Part B

LEHMAN AND "ORDERLY LIQUIDATION"

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Comment on Orderly Liquidation under Title II of Dodd-Frank and Chapter 14

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There continues to be substantial debate whether Title II of Dodd-Frank, providing in limited circumstances for possible liquidation by the Federal Deposit Insurance Corporation (FDIC) of systemically important financial institutions (SIFIs), effectively eliminates "too big to fail." The FDIC staff has stated that it is open to proposed changes in law to allow more effective use of bankruptcy by financial intermediaries in order to minimize the need for use of Title II liquidations.[1] Chapter 14 of the bankruptcy law, developed as part of the Resolution Project and set forth in a separate chapter, is such a proposed change. Chapter 14 is intended to create a viable bankruptcy alternative that would be more consistent with bankruptcy practice than Title II "orderly liquidation." Chapter 14 would allow possible continued management participation and more extensive creditor involvement, and would eliminate substantial (and, in material respects, essentially unchallengeable) discretion that the FDIC has under Title II to effectively pick winners and losers among creditors in conducting a liquidation.

In that connection, the hypothetical example of the liquidation of Lehman under Title II, as set out in the FDIC's counterfactual

1. R. Christian Bruce, *Krimminger's List: A Little More Chapter 11, A Little Less Title II*, Banking Daily (BNA), Dec. 13, 2011.

presentation of how the FDIC would have conducted the orderly liquidation of Lehman under the Dodd-Frank Act,[2] suggests a number of difficulties in the existing bankruptcy laws that are addressed and largely eliminated by the proposed Chapter 14. The FDIC counterfactual on orderly liquidation of Lehman concludes that liquidation of Lehman under Title II of Dodd-Frank would have resulted in a recovery rate for unsecured creditors of 97 cents on the dollar,[3] significantly more than creditors are expected to receive in the Lehman bankruptcy. As discussed in section II of this chapter, however, this conclusion likely overstates potential recoveries. Orderly liquidation of Lehman by the FDIC under Title II likely would have involved a wide range of possible more negative outcomes. The thesis of this chapter is that reorganization or liquidation of Lehman under the proposed Chapter 14—as compared to liquidation by the FDIC under Title II, under consistent assumptions (either the FDIC's or more neutral ones)—could produce preferable results and more knowledgeable valuations in most situations without implicating "too big to fail" concerns and while better protecting all creditors. A further purpose is to identify numerous overoptimistic assumptions in the FDIC's Lehman counterfactual to facilitate a more nuanced comparison with an alternative Chapter 14 resolution.

At the outset, it should be noted that in effecting "orderly liquidations" the FDIC is likely to use its discretion in a manner similar to its practices under the Federal Deposit Insurance Act (FDIA) to avoid real liquidation of business operations. The possibility of "conservatorship" as such was prohibited by the Boxer Amendment as part of the legislative process.[4] However, the FDIC can (and has

2. *The Orderly Liquidation of Lehman Brothers Holdings Inc. under the Dodd-Frank Act*, 5(2) FDIC Quarterly 31–49 (2011).

3. *Id.* at 48.

4. Dodd-Frank Act, Pub. L. 111–203 (July 21, 2010), § 214.

admitted that it will) reach effectively the same result in another way. The FDIC has indicated that it will allow continuing operation by new management of the business in a "bridge" financial institution in order to maximize value when an immediate sale in a purchase and assumption transaction to a third party is not available. It can be seriously disputed whether this is a true "liquidation." In any event, however, as recognized by the trend of modern bankruptcy law and contemplated as possible in Chapter 14, continued operation—especially by knowledgeable existing management—may produce better valuations and more successful operations.

I. TITLE II, THE FDIA, AND CHAPTER 14

The FDIC has argued that its discretion is substantially limited in liquidations under Title II and that "too big to fail" has been eliminated with respect to nonbank financial intermediaries.[5] Close examination suggests that (1) in the actual exercise of its liquidation authority, the FDIC has essentially the same wide discretion historically exercised in the case of failed banks under the FDIA, notably in determining those assets and liabilities to transfer to a bridge institution; and (2) the FDIC's use of bridge financial institutions, in an effort to substantially preserve going concern value, is likely to be a principal approach under Title II and may effectively allow continuation rather than liquidation of the business of the failed company, notwithstanding claims to the contrary by Congress

5. Sheila C. Bair, "We Must Resolve to End Too Big to Fail," Remarks before the 47th Annual Conference on Bank Structure and Competition, sponsored by the Federal Reserve Bank of Chicago, May 5, 2011, reprinted in 5(2) FDIC Quarterly 25–29 (2011).

and the FDIC.[6] Moreover, the FDIC's discretion is likely to be exercised in a manner adverse (perhaps necessarily so) to the interests of some disfavored creditors.[7] The successful operation of Orderly Liquidation Authority (OLA) under Title II depends on the exercise by the FDIC of its substantial discretion so as to avoid a central feature of Title II: liquidation, as opposed to continuation of the business in another form. This could be regarded as the continuation of past "too big to fail" policies and the accompanying moral hazard, just in a modified form. By comparison, Chapter 14 affords a method both for realizing greater value by continuing knowledgeable management in place and for allowing a distribution of that value to creditors in a manner more consistent with U.S. bankruptcy law and expectations and more equally among creditors of the same class.

