6

The Going-Concern Value of a Failed SIFI

Dodd-Frank and Chapter 14

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One of the principal objectives in a resolution of a failed systemically important financial institution (SIFI), as with any company, is to seek to maximize the remaining value of the firm and thereby reduce losses to its creditors or others. Thus, as the Federal Deposit Insurance Corporation (FDIC) put it in an article on "The Orderly Liquidation of Lehman Brothers Holdings Inc. under the Dodd-Frank Act":

> The keys to an orderly resolution of a systemically important financial company that preserves financial stability are the ability to [1] plan for the resolution and liquidation, [2] provide liquidity to maintain key assets and operations, and [3] conduct an open bidding process to sell the company and its assets and operations to the private sector as quickly as practicable.[1]

The point of the FDIC article is that Title II of the Dodd-Frank Act ("Dodd-Frank") provides a procedure much superior to the (existing) Bankruptcy Code, as shown by a hypothetical FDIC resolution of the failed Lehman Brothers investment bank.[2]

1. 5 FDIC Quarterly 1 (2011).
2. For an analysis of the hypothetical, *see* William F. Kroener, *Comment on Orderly Liquidation under Title II of Dodd-Frank and Chapter 14*, chapter 3 in this volume.

Prior to the adoption of Dodd-Frank, members of the Resolution Project had lengthy discussions about the "best" way to resolve large financial companies in financial distress. Goals included maximizing value for the claimants, minimizing systemic effects that were directly due to the distress or failure of a particular financial institution (rather than, say, caused by an event raising concerns about troubled assets held by a number of large financial institutions), and reducing the possibility of government bailouts that would distort market-based decision making and discipline.[3]

Out of this, the Resolution Project group set as a goal the development of a new Chapter 14 for the Bankruptcy Code, designed specifically for large financial companies, as the vehicle best suited to meet these goals. While Congress went in a different direction with its "orderly liquidation authority" in Title II of Dodd-Frank, we continue to believe the Chapter 14 solution has much in its favor. Thus, we continue to urge its adoption even if Title II of Dodd-Frank were to be left untouched.[4] But the FDIC article suggests that Title II of Dodd-Frank is, in fact, superior to bankruptcy, particularly as a vehicle for capturing going-concern value. We would like to test that, not against current bankruptcy law, but against bankruptcy law as we propose it with the addition of Chapter 14.

This chapter, accordingly, analyzes the ability of a modified bankruptcy law to meet the criteria given earlier and, specifically, its ability to preserve and maintain a financial firm's going-concern value. To begin, we consider the locus of value in such firms, using

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3. Much of this work is contained in Kenneth Scott, George Shultz, & John Taylor, eds., *Ending Government Bailouts as We Know Them* (Hoover Institution Press, 2010).

4. *See* Thomas H. Jackson, *Bankruptcy Code Chapter 14: A Proposal*, chapter 2 in this volume.

Bank of America, Citigroup, and Lehman Brothers numbers as of the summer of 2008, when the financial meltdown was approaching its climax. At that point, the total book assets of Bank of America were $1.7 trillion, Citigroup $2.1 trillion, and Lehman Brothers $639 billion.[5]

I. WHERE IS THE VALUE OF A SIFI?

In looking at this, there are several categories of assets and revenues, both tangible and—also important (and often "off-book")—intangible.

A. Tangible (Other than Financial) Assets

Many firms (particularly manufacturing concerns) have substantial value in fixed assets: real estate, buildings, equipment, and other tangible assets that can be sold off separately to interested purchasers. If such assets are firm-specific (though often they are not), significant reductions in value may be incurred in a liquidation as opposed to a reorganization. However, for large financial companies such as we are focusing on, such tangible assets are—in contradistinction to manufacturing (and even retail) enterprises—likely to constitute a small part of the firm's value. We assume that a goal of maximizing the value of a firm will, with respect to a financial institution's fixed assets, rarely point either in the direction of a liquidation or a reorganization.

5. All data comes from Securities and Exchange Commission (SEC) 10-Q filings, available at http://sec.gov/Archives/edgar.

B. Securities and Financial Assets

For a commercial bank, loans are the largest part of its balance sheet (50 percent for the Bank of America, 35 percent for Citigroup), while for Lehman Brothers as an investment bank, other financial assets constitute practically everything that appears on a balance sheet. Consumer loans (mortgage, credit card, etc.) and commercial loans are difficult to sell off on an individual basis, which is why securitization pools have grown so extensively in recent years. But even asset-backed securities became illiquid in the 2008 financial panic, and institutions feared substantial losses from book values if they had to be sold into the market. The result was controversy over "fair value" accounting rules when they continued to be held on the balance sheet. Part of what is deemed "going-concern value" of a financial institution may be hard to distinguish from reluctance to recognize losses if the financial assets are sold into the market.

