from “The New Financial Deal: Understanding the Dodd-Frank Act and its (Unintended) Consequences” (Wiley, 2011)

# Chapter 8

# Bailouts, Bankruptcy, or Better? (Resolution Authority II)

A few years from now, Bank of the World (BOW), an imaginary bank that is (let us suppose) one of America’s largest financial institutions, is dangerously unstable. A bank with a storied history, BOW expanded rapidly in the 1980s and 1990s, survived the Panic of 2008, and then gambled big on a real estate recovery and new ventures in China and India. Although BOW’s investments in China and India have the makings of a brilliant global strategy, the initial costs have been far higher than expected, in part because of unanticipated problems with an Indian subsidiary BOW acquired. Suddenly, hedge funds are pulling their funds from BOW, the price of credit default swap protection on BOW debt has spiked, and rumors are flying that BOW could implode.

The Treasury secretary calls up Bank of the World's chief executive, who says the continuing worldwide slump has made things difficult for BOW and everyone else, but that earnings and the bank's liquidity are fine and the rumors are overblown. Not especially reassured, the Treasury secretary worries that other banks could be vulnerable if BOW were to collapse. He hangs up and calls the chairman of the Federal Reserve, who asks: "What should we do?"

This is the scenario for which the new resolution regime was designed.

## The Basic Framework

Here, in summary form, are some of the key features we will be considering:

- Triggering the resolution rules:
  - "Three keys turn": Treasury, Federal Reserve, Federal Deposit Insurance Corporation (FDIC).
  - Consultation with President.
- Covered companies: any financial institution.
- Limited judicial review.
- FDIC takes over:
  - Managers replaced if responsible.
  - Shareholders and creditors take losses.
  - Company must be liquidated.

A few basic details will suffice for an initial introduction to the framework. As we saw in Chapter 7, resolution under Dodd-Frank begins when the "three keys turn"—Treasury proposes to take over a systemically important financial company that is in or near default, and the Fed and FDIC concur by a two-thirds vote. The three keys are also expected to consult with the President.

Although the resolution rules clearly are designed for the systemically important institutions we considered in Chapter 5, the framework sweeps much more broadly than this. Regulators can take over any financial institution they wish if they decide that its failure could have a destabilizing effect.

The decision to step in is subject to very little judicial oversight. If the managers of the financial institution do not consent to the government takeover, regulators can initiate the resolution process by filing a petition in federal district court alleging that the company in question is a financial company that is in default or in danger of default. Regulators are not required to make any other showing, and the court can reject the petition only if it is "arbitrary or capricious." The court is given 24 hours to make this determination. Whether this severely truncated review is constitutionally adequate is subject to real question, as we will see.

Once the petition has been filed, the FDIC takes over the company as its receiver, much as the FDIC does with ordinary banks. The FDIC has nearly unfettered discretion to sell the company or any of its parts, either directly or after transferring the assets to a bridge bank. Shareholders are expected to be wiped out, and creditors ordinarily must take losses, except (a major exception) with contracts the FDIC agrees to honor. The objective is to liquidate the company in an orderly fashion, on terms dictated by the FDIC.

To fund the resolution process, the FDIC is entitled to borrow up to 10 percent of the value of the company's assets. With a major financial institution, this will give the FDIC enormous funding capacity—over $200 billion with a company like Citigroup.

Proponents of the new regime claim that it will end taxpayer bailouts and assure an "orderly resolution" of financial distress. Critics insist that it will not end bailouts, and may even make them more likely. Which will it be? And does the new framework improve on ordinary Chapter 11, which it is designed to displace?

To answer these questions, and to chart our path to the heart of the new regime, I will focus on four key objectives that I believe define effective insolvency laws. First, the insolvency framework must be initiated in a timely fashion. Even the most elegant resolution framework won't work if regulators (or the parties themselves, in the case of bankruptcy) wait too long before using it. The second objective is limiting the damaging effect of financial distress on third parties, bystanders to the company's default. In the world of Dodd-Frank, this means limiting systemic risk—the possibility that a major failure will trigger additional failures or paralyze the markets. Third, shareholders and creditors should not be paid in full if the company is insolvent—they should take haircuts, in insolvency lingo. Otherwise, the executives and other shareholders will take too many risks (why not, if it's "heads I win, tails you lose"?), while creditors will be too anxious to lend and will have little reason to monitor the company. Finally, the regime should protect as much of the value of the company's assets as possible—through reorganization, sales of the assets, or by other means. That is, it should facilitate the efficient resolution of financial distress.[1]

I will add texture to each of these factors as we go along. With the second factor, shareholder and creditor haircuts, for instance, transparency and predictability are also important considerations. But focusing on these simple issues will show us what works and does not work in the new resolution regime.

## The Trouble with Bailouts

First a few words about those bailouts, to remind us of the alternative that the drafters of Dodd-Frank purport to have ended. I have treated *bailout* as a dirty word throughout the book, and have made no secret of my view that the crisis would have been less severe if Bear Stearns had been allowed to file for bankruptcy. But even I am willing to concede that, in rare circumstances, bailouts can make sense.