There are, of course, some differences between the FDIC's discretion in the operation of liquidation authority under Title II of Dodd-Frank and in bank resolutions under the FDIA. These, however, do not change the overall fact: the FDIC has very substantial discretion, in important respects unconstrained by judicial oversight, under Title II. Among the differences between Dodd-Frank and the FDIC operations under the FDIA, the most notable that might be cited are: (1) the broader decision-making process involving the Federal Reserve, the U.S. Treasury, and the president to invoke orderly liquidation, similar to the process for systemic (but not most) bank failures under the FDIA; (2) the (nominal) requirement that the covered financial institution be liquidated; (3) the purported limited time period for completion of the liquidation; (4) certain differences in creditor priorities; and (5) involvement in appropriate instances

6. Dodd-Frank, § 204(a); *Orderly Liquidation of Lehman Brothers Holdings Inc.* (*supra* n. 2), 36.

7. Kenneth E. Scott, *A Guide to the Resolution of Failed Financial Institutions: Dodd-Frank Title II and Proposed Chapter 14*, chapter 1 in this volume.

of other functional regulators—the Securities and Exchange Commission (SEC), Securities Investor Protection Corporation (SIPC), and state insurance regulators. In fact, once a liquidation under Title II is determined to be invoked, these differences have little effect on FDIC practice. While it is true that other entities have a role in the initial decision to liquidate a covered financial company under Title II, it is the FDIC that formulates and carries out the resolution.

Under the FDIA, the FDIC has used "bridge" banks generally only in situations where no bidder has come forward due to fraud, a rapid failure for liquidity reasons, or other reasons of wide uncertainty as to values. Such situations may be expected to occur more frequently in the case of the possible failure of systemically important financial companies in the variations listed by Kenneth Scott—macro shocks, chain reactions, and common abrupt reassessments.[8] There is general agreement that such events could trigger liquidity runs and sudden changes. In such cases (and notably contrary to the Lehman counterfactual set out by the FDIC staff), it is not possible for the FDIC to have done extensive investigation and valuation and conducted an auction bidding procedure. So to preserve value, as noted previously, the FDIC would not "liquidate" the business in any commonly understood meaning of the term, but would use a "bridge" financial institution as an interim step and transfer substantial amounts of assets and liabilities to the bridge institution, thereby picking winners and losers among the creditors and effectively continuing the business.

Because of the likely rapidity of the failure of these institutions, the FDIC is unlikely to be able to use the extensive investigation and valuation procedures relied upon in the FDIC Lehman counterfactual. Instead, the FDIC is likely to use bridge institutions

8. *Id*. at 14–16.

much more frequently under Title II than it has under the FDIA. Even where there is sufficient time to plan for orderly liquidation, as assumed by the FDIC in its Lehman counterfactual, the FDIC would be transferring some assets and favored liabilities to a purchaser (rather than a bridge institution) while disfavoring others. The FDIC's practice in transferring assets and liabilities to bridge banks has varied, but generally has encompassed those items it views necessary or essential for continued operations, leaving behind claims as of the date of failure and assets where there may be questions of value. The FDIC has made an effort to assure maximum equal treatment in orderly liquidations in its new rule in 12 C.F.R. § 380.27(4), but that is a procedural protection (requiring FDIC Board action rather than FDIC staff decisions) that does not limit FDIC discretion in any substantive manner. By comparison, in the framework of the new Chapter 14, knowledgeable management could be allowed to remain in place and could itself accomplish the same value preservation; creditors would be afforded traditional rights of legal recourse and equal treatment. Moreover, by narrowing the circumstances where orderly liquidation might be necessary, Chapter 14 would eliminate some of the uncertainties as to outcomes and thereby reduce costs.