C. Revenues

Revenues may come from interest on loans and securities, or from fees (e.g., commissions), services (e.g., asset management or prime brokerage), and trading (e.g., dealing in swaps and derivatives). For the first half of 2008, Citigroup reported gross/net interest income of \$58/28 billion, Bank of America \$42/21 billion, and Lehman Brothers \$17/1 billion. Noninterest income was \$4 billion for Citigroup, \$17 billion for Bank of America, and \$37 million for Lehman Brothers.[6]

6. All reported trading losses on principal transactions: \$12 billion for Citigroup, \$1 billion for Bank of America, and \$3 billion for Lehman Brothers.

D. Human Capital

Related importantly to the prior two categories, much of the value of financial institutions (albeit appearing nowhere on its balance sheet) is best thought of as its human capital. The future stream of noninterest income, in particular, depends upon "human capital"—the knowledge, expertise, and customer relationships of higher-level employees—which is lost if the firm does not continue in existence. Unlike other firm assets, however, the human capital can move on its own to other institutions (taking with it much of the firm's revenues as well). Keeping the human capital in place may be among the most important issues in resolving financial institutions in distress in a way that maximizes firm value, and among the most difficult to accomplish unless rapid resolution (and assurance) is provided.

E. Trade Names and Intellectual Property

Again related to human capital, proprietary trading practices and information databases, as well as the firm's name itself, may be significant contributors to a financial institution's going-concern value.

II. WHAT CAUSES A SIFI TO FAIL?

Failure, of course, has many potential causes. Some are firm-specific, such as poor management or fraud. But others are more systemic, and likely to affect—albeit to different degrees—a number of financial institutions simultaneously. In this category, in particular, two factors stood out in 2008: asset losses and creditor loss of confidence.

A. Asset Losses

In the financial meltdown of 2008, the primary driver was the end of a prolonged housing price bubble and a corresponding rise in defaults on subprime mortgages (characterized by low initial-rate loans with minimal down payments by borrowers with poor credit histories). Lender banks kept some of these loans on their own balance sheets, but transferred most in the form of asset-backed securities to institutional investors (including themselves) throughout the world.[7] As defaults mounted and asset-backed securities (ABS) ratings declined, large commercial and investment banks came to question the values that their counterparties were claiming on their balance sheets.

The function of capital is, of course, to cover unexpected losses and induce creditors to keep transacting with the firm. But leverage—the ratio of liabilities to capital—had become elevated in investment banks and suspect in commercial banks. The applicable capital requirements were proving to be inadequate to provide reassurance.

B. Creditor Loss of Confidence

As counterparties begin to become concerned about the riskiness of a firm they are dealing with, they undertake to reduce their exposure. Derivatives counterparties who are "in the money" demand more or better collateral, draining assets from the firm. (This was a particular problem that prompted government intervention in AIG.) Repo lenders may decide not to renew their transactions, which are usually very short-term. The result is that funding for the firm's normal operations disappears, and liquid assets that the firm

7. For a fuller account, *see* Kenneth Scott, *The Financial Crisis: Causes and Lessons*, 22 J. App. Corp. Finance 22 (2010).

can sell on short notice are insufficient to fill the gap. The firm's clearing bank may refuse to extend intraday credit in clearing and settlement, ending the firm's ability to engage in trading. In whatever form, the firm fails.[8]

III. RESOLUTION

With this in mind, we can now turn to an analysis of how Chapter 14's approach for resolving large financial institutions in financial distress is likely to fare. While our focus is primarily on Chapter 14, it is necessary to start with a comparison of Title II of Dodd-Frank, particularly in light of its claimed superiority to bankruptcy processes (albeit without the modifications we propose in Chapter 14). While many of the governing rules between resolution under Dodd-Frank and reorganization or liquidation under our proposed Chapter 14 of the Bankruptcy Code look similar (since, indeed, Dodd-Frank copied a number of bankruptcy's substantive provisions), there are also significant differences in procedures, and in some cases in overarching authority, that suggest the ability to maximize a firm's value will in fact be distinct between the two regimes. We start briefly with Title II of Dodd-Frank before turning our focus to the Resolution Project's proposed Chapter 14.

A. Title II of Dodd-Frank

While the statutory language of what became Dodd-Frank itself seemed focused on a liquidation rather than a reorganization

8. *See* Darrell Duffie, *How Big Banks Fail and What to Do about It* (Princeton University Press, 2010).