The classic candidate for a bailout is a systemically important company that is facing a run on the bank, but is not actually insolvent. In this case, which economists call a liquidity crisis, a quick injection of funds may prevent systemic risk or other collateral damage, and the failure to make shareholders and creditors take a haircut is unproblematic because the financial distress is, in a sense, artificial. It also is not problematic that the insolvency regime is not triggered, and that the company is not restructured. The crisis is like a passing summer storm, whose damage may be prevented by timely intervention.

CH008.indd 132 10/22/10 2:05:52 PM

The classic case is quite rare, however, and regulators have strong incentives to assure us that a bailout is necessary even if it isn't. Default of an important company is messy and can make a regulator's life miserable on many dimensions. Propping the company up for a year or two more with taxpayer funds is often a tempting alternative.

Even the most successful bailouts may have serious downside consequences if the beneficiary is insolvent rather than simply illiquid. The first Chrysler bailout, in 1979 and 1980, was viewed by many as the ultimate bailout success story. The government agreed to guarantee Chrysler's loans, eventually making a profit when the loans were later repaid, and Chrysler's CEO, Lee Iacocca, became a corporate celebrity. But in retrospect we can see that the bailout postponed the more thoroughgoing restructuring the company would have undertaken had it been allowed to file for bankruptcy.

Although Lehman Brothers and American International Group (AIG) were widely acknowledged to have been insolvent in 2008, defenders have suggested that bailouts were necessary to prevent widespread market carnage—that is, systemic consequences of their failures. This conclusion is based in important respects on the Lehman myth that I hope to have put to rest in Chapter 2—the mistaken conventional wisdom that Lehman's bankruptcy triggered the chaos of fall 2008 and showed that bailouts were unfortunate but necessary. Defenders also have often failed to distinguish between ad hoc bailouts and systemwide responses to the crises in the American financial system. In his justly praised book *In Fed We Trust*, David Wessel applauds the welter of extraordinary programs Ben Bernanke and the Federal Reserve put in place in 2008 and 2009 to stabilize the money market, commercial paper, and other markets. These interventions were, on the whole, beneficial, but that doesn't mean that the ad hoc bailouts also were also beneficial.

Even in a crisis, it rarely makes sense to prop up a company that is truly insolvent. To see why, we need to distinguish among three varieties of systemic risk. The first, which economists call an information contagion, is a negative shock that stems from the information that one firm's troubles convey about other firms in the industry. If Bank of the World threatened to collapse, its woes could cause an information contagion in other banks if all of the banks in the industry held significant amounts of the same assets. The discovery that BOW's portfolio of these assets is worth less than everyone thought tells market participants that the other banks' assets are also overvalued, which could lead to a massive devaluation throughout the industry. A second form of systemic crisis—a confidence crisis—is closely related. If Bank of the World's collapse creates uncertainty as to the financial health of other large banks, it may trigger a sudden, marketwide flight by shareholders and creditors of all banks. If the reaction stems from the fact that the banks hold similar assets, it is an information contagion. But if it is based on general uncertainty about the significance of BOW's failure for other banks, it is more aptly described as a confidence crisis.[2]

The final variety of systemic crisis is a counterparty contagion. If other firms are major creditors of Bank of the World, BOW's default and inability to pay may blow a hole in the other companies' own balance sheets. BOW's failure could cause another firm itself to fail, if the firm's exposure to BOW is big enough. If a chain of firms have heavy exposures to one another, BOW's failure could even cause a sequence of failures (domino effect or cascading failures, in the standard argot), including the demise of companies that have no direct connection to BOW.

Of these three kinds of systemic bailout, only a counterparty contagion could plausibly justify the bailout of a particular company. If information contagion or a confidence crisis is severe enough to justify intervention, the government should intervene on a marketwide basis. This, of course, is just what Fed Chair Ben Bernanke did with the extraordinary interventions that Wessel praises, and Congress did with TARP. If the potential crisis is due to counterparty contagion, a targeted bailout might theoretically be possible in order to head off the possibility of multiple failures. But even this is debatable. Even if a failure of Bank of the World could trigger counterparty contagion, it may make more sense to guarantee the debts of the firms that would be affected (as when the Federal Reserve protected the commercial paper market after Lehman defaulted) than to bail out BOW.

Consider what this reasoning tells us about the 2008 crisis. Although systemic crises do not fit neatly into the three boxes I have just described, the Panic of 2008 clearly stemmed far more from an information contagion or a confidence crisis than from a counterparty contagion. At the heart of the problem throughout the crisis was the fact that the largest financial institutions all, though to varying degrees, had major exposure to mortgages and mortgage-related securities. No one knew what they were worth—indeed, we still don't—so turmoil at Bear Stearns or Lehman signaled that there was reason to worry about its peers.

The argument that serious counterparty risk was at stake was based on the concentration of the derivatives industry, with the major players—known before the crisis as the Fourteen Families—heavily connected with one another. If one fell, some have argued, the others could fall. But we now know that Lehman's bankruptcy filing did not lead to the failure of any of the bank's counterparties. To be sure, the Federal Reserve offered a helping hand by guaranteeing some of Lehman's trades shortly after it filed for bankruptcy. But the International Swaps and Derivatives Association—the principal derivatives trade group, and not an organization I typically praise—established a protocol for netting out Lehman's derivatives trades. Within a couple of weeks, the vast majority had been closed out, without any of the counterparties failing.

