Preface

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> Let's write Chapter 14 into the law so that we have a credible alternative to bailouts in practice. We can then be ready to use a rules-based bankruptcy process to allow financial firms to fail without causing financial disruption.
>
> —*George P. Shultz*

The purpose of this book is to introduce and analyze a new and more predictable bankruptcy process designed specifically for large financial institutions. We call the new bankruptcy law "Chapter 14" because it is currently an unused chapter number of the U.S. Bankruptcy Code. The new proposal will create greater financial stability and reduce the likelihood of bailouts.

Chapter 14 represents the outcome of extensive collaborative research by lawyers, economists, financial market experts, and policy makers—many of whom are contributors to this book. Much of the work has taken place during the three years since *Ending Government Bailouts as We Know Them* (edited by Kenneth Scott, George Shultz, and John Taylor) was written in 2009. Indeed, this new book is a follow-up to that earlier endeavor, incorporating more detailed research findings, and also considering the implications of the so-called "orderly liquidation authority" in Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act, which was passed in 2010.

The book starts off with Kenneth Scott's summary of the key legal and economic differences between the new orderly liquidation authority and the proposed new Chapter 14 bankruptcy process. The orderly liquidation authority increases uncertainty, raises due process issues, creates additional incentives to bail out large financial institutions, and increases moral hazard. Title II of the Dodd-Frank bill gives the government considerable power and discretion to intervene, take over, and liquidate financial companies with no role for meaningful judicial review or analysis. Even with the best of intentions, it is difficult to see how the Federal Deposit Insurance Corporation (FDIC), the agency assigned by the law to this job, can run such a liquidation process for large, complex financial institutions in a predictable rulelike manner, which is so important for the smooth operation of financial markets.

Chapter 14 would give the government a viable alternative to Title II and thereby avoid these problems. Even if the discretionary bailout option remained in the law through the new orderly liquidation authority, government officials might well find Chapter 14 more attractive—because of its more predictable rules-based features—and thereby choose this option rather than a bailout. At the least, there would be a credible alternative to a bailout, which would make bailouts less likely. As described in the quote at the start of this preface by former Secretary of Treasury, State, and Labor George P. Shultz, Chapter 14 would give the government the option of letting a failing financial firm go into bankruptcy in a predictable, rules-based way without having to cause spillovers to the economy. If possible, it would also permit people to continue to use the company's financial services—just as people continue to fly when an airline company is in bankruptcy reorganization. Creating this option thus puts incentives in place that tend to drive government officials away from the oft-chosen bailout route.

The centerpiece of the book is Tom Jackson's detailed description of Chapter 14, which would differ from current bankruptcy law under Chapter 7 and Chapter 11 in several ways. It would create a group of judges to specialize in financial markets and institutions, which would be responsible for handling the bankruptcy of a large financial firm. A common perception is that bankruptcy is too slow to deal with systemic risk situations in large complex institutions, but under the proposal, there would be the ability to proceed immediately.

In addition to the typical bankruptcy commencement by creditors, an involuntary proceeding could be initiated by a government regulatory agency. Moreover, the government or creditors could propose a reorganization plan—not simply a liquidation. An important advantage of this bankruptcy approach is that debtors and creditors negotiate with clear rules and judicial review throughout the process. In contrast, the orderly liquidation authority is less transparent, with more discretion by government officials and few opportunities for review. Chapter 14 relies more on the rule of law and less on discretion.

Following the central description of Chapter 14, the book then reviews various issues that arise in practice. William Kroener delves into the problems of how orderly liquidation would work in practice under the authority of the FDIC, showing some of the advantages of Chapter 14. Kimberly Summe examines how the Lehman Brothers' derivatives portfolio would have worked out under the existing Bankruptcy Code if Dodd-Frank had been in effect in September 2008. She concludes that for any failed "systemically important" financial company captured by Dodd-Frank, the orderly resolution authority would not have resulted in any substantial change in the way derivative trades are handled postbankruptcy. In other words, the workout process for derivatives would not have proceeded much differently under Dodd-Frank. However, the orderly liquidation authority combined with the new requirement to place derivative contracts at clearinghouses would likely lead to a significant probability that such a clearinghouse would be bailed out by the government.

In a revealing dialogue on the costs and benefits of automatic stays in the case of repurchase agreements and derivatives, Darrell Duffie and David Skeel show that the proposed Chapter 14 resolves many complex incentive issues simply by adhering to the basic legal principles of the Bankruptcy Code with small adjustments to prevent runs and/or reduce incentives for excess risk taking. The chapter by Kenneth Scott and Tom Jackson then argues that Chapter 14 can preserve the going-concern value of a failed financial institution as well as or better than the FDIC would under Title II of Dodd-Frank. In the short chapter that follows, Ken Scott elaborates on the reasons why the new liquidation authority would likely violate constitutional due process requirements in practice. But one of the most important questions is how Chapter 14 would work in the midst of a financial crisis, a topic that is addressed in the final two chapters by two former top financial officials: Kevin Warsh and Andrew Crockett.

Although the chapters in this book are authored by individual researchers, they represent the collaborative work of the Resolution Project at Stanford University's Hoover Institution. The Project has included Andrew Crockett, Darrell Duffie, Richard J. Herring, Thomas Jackson, William F. Kroener, Kenneth E. Scott, George P. Shultz, David Skeel, Kimberly Anne Summe, and John B. Taylor, with Kenneth Scott serving as chair.