(through language such as a "receivership" or, indeed, the name of Title II itself: the "orderly liquidation authority"), the Boxer Amendment was intended to make the overarching goal of Dodd-Frank a mandate for a liquidation of a failed financial institution that enters its orderly liquidation authority under Title II. "All financial companies put into receivership under this title shall be liquidated," Dodd-Frank forcefully states.[9] "No taxpayer funds shall be used to prevent the liquidation of any financial company under this title." This liquidation mandate, although wildly divergent from the basic spirit of bankruptcy law during the past 100 years (which has had, if anything, a bias in favor of reorganization or rehabilitation), was a part of the spirit of the times respecting financial institutions in which Dodd-Frank was passed. In addition to the stern edict that the firm "shall be liquidated," it was also a part of Title II of Dodd-Frank that senior management was to be terminated (which would have been the case if the liquidation mandate were, indeed, followed).[10] Taken literally, these provisions would make the prospect of salvaging going-concern value through keeping together the things that create it for financial institutions—in particular, human capital, trade/intellectual property, and associated revenues—almost impossible.

9. Dodd-Frank § 214. Even the "purpose" language of § 204 focuses on the "authority to liquidate," to be done "in a manner that mitigates [financial stability] risk and minimizes moral hazard." Not a word is said about a goal of maximizing asset values.

10. *See* Dodd-Frank § 204(a)(2) (providing that "management responsible for the condition of the financial company will not be retained") and § 204(a)(3) (directing that "management" and "directors," among others, "having responsibility for the condition of the financial company bear losses consistent with their responsibility, including actions for damages, restitution, and recoupment of compensation and other gains not compatible with such responsibility"). *See also* Dodd-Frank § 206(4) and (5) (making such removal actions "mandatory" on the part of the FDIC).

Despite this seemingly inflexible liquidation mandate, buttressed by the provision of § 212 of Dodd-Frank that "[n]o governmental entity may take any action to circumvent the purposes of this title" (of which the required liquidation of a failed financial institution certainly sounds as though it qualifies), it is inevitable that regulators will rely on other, not entirely consistent, provisions in Dodd-Frank to restructure the firm via a merger, a sale of assets, or a transfer of assets to a "bridge financial company" (the latter being a putatively temporary company, but one that can exist for a long enough period so as to ultimately merge into yet another firm).[11]

Even this possible alternative, however, is not structured in a way easily designed to maximize values. The FDIC, being ill-equipped to manage a very large financial institution by itself (and recall, one of its first jobs is to ensure that responsible management has been terminated), is almost certainly likely to exercise these options in quick order, relying on its own judgment rather than the market.[12] Indeed, the determination of which parts of the financial institution warrant continuation and why, as well as the value of the assets and liabilities that are being sold or transferred, seem by Dodd-Frank to be left wholly to the discretion of the FDIC. Thus, even if one ignores the language of the Boxer Amendment, which seems probable, the structural obstacles put in place by the FDIC having to be the receiver attempting to run the business in the

11. All of these possibilities are at least open because of the language of Dodd-Frank § 210. *See generally* Douglas Baird & Edward Morrison, "Dodd-Frank for Bankruptcy Lawyers," 19 Am. Bankr. Inst. L. Rev. 287 (2011), also available at http://www.law.northwestern.edu/searlecenter/jep/symposia/documents/Baird_Dodd-Frank_for_Bankruptcy_Lawyers.pdf (making the point about the ability under Dodd-Frank to achieve a de facto reorganization).

12. A point persuasively made by David Skeel, *The New Financial Deal: Understanding the Dodd-Frank Act and Its (Unintended) Consequences* 149–50 (John Wiley & Sons, 2010).

interim (either directly or via the created "bridge" institution)—after discarding much of senior management with likely the largest human capital contributions to the institution—suggest that market-based valuations of any parts of the firm with a going-concern value will not be forthcoming.[13]

B. Bankruptcy under Proposed Chapter 14

A financial firm could file, under Chapter 14, either for liquidation or for reorganization. Consistent with a practice in existence since the equity receivership for railroads was invented in the nineteenth century, a firm that may have a positive going-concern value (or parts of it having such a potential value) will file in the first instance for a reorganization (Chapter 11 proceeding) under Chapter 14. In addition to the determination as to whether a firm is worth more as a going concern than liquidated, the bankruptcy process is focused on the determination of the value of assets, the value (and priority) of claims, and the distribution of the asset values to the claim holders in accordance with established priorities (known as the "absolute priority rule")—that is, secured creditors get paid first (up to the value of their collateral), unsecured creditors next, and various forms of shareholders last.[14] The question of how these com-

13. The requirement for wind-down plans may provide limited guidance to the FDIC as to parts of the business most likely to warrant continuation, even in the absence of market-based input as to values.