Americans' deep hostility to the bailouts of Bear Stearns and AIG was thus well-founded. The analysis also suggests that bailing out a troubled firm that would otherwise find itself in insolvency proceedings is rarely justified unless the firm is actually solvent. The only other exception is for a company whose failure would cause a counterparty contagion, which will seldom be the case.

## Who Will Invoke Dodd-Frank Resolution, and When?

One of the more surprising attributes of the new legislation—for which the drafters deserve praise—is its effort to make precisely the distinction I have just outlined between systemic responses to a crisis and bailouts of individual firms. When Timothy Geithner and his colleagues at Treasury outlined their initial financial reform proposal, they did not call for any meaningful constraints on the Federal Reserve's ability to intervene in a crisis. The Fed's principal legal basis for extraordinary lending is known as its 13(3) authority, after the section in the Federal Reserve Act that authorizes the Fed to extend credit in "unusual and exigent circumstances." This was the Fed's go-to authority for most of the extraordinary loans and guarantees it made during the crisis, such as the money market and commercial paper facilities. In its White Paper, the Treasury proposed only that the Fed be required to obtain prior written approval from the Treasury before exercising the extraordinary authority. It is hard to imagine a situation in which the Treasury—the most political of agencies, whose head answers directly to the President—would balk at a bailout or other intervention the Fed wished to make. The Treasury approval requirement was simply window dressing on a proposal that was designed to institutionalize the bailouts of 2008.[3]

The ostensible theory for the new resolution rules is that they will displace bailouts as the mechanism for dealing with systemically important financial institutions in distress. Although the Treasury proposal made no serious effort to achieve this objective, the Dodd-Frank Act does. In revising the Fed's 13(3) powers, Dodd-Frank retains the prior approval requirement proposed by the Treasury, but goes substantially further as well. Not only does the new law state that "emergency lending is for providing liquidity to the financial system and not to aid a failing financial company," but it amends the authority to allow only "broad-based" interventions, which are defined to mean interventions that are not aimed at a particular company. (Under the old provision, by contrast, the Fed could lend to any "individual, partnership, or corporation.") Whether this new restriction will actually prevent bailouts is subject to question, as we will see; but the revision is clearly designed to limit bailouts.[4]

The restriction on extraordinary funding of individual companies puts the first of my four insolvency regime factors—timely initiation—into sharp relief. Will the limitation on Fed funding ensure that regulators seize control of a floundering, systemically important financial institution sooner rather than later, without bailing it out?

While no two regulators are alike, any more than two CEOs are, considering the kinds of incentives that Dodd-Frank creates is the best way to predict how each is likely to respond when a bank like Bank of the World is in trouble. The effects of Dodd-Frank could hardly be more dramatic. It does not take a rocket scientist to predict how the major characters, managers especially, will view the new regime. The incentives created by the framework are not encouraging.

## Triggering the New Framework

Here, in more detail than our initial discussion, are the key rules for taking a systemically important financial institution down:

- The "three keys": Treasury, two-thirds of Federal Reserve Board, two-thirds of FDIC.
- The initial petition:
  - Filed in federal court in Washington, D.C.
  - Alleges that "covered company" is "in default or is in danger of default," and alternative responses "would have serious adverse effects on financial stability."
- Judicial review: Court can reject only if "arbitrary and capricious"; must decide within 24 hours.
- FDIC generally appointed as receiver:
  - Managers replaced if responsible.
  - Shareholders and creditors take losses.
  - Company must be liquidated.

At the outset, Treasury is the quarterback of the new resolution process. If the Treasury, backed by two-thirds votes of the Federal Reserve and the FDIC, concludes that a financial company is on the verge of default or has defaulted, and that its failure "would have serious adverse effects on financial stability in the United States," it can trigger resolution by filing a petition in federal court in Washington, D.C. Judicial review is extremely limited. So long as it was not "arbitrary and capricious" for regulators to determine that the company is a "financial company" and was in danger of default, the court must sign off on the petition. If Treasury persuades the company to accept the petition, it can avoid review altogether.[5]

While it would be natural to assume that the companies subject to this process are the same ones that we considered in Chapter 5—bank holding companies with more than $50 billion in assets, and nonbanks designated as systemically important—there is no explicit connection. Any financial company—that is, a company that derives at least 85 percent of its earnings from financial activities—can be labeled as a "covered company" and thrown into resolution if the regulators believe that its default would cause financial instability. Surely the two sets of companies will overlap significantly, but regulators' failure to have designated a company as systemically important for the purposes of the new capital requirements and other regulation discussed in Chapter 5 does not preclude them from stepping in under their resolution authority.[6]

