuations of thousands of securities, and hurriedly presented them at the hearing. That afternoon the judge can review voluminous fillings, arrive at reasoned conclusions and findings, and write an explanatory opinion of a denial in a couple of hours, or give up and simply rule that with so much paper work no action can possibly be arbitrary, or just let the clock run out at 5 o'clock instead of serving as a rubber stamp.[6]

What about post-seizure judicial review, as some emergency circumstances can justify? The reviewing courts are limited to the same truncated and one-sided record and a dilemma as to any real relief. Though they can take more time, they are prohibited from issuing any stays, and liquidation is meanwhile mandated to be proceeding apace. And even if somehow a final ruling were in the company's favor, irreparable damage would already have occurred. Nor could the company simply sue the United States for monetary compensation for a due process violation—it would likely claim sovereign immunity.[7]

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4 See http://www2.goldmansachs.com/our-firm/on-the-issues/valuation-pricing-doc.pdf

5 §202(c)(4).

6 The Supreme Court has recognized, but did not have to reach, the due process question of "whether the time is so short that it deprives litigants of a meaningful opportunity to be heard…" Miller v. French, 530 U.S. 327, 350 (2000). Justice Souter in a separate opinion suggested that providing insufficient time for a court to make a determination could raise "a serious question whether Congress has in practical terms assumed the judicial function." Id. at 352.

7 There is apparently no Tucker Act damage remedy for violations of Fifth Amendment due process: Scheafnocker v. C.I.R. 642 F.3d 426, 434 (3d Cir. 2011); Smith v. U.S., 51 Fed. Cl. 36, 38 (2001). Perhaps a "takings" claim could be maintained, but it would face the assertion that Congress had excluded that remedy, by providing an exclusive avenue of appeal from a "final" decision. §202(a)(1)(B). Nor would there be a likely remedy under the Federal Tort Claims Act. See U.S. v. Gaubert, 499 U.S. 319 (1991). The Act contains an exception for "discretionary functions", even if the discretion is abused. 28 U.S.C. §2680(a).

Note that none of these problems would arise if the company were simply put into judicial bankruptcy proceedings, as in fact was Lehman Brothers. And it is hard to find actual disasters occasioned by the Lehman process itself—as opposed to the shock to the markets that the Government wasn't coming to the rescue as it had with Bear Stearns.[8] There are desirable adjustments to the Bankruptcy Code that could somewhat reduce spillover effects in such cases. But if the Dodd-Frank procedure meets Constitutional requirements, there isn't much left of the Due Process Clause for financial companies.

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8 See, e.g., K. Summe, "Lessons Learned from the Lehman Bankruptcy", in K. Scott. G. Shultz & J. Taylor, eds., Ending Government Bailouts (2010).