14. These rules are first set out in Chapter 7 of the Bankruptcy Code, notably §§ 725 and 726. In turn, they become the background rules for plan confirmation in Chapter 11, particularly via § 1126 (acceptance of plan), § 1129(a)(7) (nonaccepting claim holders must receive at least what they would have received in a Chapter 7 liquidation), and § 1129(b)(2) (for nonaccepting *classes*, the claimants are paid in full or no junior class receives or retains any property on account of the claims or interests of that junior class).

ponents interrelate, particularly in the context of a large financial institution, is the focus of the remainder of this chapter.

1. Running the Business Immediately after the Filing

While Dodd-Frank's orderly liquidation authority places the FDIC as receiver, and "requires" responsible management to be terminated, Chapter 14 (using the general rules of reorganization under Chapter 11) assumes that the "debtor" remains "in possession."[15] What this means, as a matter of common practice, is that the existing management of the firm continues to manage its operations, on the view that they have the best information about the firm's activities, as well as a sense of the valuable assets (including human capital). The notion is both that management presumptively has firm-specific knowledge (and value) *and* that a firm's financial distress is not inevitably the consequence of "bad management" (in the sense of management that was distinctly lower in competence and judgment than the management of other comparable institutions).

To be sure, management in some cases may not be ideal or may be too responsive to the old shareholders, and Chapter 11 (and thus Chapter 14) has a process for management to be replaced upon creditor (or also, in the case of Chapter 14, government) petition.[16] But the decision to replace management is both orderly and dependent on context (i.e., all things considered, is there a better manager?) rather than being a preemptive replacement of management by the FDIC as receiver. And with management (and other valuable employees—the firm's human capital) presumptively intact, the bankruptcy process can figure out, with the assistance of the constituent players (including creditors), what the likely best course is

15. Bankruptcy Code §§ 1101(1), 1107.
16. Bankruptcy Code §§ 1104, 1108.

for the assets—is it a continuation, a partial sale, or a liquidation? Continuation funding during this interregnum is possible because of the fact that postpetition financing is automatically entitled to administrative expense priority over preexisting unsecured claims,[17] and even higher priority can be given under certain circumstances, via the procedures in § 364 of the Bankruptcy Code.

2. Reorganizing or Selling the Assets

When the Bankruptcy Code was adopted in 1978, its structure (and history) suggested that the choice was either to "reorganize" and continue the firm under Chapter 11 or "liquidate" it under Chapter 7. Although the 1978 Bankruptcy Code originally structured itself around an idea of a "piecemeal liquidation" pursuant to Chapter 7, and a "going concern" reorganization pursuant to Chapter 11, events since that time have demonstrated that the two ideas are not as separate as originally conceived—and there are considerable advantages to a going-concern sale within a Chapter 11 reorganization.

For the first years after the enactment of the 1978 Bankruptcy Code, Chapter 11 reorganizations were ponderous events. The going-concern option—the reorganization—contemplated a process supervised by the bankruptcy court, but one in which the constituent players, through an adversarial system, argued about asset and liability values, and in which the "debtor-in-possession" had exclusive control over important parts of the process for long periods. The structure of Chapter 11 contemplated a debtor-in-possession who would have an exclusive period (presumptively, 120 days) in which to propose a plan of reorganization,[18] which would then be

17. Bankruptcy Code §§ 364, 503.
18. Bankruptcy Code § 1121(b).

voted on by the various classes of creditors and shareholders, with a bankruptcy judge overseeing the process, based on that judge's perception of the value of various securities given out in a reorganization and whether that satisfied the substantive tests ("best interests of creditors" for dissenting members in a class,[19] and "absolute priority rule" for a dissenting class[20]).

Even this description overstates the speed with which major reorganizations proceeded, as bankruptcy judges in the early years after the enactment of the Bankruptcy Code routinely extended the debtor-in-possession's exclusivity period for numerous reasons, including the difficulty of resolving disputed claims in time for Chapter 11's voting procedures that would follow upon the filing of a plan. In short, not only were markets (largely) not relied on, but the creditors (presumptively the new residual owners of an insolvent firm) found statutory obstacles in terms of real leverage over the future direction of the firm. This Chapter 11 process was often justly criticized as a mechanism for transferring value from creditors to shareholders through extended shareholder control over the firm and the reorganization process and plan, as well as inflated (or, at least, overly optimistic) judicial valuations, rather than focusing on maximizing firm values and allowing those values to be distributed according to the absolute priority rule.

Increasingly over time, however, the participants in a reorganization—including the bankruptcy judges overseeing the process—began to eliminate some of the worst abuses of the original

19. Essentially, whether the dissenting creditors would receive as much as they would have received "if the debtor were liquidated under chapter 7," Bankruptcy Code § 1129(a)(7)(A)(ii).