If the petition is approved, the FDIC is appointed receiver (other than with investment banks, where the SEC is receiver, and insurance companies, whose receiver is the new federal insurance regulator), and is given extensive authority to borrow money and to take over the company's operations during the receivership. Lest resolution have the appearance of a pleasant landing, the FDIC is instructed to kick out any of the company's managers who are "responsible" for the financial distress, to wipe out shareholders' interests, and to pay creditors whose claims are not assumed (a vital qualification, as we will see later). Unlike either ordinary bank resolution, which permits the FDIC to reorganize a bank through a conservatorship, or bankruptcy, Dodd-Frank resolution provides only for liquidation. Although it may be possible for the FDIC to circumvent this through the creation of a "bridge financial company," the framework is designed with liquidation in mind. A late amendment proposed by Senator Barbara Boxer added an exclamation point, stating that any company in resolution must be liquidated.[7]

It would be hard to overstate how radical these powers are. Bank regulators are likely to postpone resolution if they can, and this problem will be the focus of much of my discussion that follows. But suppose the Treasury secretary in the next crisis decides to take a more aggressive stand—to invoke the resolution rules preemptively and take over Bank of the World? There is very little BOW can do to prevent the preemptive strike, once the Fed and FDIC approve. BOW's only grounds for challenging the petition are that it is not a "financial company" or that it is not "in default or in danger of default." It will be nearly impossible to challenge either—BOW obviously is a financial company and "in danger of default" is broad enough that that will almost certainly be satisfied in any case in which the Treasury secretary is anxious to intervene. BOW is not entitled to challenge any of the other prerequisites for invoking the resolution rules. It cannot object that its default really wouldn't cause financial instability or that a private-sector alternative is available.[8]

The deck is stacked against BOW in other ways as well. The court decision is made within 24 hours, and it is conducted in secret.[9] Moreover, once the court makes its decision, the resolution cannot be put on hold if BOW wishes to pursue an appeal to a higher court. The prospect of stopping even the most outrageous invocation of the new rules is close to nil. Once the company is in resolution, the FDIC has total control.

If your reaction is that this can't possibly be constitutional, you may well be right. There is a very good chance that the resolution rules, with their severe limits on the scope and opportunity to challenge the takeover, violate the due process clause of the Constitution. Due process requires notice and an opportunity to be heard. While the Supreme Court allows Congress to limit due process in some respects, the restrictions on challenge to the resolution rules are so severe as to raise serious Constitutional doubts.[10]

Rather than intervening at the first whiff of trouble and taking advantage of their massive new powers, regulators are more likely to delay their intervention. After all, taking over would mean selling or dismembering a complicated financial institution. Even a Treasury secretary who is less of a bailout enthusiast than Timothy Geithner will want to put off the day of reckoning, and it seems unlikely that the Fed or FDIC will be more anxious to invoke the regime.

Under these circumstances, what are the regulators' options? Although the Fed no longer has carte blanche to make extraordinary loans, there are several ways it could step in, particularly in a crisis. Dodd-Frank authorizes the Fed to guarantee the debt of banking institutions, which would give it considerable power to buttress a bank's stability. While the Fed is now prohibited from making single-company loans, it may be able to circumvent this restriction by establishing a broad-based program that just so happens to benefit a systemically important firm that is stumbling. The program could include restrictions that exclude nearly every firm other than the troubled institution, for instance, or the Fed could simply bail out the industry more broadly. As the Panic of 2008 revealed, regulatory creativity is at its height when regulators are cobbling together a bailout.

Alternatively, using the leverage the Dodd-Frank Act gives them, regulators can force the peer institutions of a troubled bank to pitch in for a bailout. Several of the bailouts of recent decades were privately funded, including the bailout of Long-Term Capital Management in 1998 and a rescue package put together for Korea during roughly the same period. In the past, regulators have been forced to rely on moral suasion, and they couldn't be certain everyone would go along. But, as we saw in Chapter 5, Dodd-Frank has provided the government with new levers to use in its partnership with the largest banks. While a privately-funded bailout does not directly implicate taxpayer funds, it has many of the same pernicious effects.

Even if regulators wanted to intervene in a timely fashion, the complexity of the nation's largest financial institutions is sufficiently great that they are not likely to know until late in a company's decline that the time has come. If regulators are making the decision when to invoke Dodd-Frank resolution, it will come either too late or even (if the company is bailed out) never.

The people who are likely to have the best information about the company's condition are, of course, its managers. With ordinary companies, Chapter 11 is well designed to encourage the managers to take matters into their own hands when a company is in trouble. In Chapter 11, the managers continue to run the business after it files for bankruptcy, and they are the only ones who can propose a reorganization plan for the first six months of the case, and often longer.[11] Although shareholders do not receive anything in many cases, they sometimes end up with something, either because the company does well during the bankruptcy or because shareholders succeed in negotiating at least a limited payment for themselves. These attributes of Chapter 11 encourage managers to file for bankruptcy in a timely fashion.

Because the Dodd-Frank resolution regime dispenses with these carrots, the managers of a company like Bank of the World have no reason to point the company toward resolution. Indeed, much as with Lehman and AIG, the managers have every reason to make a potential resolution look as messy as possible in the hope of securing a bailout or persuading regulators to delay intervention.