II. THE LEHMAN CASE

This brings us to consideration of some of the specifics of the FDIC's Lehman counterfactual on "orderly liquidation" under Title II. The FDIC's analysis raises a number of questions. First and most important, there is an assumption of complete, up-to-date information possessed by the FDIC and other regulators. In order to derive its claimed recovery, facts are cited from the record of later court proceedings and the examiner's report. These facts are assumed to be known *ex ante* by virtue of the examination authority and on-site supervision by the FDIC. This state of knowledge is unrealistic in the real world in the case of a rapid liquidity failure of a large financial institution in one or more of the scenarios previously identified. Extensive past experience indicates that information regarding failing institutions can be very far from robust, and failures can arise very suddenly. The most recent example, which hopefully will not often be repeated, is the failure of MF Global, where for almost six months approximately $1.6 billion in assets remained missing; although those assets apparently have now been located, it remains unclear whether any are recoverable.[9] This uncertainty and lack of full information arises often in the failure of smaller banks and invariably in larger failures. Consider, for example, the case of Wachovia, where the FDIC had initially agreed to a less-favorable bid from Citigroup that would have cost considerably more than the ultimate acquisition by Wells Fargo.

Second, the FDIC Lehman counterfactual assumes complete and largely transparent coordination with foreign regulators and the absence of international complications or adverse foreign court rulings that would impede the liquidation by the FDIC. As shown in Kimberly Summe's presentation and noted elsewhere,[10] this is contrary to what actually happened in Lehman, where substantial funds were trapped offshore in foreign subsidiaries. The FDIC has admitted that developing a better understanding of the international aspects

9. Testimony of James W. Giddens, Trustee for the Securities Investor Protection Act Liquidation of MF Global Inc. before the U.S. Senate Committee on Banking, Housing and Urban Affairs, April 24, 2012.

10. Kimberly Anne Summe, *An Examination of Lehman Brothers' Derivatives Portfolio Postbankruptcy: Would Dodd-Frank Have Made a Difference?* chapter 4 in this volume.

of orderly liquidation and better knowledge of and relationships with foreign financial regulators is a subject that needs far more attention and progress. The FDIC staff has also noted that there is little likelihood there could be an international treaty on financial institution resolution. In fact, the Lehman bankruptcy entailed numerous international complications and the need ultimately for a formal protocol among creditors. It is unrealistic in the face of this past experience and the current state of international cooperation to believe that the orderly liquidation of Lehman could have been effected speedily without material international complications.

Third, and related to the second point, the counterfactual focuses only on the top company, Lehman Brothers Holdings Inc., and ignores the possible effects of related liquidation, bankruptcy, or other proceedings in the United States or abroad involving subsidiaries and affiliates of Lehman. There is also material risk that U.S. domestic subsidiaries and operations will be distressed and may need reorganization or resolution, further complicating matters. In fact, there were a number of significant proceedings in Lehman involving subsidiaries and affiliates and intercompany obligations,[11] and ultimately it was necessary to agree on an extensive cross-border insolvency protocol among creditors. Among the international issues arising in the Lehman proceedings were allegations of automatic stay violations, conflicting U.S.-U.K. judgments, cross-border valuation questions, intercompany claims, subordination conflicts, and others.[12] The concept that the top Lehman company could be

11. *See*, for example, Lehman International Proceedings, in the International Protocol Proposal, Presentation to the Bankruptcy Court by Alvarez & Marsal (Feb. 11, 2009); Presentation to the American Bar Association, Business Law Section, Spring Meeting (April 15, 2011); and ABA Business Law Section, Annual Meeting Materials (August 2011).

12. Milbank, Tweed, Hadley, & McCloy, "Lehman Failure Replayed: Would FDIC Liquidation Be More Orderly than Bankruptcy?" Presentation to the Ameri-

liquidated under Title II without complications from subsidiaries and affiliates is not warranted. And some of these complications could occur in a purely domestic context as well.

Fourth, the FDIC assumption about funding in its Lehman counterfactual may also be unrealistic. The FDIC simply asserts that sufficient funding would be available because there is no need for court approval. However, § 210(n)(6)(A) of Dodd-Frank explicitly limits available funding for the FDIC to 10 percent of the book value of the consolidated assets for the first 30 days or until there has been a valuation of the assets of the covered financial company. It appears that an amount in excess of this 10 percent book value would have been needed immediately to cover collateral obligations and meet Lehman's debt problems.[13] At a minimum, this could result in the necessity for either a very rushed and suspect valuation of assets and positions or a very quick need for third-party financing guaranteed by the FDIC to avoid that restriction.