20. Essentially, that they are "paid in full," or a junior class "will not receive or retain under the plan on account of such junior claim or interest any property," Bankruptcy Code § 1129(b)(2)(B)(ii).

Chapter 11 process, principally by eliminating lengthy delay caused by extended exclusivity periods and by relying on market, rather than contested judicial, valuations of a firm's assets. Using the sale procedures of Chapter 3,[21] which originally had been contemplated largely for use in Chapter 7 (and for the disposal of "stray" unwanted assets in a Chapter 11), § 363 became the vehicle for going-concern sales of the entire business or major portions of a business. Such a procedure brought the market into play, with two significant consequences.

First, most of the ponderous delays in Chapter 11 could be avoided by a rather quick market bidding and sale procedure. The successful buyer of the assets (which could include creditors of the firm, particularly secured creditors, who could use their claims' value as a part of the purchase price), if it wished to continue them as a going concern, would put on them the appropriate capital structure, and the purchase price would become the new "assets" of the bankruptcy estate, to be divided among the nontransferred claimants according to the bankruptcy distribution rules. Disputed claims—unless assumed and transferred in the sale—did not need to be resolved prior to the sale, assets could be sold via market procedures, and the resulting "purchase price" could then be held by the bankruptcy estate while remaining claims' valuation issues were determined. Essentially, this allowed the assets (the business) to be severed from often complex and messy prepetition claims issues associated with the firm that had filed for reorganization. If claim valuation issues remained, they could be resolved without slowing down the process of selling the valuable assets to a new buyer in a market-based process.

21. Principally Bankruptcy Code § 363, providing for the "[u]se, sale, or lease of property."

Second, "distributional" valuation issues and disputes could be minimized when the proceeds of the sale consisted of cash and/or marketable securities. Importantly, such market valuations, via the sale proceeds, facilitated classwide voting and also determined the consequences of that voting. It was much clearer what value a dissenting creditor (or a dissenting class) would receive—a hugely valuable displacement of the disputes over value when a bankruptcy judge was making those determinations without reference to the market.

3. Reorganizations, Going-Concern Sales, and Financial Institutions

These features that developed since 1978—a quick, market-based bidding and sale—are essential cornerstones for Chapter 14 to build on as a viable process for reorganizing the nation's largest financial institutions, as we propose it should be. These market-based processes, in which a firm is run (often with existing management) while the appropriate response from market players helps inform a decision as to whether and how to sell the assets under § 363, has several key advantages for financial institutions. First, during the period following the filing, when the liquidity needs of the firm may be greatest, the sharp "severance" of prepetition from postpetition creditors encourages continuing dealings with the firm (through the receipt of administrative expense priority), unless the firm is perceived as badly insolvent and unlikely to be salvageable as a going concern. Second, markets and not the FDIC (or a bankruptcy judge) determine values—and, crucially, whether a firm's assets are worth more as a going concern or broken up and liquidated. Third, because the purchasers can be virtually any institution or group that can put together the financial package to enable the purchase, it is much less likely to lead—as does a bridge bank followed by a merger under Dodd-Frank—to increased concentration in an already-concentrated industry. Fourth, because the process involves market-based bidding for assets, and the receipt by the debtor in the Chapter 14 process of presumably marketable securities (if not cash) for the assets, it means that the valuation issues associated with the paying of nonassumed claims will themselves have a market-based foundation, making it much more difficult to have disguised bailouts than is the case in a bridge bank scenario.[22]

It is here where several features of the Chapter 14 proposal we have advanced join in order to ensure that bailouts taking place through a flawed sale under § 363 are minimized, as are other outright evasions of the legally clear priority rules enshrined in bankruptcy law. Those features include the ability to draw on the knowledge and expertise of federal agencies while, at the same time, minimizing the possibility that the experienced and independent Article III judges Chapter 14 contemplates will be subject to undue pressure by such a government agency to facilitate bailouts or other disruptions of preexisting priority rules.

To be sure, a government bent on a bailout can no doubt endeavor to accomplish it, even within the confines of (or in conjunction with) a Chapter 14 proceeding, but the transparency of a process overseen by an Article III judge, subject to clearly established legal priority rules and review by further Article III courts, can make this

22. The FDIC response to an earlier piece by Kenneth Scott suggested that this is overstated because, through the idea of continuing relationships, bankruptcy can (with reluctance, as the response acknowledges) sometimes "assume" obligations as postpetition administrative expenses (such as the decision by an automotive producer in bankruptcy to assume warranties of cars sold prior to bankruptcy). But this comes under a doctrine of necessity that requires judicial affirmation (and is subject to appeal). This seems almost certainly to be less "ad hoc" than would a comparable decision by the FDIC about which preresolution obligations to favor because of "necessity."

more difficult to disguise (and is a major reason why we favor the use of Article III judges rather than bankruptcy judges—since the latter do not have the political independence that comes from lifetime appointment).