Dodd-Frank does have one important provision that could limit managers' ability to ensure that resolution would mean chaos. Systemically important companies are now required to file a so-called living will—a report that details how the company could be closed down in orderly fashion if it were to descend into financial distress. If regulators demand detailed and plausible resolution plans, the living wills could avert some of the disruption of a default. Regulators might even presumptively commit to following the course of action outlined in the living will in the event they later invoked the resolution rules. But the living will requirement applies only to companies that have been formally designated as systemically important. And managers are unlikely to devise serious and realistic plans unless regulators are unusually vigilant in enforcing the new obligation.[12]

An interesting question is whether the managers of a company like Bank of the World will file for bankruptcy as an alternative to resolution. Bankruptcy is not a great career move for the managers of a financial institution, but it does have the advantages I mentioned earlier: The managers continue to run the business, and they are the only ones who can propose a reorganization plan—or other action, such as a sale of the company's assets—for a period of time.

Compared to Dodd-Frank resolution, bankruptcy doesn't look so bad, but it has several important limitations from the managers' perspective. The first is that, if the managers file for bankruptcy, Dodd-Frank gives bank regulators the power to pull the case out and put it in resolution. Resolution trumps bankruptcy, so a Chapter 11 filing could simply prove to be a temporary reprieve, before regulators take over. Second, although managers do retain their jobs at first, they are likely to be forced to step down before the case reaches its conclusion. Finally, derivatives and other financial contracts are not subject to core bankruptcy provisions such as the automatic stay, which limits the managers' ability to arrange a sale or other disposition of the company's assets. (I will revisit the problematic effect of these rules in Chapter 9 when proposing ways to limit some of Dodd-Frank's flaws.)

Given these limitations, Chapter 11 is a risky option from a manager's perspective—better, but only marginally so, than Dodd-Frank's harsh medicine. From their perspective, sticking with the business and forgoing any meaningful disaster planning is likely to be the best bet.

Because neither of the principal parties—regulators or managers—will be anxious for Dodd-Frank to be invoked, timely initiation is unlikely.

## Controlling Systemic Risk

The case for a governmental resolution regime rested on two claims: the FDIC analogy we dissected in Chapter 7, and the contention that only administrative resolution can prevent systemic crises. Controlling systemic risk, the second objective of an effective insolvency regime, is indeed the one thing Dodd-Frank may do tolerably well. But it will do so by smuggling bailouts into the resolution regime.

Two sets of rules lie at the heart of Dodd-Frank's response to systemic risk, both borrowed from FDIC resolution of ordinary banks. The first is a special set of rules for derivatives and other financial instruments—known as qualified financial contracts (QFCs) in the banking world. The second is broad discretion for the FDIC to fund almost anything it wants. Whatever bailout authority was siphoned off from the Fed outside of resolution has reappeared in the hands of the FDIC in the new regime.

Here is a summary of the key rules:

- Rules for QFCs (derivatives):
  - Ipso facto clauses: unenforceable for one business day.
  - Master agreement: treated as single contract.
  - All or nothing: FDIC must assume all or none with each party.

- FDIC's power of the purse:
  - Broad funding discretion: can buy or guarantee assets.
  - Huge borrowing capacity: up to 10 percent of value of preresolution assets; 90 percent postresolution.
  - FDIC borrowing entitled to priority.
  - Source of funds: any remaining obligations paid for by assessments on large financial institutions.

In the standard swap contract, bankruptcy or insolvency proceedings are an event of default, entitling the other party to cancel the contract and sell any collateral. In bankruptcy, these provisions—known as ipso facto clauses—are fully enforceable. If a systemically important institution like Bank of the World—or AIG in 2008—filed for bankruptcy, all of these counterparties theoretically could cancel their contracts at the same time. If everyone sold their collateral at once, it could drive down asset prices and exacerbate an existing crisis. In 2008, for instance, sales of the mortgage-related securities that AIG had posted as collateral could have sent mortgage values spiraling down even more.

Dodd-Frank resolution addresses this risk by putting the counterparties' right to cancel their contracts on hold for a brief period of time. The FDIC has until 5 P.M. the next business day to decide how to handle these financial contracts. Although the delay is often described as one day, regulators could stretch it to nearly four days if they cleverly timed the beginning of the resolution. If the resolution began early on a Friday morning, the enforcement ban would last until 5 P.M. on Monday, since Monday is the next business day.[13]

During this time (and after, if the other party doesn't cancel the contract), the FDIC has the decision whether to repudiate the contracts or promise to pay them in full. In deference to the derivatives industry, Dodd-Frank imposes two related constraints on the FDIC's options at this point. The first is that, if the troubled bank has a master agreement covering a variety of different transactions with the same counterparty—which is standard practice with derivatives—the FDIC must give the same treatment to all of the contracts, either keeping them or repudiating them. Second, the same principle applies more generally to all of a debtor's swaps with a particular party. The FDIC's choice is all or nothing. It must repudiate all of the contracts or none of them.[14]

Although current FDIC chair Sheila Bair is a tough-minded regulator and not so enamored of bailouts as Treasury Secretary Geithner is, she surely would respond in similar fashion if a large institution like Bank of the World were put in resolution. Faced with an all-or-nothing decision, she or any other FDIC chair would guarantee all of the derivatives with all of BOW's major counterparties, rather than risk systemic problems. If most of the contracts were subject to clearinghouse arrangements, the pressure to honor all the contracts might be reduced somewhat, but the FDIC will still worry about the effect of repudiation on the clearinghouses, and the risk that sales of the accompanying collateral by the clearinghouses could have a systemic effect.