Fifth, the FDIC's counterfactual identifies resolution plans (the so-called "living wills") that might have been prepared by Lehman as giving orderly liquidation under Title II an advantage over bankruptcy proceedings. Of course, this advantage should be at least equally available under Chapter 14. In fact, under § 165 of Dodd-Frank, these resolution plans are required to be prepared for resolution of the covered financial company under the bankruptcy law rather than under Title II. Thus, insofar as detailed advance planning had been in fact accomplished by Lehman (or in the future by

can Bar Association, Business Law Section, Spring Meeting (April 15, 2011); ABA Business Law Section, Annual Meeting Materials (August 2011).

13. The FDIC staff has indicated that, in any event, this limitation may be avoided by the FDIC guaranteeing third-party indebtedness to fund the bridge institution, since guarantees are valued based on the risk of payment rather than their face value.

other entities), it would seem more useful in a bankruptcy proceeding (under Chapter 14, if it were put in place) than in a Title II FDIC liquidation. An additional advantage, previously noted, would be that a Chapter 14 bankruptcy proceeding could be initiated and possibly overseen by continuing management that prepared the living will and has full current knowledge of the operations.

Sixth, the FDIC counterfactual notes the advantage of the ability of the FDIC to briefly delay, close out, and possibly transfer to third parties qualified financial contracts under Title II. Assuming these are important steps, despite the doubts raised by Summe's analysis,[14] these advantages would be similarly available under the proposed Chapter 14 since the governing provisions are similar, albeit more narrowly tailored to firm-specific collateral.

Seventh, as noted elsewhere,[15] the FDIC counterfactual makes unrealistic assumptions as to value in concluding that unsecured creditors would have achieved a 97 percent return on claims. Specifically, the FDIC assumes that only the "suspect" assets (of from $50 billion to $70 billion) would lose any value and all other asset values would remain stable for the orderly liquidation. This seems very unrealistic in any situation of serious distress.

Eighth, and significantly, in assessing the likely recovery by unsecured creditors in its counterfactual, the FDIC explicitly assumes that "losses had been distributed equally among all of Lehman's remaining unsecured creditors." This is, of course, substantially what would happen under Chapter 14, but contrary to how the FDIC might distribute losses in liquidation under Title II (unless "remaining" is read to exclude unsecured creditors whose claims are trans-

14. Summe, *An Examination of Lehman Brothers' Derivatives Portfolio Postbankruptcy* (*supra* n. 10), pp. 85–129.

15. Stephen J. Lubben, *The F.D.I.C.'s Lehman Fantasy*, New York Times, Dealbook Column (April 19, 2011).

ferred to the bridge institution; in which case, the meaning of "equally" is distorted). In a liquidation under Title II, the FDIC has substantial discretion (similar to that the FDIC exercises in resolutions of insured banks) in determining whether to transfer claims to a bridge institution or leave them behind in the receivership. Claims that are transferred to the bridge institution, if it operates in accordance with FDIC expectations,[16] end up fully paid with any excess amounts returned to the receivership. Claimants remaining behind in the receivership, by contrast, are entitled only to claim *pro rata* by claim priority what is ultimately available from the receivership assets, which for general, unsecured creditors is almost always considerably less than a full 100 cents on the dollar. The FDIC in its counterfactual neither details the differences among creditors as to winners or losers, nor explains how the latter would be assured a minimum recovery of what they might have received in an actual bankruptcy liquidation.

Finally, the FDIC counterfactual assumes a successful sale of business to a third party, something that would be equally possible under Chapter 14. The bidding under Chapter 14 would be competitive and subject to judicial overdraft and scrutiny.

III. CONCLUSION

The FDIC's counterfactual is, in sum, a comparison of the actual unplanned liquidation of Lehman under current bankruptcy law with retrospective application of Title II using assumptions of perfect

16. It is possible, of course, that these expectations could be overoptimistic and the bridge institution could in turn fail or have to be liquidated with creditors receiving less than their full claimed amount.

knowledge and value stability. In a Title II liquidation, there is no possibility of continuing prior "responsible" management, no creditors' committee, no court monitoring, and the absence of equal treatment of similarly situated creditors. The FDIC unilaterally makes all the decisions, and these are final in all respects. By contrast, Chapter 14 restores these features of traditional bankruptcy, provides greater clarity of application, and is intended to avoid some of the key problems that have been troublesome in the Lehman proceedings.

For all of these reasons, the FDIC's Lehman counterfactual is subject to considerable doubt. In some cases, the operating assumptions are too optimistic; the problems of imperfect knowledge and the difficulties of international coordination are ignored; and the claimed advantages over bankruptcy result from aspects of existing bankruptcy law that would be substantially addressed by the proposed Chapter 14. Therefore, a full counterfactual Lehman bankruptcy comparing a Title II liquidation with Chapter 14 on a common baseline, with realistic assumptions as to the state of knowledge and international complications, would be a more effective way to test the asserted superiority of Title II.