An instructive example is the Chrysler bankruptcy. In essence, apart from a couple of unwanted plants, the consequences of Chrysler's Chapter 11 bankruptcy filing were that all of Chrysler's assets were sold in a § 363 going-concern sale for $2 billion to a new entity (the "New Chrysler"). The assets received—the $2 billion purchase price—were all given to the senior secured creditors (who had claims of around $6.9 billion), thus satisfying, at least through the narrow lens of the Chapter 11 proceeding itself, the absolute priority rule. The buyers of the assets were, effectively, the U.S. and Canadian governments, which took a senior secured position in the New Chrysler for their cash contribution ($6 billion in total, of which $2 billion was used to "purchase" Chrysler out of the bankruptcy estate). Other securities against the New Chrysler were issued to Fiat (35 percent of the equity of the New Chrysler), to a new voluntary employee beneficiary association (VEBA) for retiree health-care obligations (a $4.6 billion note and 55 percent of the equity of the New Chrysler), and to the U.S. and Canadian governments (10 percent of the equity of the New Chrysler, in addition to the $6 billion senior secured position noted earlier—as well as some "upside potential" if the New Chrysler's stock price boomed). Warranties and the like, as well as obligations to most suppliers, were assumed; a number of dealership contracts were rejected (although a number of these rejections were later undone as a result of congressional pressure).[23]

23. Whether the meshing between state auto franchise laws and bankruptcy's executory contract provisions in § 363 permitted dealership rejections is a complicated question, not directly involved in this chapter's focus.

While structured as two distinct transactions, to satisfy the priority requirements of Chapter 11 (and to keep all of the issuance of claims in the New Chrysler outside of the bankruptcy process), collapsing the two transactions reveals a much less pretty picture in terms of legal rules and principles. In essence, the secured creditors, for $6.9 billion of claims, received $2 billion, while a group of unsecured creditors, far lower in priority—significantly, the retirees with future health-care benefits—received significant amounts of the New Chrysler. If (the old) Chrysler was, indeed, "worth" only $2 billion, then there should have been nothing of value to give to these retirees (or, for that matter, to Fiat, which added almost nothing constituting "new value" in any contractually enforceable sense).[24]

This was a rather shocking use of the § 363 sale process, as it allowed most of these "games" to be played outside of the bankruptcy process, in the New Chrysler, but in a way that surely shortchanged the secured creditors *in* the bankruptcy process.[25] The government would have run a significant risk that its desired bailout of the retirees (in particular) could not have been accomplished in a Chapter 11 reorganization through a true sale. Despite having a dollar majority of first secured claimants agreeing to the deal, the Chrysler that was subject to Chapter 11 might have lacked that class's acceptance of the plan (which requires both two-thirds in amount and 50

24. Fiat's 35 percent stake was for "access to competitive… vehicle platforms," "distribution capabilities in key growth markets," and "substantial cost saving opportunities." None of this sounds particularly "firm" in terms of committed new value. While the U.S. and Canadian governments did provide $6 billion to the New Chrysler, they were in fact given a senior secured claim for that $6 billion—so the $4 billion "kept" by the New Chrysler does not form the basis of the other securities given to Fiat or the VEBA.

25. *See* Mark Roe & David Skeel, *Assessing the Chrysler Bankruptcy*, 108 Mich. L. Rev. 727 (2009).

percent in number), particularly since the votes of Troubled Asset Relief Program (TARP) recipients might very well have been challenged as lacking "good faith," because of the federal government's pressures against these entities as the supplier of TARP funds.[26]

If so, under a plan of reorganization, the relevant test becomes not the "best interest of creditors" test under § 1129(a)(7), but the "absolute priority rule" as codified in § 1129(b). There would be almost no way to meet § 1129(b) without giving the secured creditors everything of value from (the old) Chrysler, including equity ownership in the New Chrysler that would result from the reorganization. It would have been very difficult to argue that the VEBA's note and equity interest in the New Chrysler were not being given "on account of" prebankruptcy unsecured obligations (retiree healthcare benefits). There would be similar questions about preserving prepetition warranty claims and prepetition trade debt in the New Chrysler (although some of these—continuing warranty claims—were more defensible than others for a continuing business). Finally, the bankruptcy judge overseeing a "traditional" Chapter 11 reorganization would have been challenged on matters such as whether