The fact that the FDIC chair will not be making the repudiation decision in isolation will add further pressure to rescue the derivatives contracts. Both the Fed and the Treasury must also approve the decision to put the company in resolution, which will give each the opportunity to insist that the derivatives need to be protected.

The special derivatives rules create a strong temptation to rescue these contracts, as we have just seen, and Dodd-Frank's financing rules provide both funding and authority to take other rescue actions as well. Dodd-Frank invites the FDIC to purchase or guarantee the company's assets, to assume or guarantee its debts, or to intervene in almost any way it wishes. To finance these interventions, Dodd-Frank authorizes the FDIC to harness the borrowing power of the U.S. Treasury, issuing Treasury obligations up to 10 percent of the value of the company's pre-resolution consolidated assets during the first 30 days of the case, and up to 90 percent of the value in resolution thereafter.[15] To visualize how much funding this is, consider that Lehman Brothers reported $639 billion in assets when it filed for bankruptcy. Under the new Dodd-Frank resolution, the FDIC would have had $63.9 billion at its disposal during the first 30 days of the case. With Citigroup or Bank of America, the FDIC would have more than $200 billion.

If there is a virtue to this massive honey pot, it is the FDIC's flexibility to prevent systemic crises. Protecting the creditors of a troubled company is one response to systemic risk, although industry-wide responses will more often be effective, as we have seen. And the vice of the FDIC's sweeping authority is that it invites interventions that are essentially bailouts.

Dodd-Frank does try to limit *taxpayers'* responsibility for the costs of the FDIC's funding decisions. The FDIC obligations—which will initially be funded as debt issued by the Treasury—are given priority status in the resolution through provisions that instruct the FDIC to pay itself before paying ordinary creditors. For any costs that aren't covered in the resolution proceeding itself, Dodd-Frank provides for payment from an Orderly Liquidation Fund, to be paid for through assessments imposed on other systemically important institutions after the resolution.

These provisions are the basis for Dodd-Frank enthusiasts' claims that the legislation has ended taxpayer-funded bailouts, culminating with a triumphant "never again" from President Obama when he signed the legislation. That isn't the case, since we still may see bailouts outside of the resolution regime. But even in the absence of a preresolution bailout, FDIC intervention may have many of the same damaging effects as a bailout—and indeed, will be a bailout, as I explain in the next section. It just won't be a taxpayer-funded bailout.

## Third Objective: Haircuts

The third objective of an effective insolvency regime is to ensure that the shareholders and creditors of an insolvent company suffer losses roughly consistent with the priority of their interest and the value of the floundering company. Suppose, for instance, that the value of the company's assets is $100, and that it owes $80 to Senior Creditor, whose claim is collateralized by all of the assets; it owes $50 to Junior Creditor, a general creditor; and there is one Shareholder, who also is the company's manager. If this company defaults, we would expect the insolvency regime to ensure that Senior Creditor is paid in full, Junior receives most or all of the $20 that remains (but loses $30), and Shareholder's interests are wiped out. In its strict form, this general principle is known as the absolute priority rule. We may have good reason to depart from it in some respects. Giving Shareholder a small payment may make Shareholder more willing to put the company into an insolvency proceeding sooner rather than later, for instance. But an effective insolvency regime should generally stick with absolute priority.

If the government steps in and bails out Junior Creditor or Shareholder, or both, by contrast, promising to pay them in full, the bailout introduces serious distortions. The managers and shareholders of companies similar to this one may adopt risky strategies—such as the extraordinary leverage taken on by investment banks like Bear Stearns and Lehman—on the assumption that the rewards of success will be great if the gamble succeeds, while they won't be punished if it fails. This phenomenon—risk taking by those who are protected against risk—is the familiar problem known as moral hazard. Similarly, junior creditors will be more willing lend to companies like this one and may not spend much time monitoring its performance, if they expect the government to ensure they will be paid in full. Peter Wallison has dubbed the credit market distortions this creates the "Fannie Mae effect," in reference to the artificially low borrowing costs Fannie Mae and Freddie Mac enjoyed due to the government's implicit guarantee of their debt before they were formally nationalized in 2008.

During the 2008 crisis, the three regulatory musketeers—Paulson, Geithner, and Bernanke—went to great lengths to prevent shareholder moral hazard. Paulson was so anxious to make sure that managers and shareholders were punished that he pressured JPMorgan to *lower* the price it offered for Bear Stearns from $4 to $2 per share (JPMorgan ended up paying $10 per share).[16] The triumvirate forced AIG's chief executive to step down, and drastically diluted its shareholders' interests, for the same reason.