26. *See* Mark Roe, *A Chrysler Bankruptcy Won't Be Quick*, Wall Street Journal (May 1, 2009), at http://online.wsj.com/article/SB124113528027275219.html ("Worse, there could be a legal fight over whether the vote of Citibank and the other 'big four' creditors—J.P. Morgan Chase, Morgan Stanley and Goldman Sachs, who together hold 70% of Chrysler's debt—should be counted toward the two-thirds threshold that would bind the company's other 42 creditors. The Bankruptcy Code requires that the votes of creditors be given in 'good faith.' It won't be hard for the smaller creditors to argue that Citibank and other TARP recipient's votes aren't in full good faith. In agreeing to Treasury's offer of 32 cents for each $1 of their debt, the objectors would say, Citibank and some others were influenced by the fact that Treasury was keeping them afloat with federal subsidies. If this type of litigation begins, it won't be easily resolved."). *See also* brief filed on May 4, 2009, in the bankruptcy court of the SDNY by Chrysler's non-TARP secured lenders, http://www.scribd.com/doc/14952818/Objection-to-Chrysler-Sale-Motion.

Fiat's 35 percent equity interest in the New Chrysler was appropriate as an exchange for its "new value."

The end run in Chrysler's reorganization around the absolute priority rule and the rights of the senior secured creditors, and the bailout of others (such as retiree health-care benefits), was largely due to two factors. First, the bankruptcy judge nodded.[27] He permitted a condition to the § 363 going-concern sale being an understanding that any alternative bid would be "tested" against the requirements of the "government's" bid, including the receipt of claims against the New Chrysler of the retiree health-care plan.[28] And second, there

27. While the bankruptcy judge's opinion permitting the sale under the dubious procedures and restrictions was affirmed in a hasty decision by the Second Circuit, *In re Chrysler LLC*, 576 F.3d 108 (2d Cir. 2009) (argued on June 5, 2009, decided on June 5, 2009, with an opinion issued after the fact on August 5, 2009), the Supreme Court, on December 14, 2010, granted certiorari, vacated the Second Circuit's (and bankruptcy court's) opinion, and directed that the Second Circuit dismiss the suit as moot. *Ind. State Police Pension Trust v. Chrysler LLC*, 130 S.Ct. 1015 (2009). As a consequence, the Second Circuit's opinion has no precedential value. *United States v. Munsingwear*, 340 U.S. 36 (1950). This rather remarkable step—since the Supreme Court in July had issued and then lifted a stay, following the Second Circuit's ruling (and prior to the Second Circuit's written opinion justifying that ruling), allowing the sale to be consummated, 129 S.Ct. 2275 (2009)—has led some to speculate that the Supreme Court's vacating the Second Circuit opinion six months after the Court lifted the stay allowing the sale to go forward "was an expression of its disagreement with the Second Circuit's interpretation of the requirements of § 363(b)." Fred David, *Interpreting the Supreme Court's Treatment of the Chrysler Bankruptcy and Its Impact on Future Business Reorganizations*, 27 Emory Bankr. Developments J. 25, 27 (2010), found at http://www.law.emory.edu/fileadmin/journals/bdj/27/27.1/David.pdf. This is plausible, since at the time the Supreme Court lifted the stay and allowed the transaction to be consummated, the Second Circuit had not yet written its opinion explaining its reasons for affirming the bankruptcy judge's decision to allow the sale to go forward as then structured.

28. Assessments of competing bids included (1) whether the assets purchased are essentially the same; (2) whether the terms and conditions of the purchase would be "in substantially the form of the Purchase Agreement"; (3) whether the assumption "of any collective bargaining agreements" and entering into "the UAW Retiree Settlement Agreement" would occur; and (4) "any benefit to the Debtors' bankruptcy estates from the assumption of liabilities."

was also the real concern of a number of the secured creditors, who had themselves been recipients of TARP funds, that the government would be "all over them" if they engineered a higher competing bid—including by "bidding in" up to their $6.9 billion in secured claims.[29]

While there is little that Chapter 14 can do about the latter concern, it is designed to minimize the first concern: the undermining of market-based sales. It is our belief in proposing Chapter 14 that independent Article III judges, with the ability to hire experts to advise them, would not fail to see—and hence prevent—the kind of undermining of a true market-based sale (and valuation) that ultimately existed in Chrysler's case.

C. Systemic Consequences

While the focus of this chapter has been on the issues identified at the start by the FDIC's paper, we would be remiss in ending without at least mentioning issues of systemic consequences. Since bankruptcy (as currently fashioned) responds to the interests of the parties before it, it would perhaps seem to follow, almost *a fortiori*, that Title II's Orderly Liquidation Authority, conducted by the FDIC, would be better able to handle systemic consequences. We caution against reaching that conclusion for the following three interrelated reasons.

First, several of the proposals outlined in "Bankruptcy Code Chapter 14: A Proposal" (chapter 2), particularly the provisions involving

29. *See supra* n. 26. In an opinion earlier this year, the Supreme Court unanimously held that "going concern" sales under § 363 that did not permit the secured creditor to "credit-bid" violated the structure and spirit of the Bankruptcy Code. Radlax Gateway Hotel, LLC v. Amalgamated Bank, at http://www.supremecourt.gov/opinions/11pdf/11-166.pdf (May 29, 2012).

prepayments to existing creditors through debtor-in-possession financing and the direct "standing" to be heard and participate for the institution's primary regulator,[30] are designed to allow bankruptcy, as admittedly is not the case today, to deal directly with these issues. So, the comparison should be between Title II's Orderly Liquidation Authority and bankruptcy, *after* the addition of Chapter 14.

Second, as John Taylor (among others) has noted,[31] determining what constitutes a systemic consequence of the failure of an individual firm is very difficult. It is easy to think one sees "systemic" consequences, when all one really sees is correlation or access to new information. The issue, in terms of correctly identifying potential and dangerous systemic consequences, seems better handled in an adversarial system such as bankruptcy, overseen by a neutral judge who has statutory rules and principles to apply, than in a system overseen by regulators who may be under political pressure to "limit" the damages that might be forthcoming, not so much because of systemic risk as because of losses being suffered in a portion of the financial system that could (and should) be absorbed by the counterparties to those firms.

Third, and closely related to the second reason, is the question of which system is *both* better able to contain true systemic consequences *and* avoid bailouts. Under Chapter 14, as we have proposed it, it is difficult to bail out existing creditors of a failed firm,[32] forcing regulators to defend interventions that do so in a way in which they will find it harder to disguise discretionary bailouts of favored credi-

30. Jackson, *Bankruptcy Code Chapter 14* (*supra* n. 4), pp. 39–45.

31. John B. Taylor, *Defining Systemic Risk Operationally*, in *Ending Government Bailouts* (*supra* n. 3).

32. This is a consequence of the strictures for prepayments to existing creditors; *see* Jackson, *Bankruptcy Code Chapter 14* (*supra* n. 4), pp. 27, 39–45.

tors in the name of systemic risk. Again, we believe that the features that make a court venue so desirable in the first place—openness, transparency, judicial oversight, and appellate review based on established statutory rules and precedent—are promising also in distinguishing between avoiding systemic consequences and bailing out selected parties because they are politically influential or the regulator wants to avoid personal political risk.

IV. CONCLUSIONS

To summarize this discussion briefly, we return to the three criteria identified by the FDIC at the outset. The first is advance *planning* for failure and resolution. In the post-Dodd-Frank world, major financial companies are supposed to have prepared (and have approved by their supervisors) wind-down plans for going into bankruptcy. Since the past gives us only modest reason to have confidence that either managements or regulators will have correctly foreseen the source of the next crisis that comes along, and which operations or investments will be generating fears of insolvency, we should not rely too heavily on previously drawn up "living wills" to solve their resolution problems. Still, if the exercise improves the understanding of both managements and regulators with regard to the complexity of these giant firms, and perhaps leads to some simplification of their corporate structures, it could prove of value. But the value would be as great or greater in bankruptcy proceedings as compared to Dodd-Frank Title II, since the statute requires that the plans be designed with the former in mind.

The second criterion identified by the FDIC is *liquidity* to continue operations: to facilitate carrying on profitable aspects of the firm and endeavoring to minimize losses from unwinding the others.

Dodd-Frank gives the receiver the right to go to the Treasury at once for up to 10 percent of the book value of the firm's assets (and more later) with a priority claim against the estate, while Chapter 14 would provide that the debtor-in-possession (or trustee) could go to the market for such funds (also with a priority claim). If there is concern that in a financial crisis such funds could not be obtained even on that basis, the Treasury authority could, by statute, be extended in those circumstances, if needed.

The third criterion is an *open bidding* process to sell the company and its operations to the private sector. There are well-established rules and procedures to do this in bankruptcy reorganizations, including having unsecured creditors as bidders and thereby converting debt claims to equity and creating a solvent firm. The FDIC, acting as receiver for failed banks, has been accustomed to contacting a few other banks for a form of merger ("purchase and assumption"), in a process that has been far from open and transparent and results in the creation of still bigger banks. Indeed, with the very largest megabanks, it probably could not work at all. That is not to say that the FDIC could not possibly learn new tricks, but it clearly has no comparative advantage over bankruptcy for such a process.

Therefore, as we stated at the outset, we continue to urge adoption of a Chapter 14, even if Title II of Dodd-Frank were left untouched.