Although the regulators initially claimed that their interventions weren't bailouts, in each case the government fully protected the company's creditors. The expectation that creditors would be bailed out, and the distortions this creates (credit subsidies for favored firms and creditor moral hazard), explains why prices for the bonds of the biggest financial institutions stayed so high throughout the crisis, and the prices for credit default swaps on Lehman did not anticipate its default. The bailouts of 2008 were creditor bailouts.

The Dodd-Frank resolution regime (once again departing from the original Treasury proposal) announces a policy of forcing shareholders and creditors to take haircuts in resolution, and of throwing the managers out. According to a provision labeled "mandatory terms," the FDIC shall:

> ensure that the shareholders of a covered financial company do not receive payment until all of the claims and the Fund are fully paid; . . . ensure that unsecured creditors bear losses in accordance with the priority of claim provisions . . . ; [and] ensure that management responsible for the failed condition of the covered financial company is removed.[17]

In addition to this "mandatory" priority structure, the new regime includes a cluster of provisions, most borrowed from bankruptcy law, that have related concerns in mind. The FDIC is authorized to retrieve payments made to a creditor during the 90 days before the start of resolution, and to invalidate sales or other transfers of the company's property if the company received less than the property was worth. (These are known as preference and fraudulent conveyance powers.) In addition, if any creditor is given more than the claim it would receive in a bankruptcy liquidation, the creditor is required to give the difference back to the FDIC. Each of these rules is designed to ensure that similarly situated creditors are treated the same, and to police situations that have the effect of giving priority treatment to some creditors and not others.[18]

For anyone who is familiar with ordinary bank resolution, these provisions will come as a refreshing surprise. When it closes an ordinary bank, the FDIC has broad discretion in determining which claims get paid, and to what extent. This means that basic priorities may not be respected. It also means that creditors cannot predict in advance how they will be treated. Dodd-Frank seems to have a much more formal and transparent priority structure.

Unfortunately, the rules will prove irrelevant in practice for many of the financial institution's largest and most important claims. The problem is that these careful priority requirements, with all of their sensible adjustments, can easily be evaded. As with ordinary bank resolution, Dodd-Frank resolution gives the FDIC blanket authority to pay claims in full if it wishes, as we saw in our discussion of systemic risk. As the receiver of a company like Bank of the World, the FDIC will likely pay off all or almost all of the derivatives and other financial claims, and perhaps other claims as well. Although these creditors theoretically must give some of their recovery back if other creditors receive less than they would get in a liquidation, the FDIC can simply give the other creditors a pittance and argue that this is more than a bankruptcy liquidation would have brought. Had there been a bankruptcy, the FDIC might say, the firm's value would have evaporated and creditors would have gotten almost nothing. Using this reasoning, the FDIC can easily bail out the most important creditors while giving little or nothing to other, theoretically comparable claims.

As President Obama once said in another context, the priority rules are just lipstick on a pig.

## All Liquidation, All the Time?

We come now to the final objective of an effective insolvency regime: resolving the company's financial distress efficiently, to protect as much value as possible.

In my dissection of the FDIC analogy in the preceding chapter, I pointed out that the standard FDIC strategy for closing an ordinary bank is much dicier for a systemically important financial institution. With the little banks that are its bread and butter, the FDIC secretly lines up a buyer if the bank is failing, closes the bank at the end of the day on Friday, and then completes the sale in time for customers to have access to their deposits and for businesses to have access to their lines of credit on Monday morning. With the largest banks and nonbank financial institutions, by contrast, the number of plausible buyers is far smaller. It will be more difficult, and sometimes impossible, to arrange a sale. Who exactly would buy Citigroup or Bank of America if it were sinking? And because the potential buyers are other large financial institutions, the sales that do occur will make a financial giant even bigger.

The drafters of Dodd-Frank compounded this problem by limiting the FDIC to a single set of resolution options: liquidation. Prior to a late amendment proposed by Senator Boxer, this restriction would not have been obvious to anyone but a banking nerd. It is signaled in Dodd-Frank by the appointment of the FDIC as receiver of the troubled institution, the references to the regime as "receivership," and the absence of any mention of "conservatorship." Conservatorship is the principal—though rare—technique for reorganizing a troubled bank rather than selling it or shutting it down. Thanks to the Boxer amendment, this careful parsing of the resolution regime is no longer necessary. The new law could not put it more clearly: "All financial companies put into receivership under this title shall be liquidated. No taxpayer funds shall be used to prevent the liquidation of any financial company under this title."[19]

It is theoretically possible for clever regulators to restructure a financial company rather than truly liquidating it. As an alternative to arranging an immediate merger or piecemeal liquidation, Dodd-Frank authorizes the FDIC to transfer assets and liabilities to a "bridge financial company." The bridge company is designed to be temporary, but Dodd-Frank allows it to continue for up to three years. By picking and choosing which assets and liabilities to transfer to the bridge company, and subsequently merging it with another firm or selling stock to investors, the FDIC could achieve a de facto reorganization.[20]

This stands in obvious tension with the Boxer amendment's proclamation that the company "shall be liquidated," but this violation of the Boxer amendment's spirit is unlikely to prevent disguised reorganizations. The more important obstacle is the centrality of regulators, rather than the parties themselves. The FDIC is not set up to oversee a major financial institution for long enough to achieve a genuine reorganization or even a more patient liquidation. After IndyMac failed in 2008, for instance, the FDIC sold its assets much more quickly than many observers thought optimal, because of its reluctance to manage assets for a substantial period of time. "When the FDIC steps in," as one account of its role in the new resolution framework put it, "it assumes control over all assets and operations. The goal is not to save the company. On the contrary, it's to liquidate it in an orderly way that maximizes its value."[21]

This bias toward liquidation marks a radical change in American insolvency regulation. The distinctively American response to the financial distress of large corporations emerged in the late nineteenth century during periodic crises in the railroad industry. At the behest of the Wall Street banks that financed the railroads and the banks' lawyers, American courts devised a procedure known as the equity receivership—which was the ancestor of and inspiration for current Chapter 11. The premise, then as now, was that reorganization is often the most efficient method of resolving financial distress, especially with the largest companies—that reorganization can preserve value that would otherwise be lost.[22]

Some may object here that financial institutions are different from other large corporations in this regard. The value of a commercial bank, the reasoning goes, disappears in a cloud of smoke as soon as it defaults. While this may be true of the commercial bank entity itself, it does not accurately describe bank holding companies or other financial institution holding companies—each of whose insolvencies were handled only in bankruptcy prior to the Dodd-Frank Act. For some of these a restructuring may be far superior to a receivership, particularly if there are no or few potential buyers for the company's assets. Restructuring a troubled financial institution could also promote competition in the financial services industry, by preserving a competitor rather than shrinking the industry through the liquidation of one of a limited number of giant companies.

Dodd-Frank doesn't take these options off the table altogether, but it makes them far less likely. This increases the potential for value to be squandered in connection with a Dodd-Frank resolution—a risk that is particularly serious given the limitations of FDIC-style resolution with the largest financial institutions.

■ ■ ■

By my reckoning in this chapter, Dodd-Frank resolution is ill-equipped to handle three of the four objectives of an insolvency regime. The decision when to put a company in resolution will be made by regulators, rather than managers and market participants. This makes timely intervention unlikely; it and the prospect of immediate ouster will discourage the managers of a floundering financial giant from making any preparations for an orderly resolution. Because the FDIC can pay any creditors it wishes, there is no assurance that any given class of creditors—such as those holding derivatives—will be forced to take losses. And Dodd-Frank discourages and purports to forbid reorganization, even if that may be the best resolution option.

The only objective that Dodd-Frank handles tolerably well is limiting the danger of systemic risk. The same FDIC powers that make the promise of creditor haircuts illusory and undermine the priority scheme will enable the FDIC to respond to the threat of systemic risk by protecting vulnerable parties. The FDIC can promise to make good on the company's derivatives, for instance, if it concludes that mass repudiation could ignite a systemic crisis.

Assessing an insolvency regime is not simply a matter of adding up the grades on the various attributes of the framework, and tallying up the score, of course. Perhaps the best defense of the Dodd-Frank regime comes by analogy to Winston Churchill's famous defense of democracy: Dodd-Frank is the worst possible strategy for handling the financial distress of systemically important financial institutions—except, that is, for all the others.

But the Churchill dictum doesn't hold true here. The only thing that the Dodd-Frank resolution rules do at all well—responding to systemic risk—will soon be less crucial for most financial institutions, thanks to other, more effective parts of the Dodd-Frank Act. If most of the company's derivatives are backstopped by a clearinghouse, for instance, it will be much less important that the FDIC step in and make sure they all are honored.

Some have defended the resolution rules by emphasizing that they displace the normal, rule-of-law-oriented bankruptcy process for only a small group of companies, the very largest financial institutions. The hole may be deep, the argument goes, but it is narrow. But this reasoning is highly misleading. The "small" number of institutions covered by the new rules isn't so small. It already consists of the 36 bank holding companies with more than $50 billion in assets, and it will expand to include the nonbank financial institutions the Financial Stability Oversight Council deems systemically important, plus any other financial companies whose financial distress seems to regulators to jeopardize the nation's financial stability. Not only is this a sizable group, but each of its members dwarfs all but a handful of ordinary businesses in size. Their significance far outstrips their number.

These financial giants are now subject to an ad hoc, unpredictable insolvency process. No one knows for sure who is subject to it, since regulators can decide at the last minute that a financial company is in danger of default and that its default would pose a risk to financial stability. If regulators decide to take over, it will be essentially impossible for the company to resist, since the company is given almost no time and no basis for resisting—in violation of the ordinary right to due process. Once resolution is under way, regulators can pick and choose which claims to pay and which not to pay. The rule of law takes a backseat as soon as regulators begin thinking about intervening.

Thus, the bad news: The Dodd-Frank resolution is a mess. The good news is that it can be salvaged. I believe that the most serious problems can be fixed through simple adjustments to the ordinary bankruptcy laws to encourage troubled companies to initiate voluntary bankruptcy proceedings in the event of a crisis. Those adjustments are the subject of the next chapter, which shifts from description and diagnosis to possible cures.