INTRODUCTION

Consistent with the broader theme of the deregulatory era, the past few decades have seen a growing divide between banking and bankruptcy. Through deregulation, banking and financial institutions have been increasingly held to different standards than other types of corporations in the bankruptcy setting. This divide between banking and financial institutions on the one hand and all other types of corporations on the other essentially excepted banking and financial institutions from the normal rules of corporate law and corporate failure. That is, finance became excused from bankruptcy.

The divide had long existed, fostered by the unique nature of a class of debtors with a large group of government-insured creditor-depositors. But the past decades saw the banking community move away from the bankruptcy system, and chapter 11 in particular, with a vigor nearing revulsion. The only way bankers would be involved in bankruptcy was as creditors. The collapse of Bear Stearns seems to confirm the special place that bankers held in the order. Bear Stearns and its stakeholders

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1. I do not use the phrase “deregulatory era” pejoratively. For example, the deregulation of the railroads under the 1980 Staggers Act was arguably a good thing given their financial condition under regulation. Staggers Rail Act of 1980, Pub. L. No. 96-448, 94 Stat. 1895 (1980).

2. I conceive of this era as extending from at least the passage of the Staggers Act in 1980, which deregulated the railroads, through 2010, which saw both the passage of healthcare regulation and the recent financial reform legislation. Although I trace the real growth of the divide to the deregulatory era, I agree with David Skeel that the roots of the division trace back to at least the 1930s and the decision to exclude Wall Street from most corporate restructurings. David A. Skeel, Jr., Bankruptcy Boundary Games, 4 BROOK. J. CORP. FIN. & COM. L. 1, 1 (2009).


were not subjected to the same fate as mundane insolvent companies, with bondholders and, even more importantly, shareholders receiving a buyout on claims that were likely worthless.

And then Lehman. Bankers faced the cold reality that the growth of “shadow banking” had moved finance out of the comfortable realm of the OCC, the FDIC, and the Federal Reserve. The government rescue of AIG can be seen as a desperate attempt to regain control. The subsequent treatment of Citibank and Merrill Lynch, contrasted with the treatment of Lehman, reaffirms this interpretation.

The Dodd-Frank Act formalizes this attempt to restore the old order. Under the Act, all large bank holding companies will be subject to a new resolution regime—essentially a glorified receivership process—controlled by the FDIC and initiated by the Treasury Secretary and the Federal Reserve. The new system will cover the large banks as well as the former investment banks, such as Goldman Sachs, and many other important institutions with more than 85% of their activities in “finance.”

But by developing a new system for addressing financial distress, instead of integrating the new system into the existing structure of the Bankruptcy Code, the financial reform act simply recreates the prior problem in a new place while also creating new problems. The future Lehmans and AIGs will be covered by the new procedure, but other firms that have 84% of their activities in finance will not. In short, the disconnect between bankruptcy and banking has moved to a different group of firms. And we may have done nothing but protect ourselves against an exact repeat of the financial crisis.

This change will reduce the overall risks to the financial system to the extent that the size of Lehman, AIG, Bear Sterns, and others was the key problem in the recent financial crisis. But if instead the problem was

8. Under the Dodd-Frank Act, a company is “predominantly engaged in financial activities” if (1) the annual gross revenues of the company and all of its subsidiaries from activities that are financial in nature (as defined in § 4(k) of the Bank Holding Company Act) represent 85% or more of the company’s consolidated annual gross revenues, or (2) the consolidated assets of the company and all of its subsidiaries related to activities that are financial in nature (as defined in § 4(k) of the Bank Holding Company Act) represent 85% or more of the company’s consolidated assets.
the interconnected nature of these firms, the difference between 84% and 85% is unimportant.\footnote{10} And in focusing on the biggest of the big, the recent financial reform bill has left behind the banking industry’s detritus in the bankruptcy system.\footnote{11} For example, derivatives will now get special treatment in bankruptcy only in those cases where it is least needed to protect the banking industry, even though these provisions were originally justified based on their application to the financial system.\footnote{12}

Expecting that the financial reform bill is not the last piece of legislation in this area, I explore the divide between banking or finance and bankruptcy.\footnote{13} As with any other industry, bankruptcy is of limited import to the financial industry in normal times, save for its role in general debtor–creditor law. But even here, bankruptcy rules are a vital part of every financing contract, operating to make claims consistent across similarly situated creditors and discouraging runs on the assets of the firm.

In times of general financial stress, the content of these rules and their strength becomes ever more vital. And if the rules are unclear or their application uncertain, the risk to the financial system becomes acute. This is especially true in the financial industry, where the horizontal connections between firms go far beyond those found in any other industry.

In this Article, I argue that there are significant gaps in the federal system for resolving financial distress in a financial firm even after passage of the Dodd-Frank bill. These gaps represent potential sources of systemic risk—that is, risk to the financial system as a whole. They must be fixed.

\footnote{10}{Dodd-Frank Act § 201(b).}
\footnote{12}{Under Dodd-Frank, banks will have to spin off (into their broker-dealer affiliates) their trading in equity swaps, commodity swaps, energy swaps, CDS on non-investment-grade reference entities, and uncleared CDS on investment-grade reference entities. Dodd-Frank Act §716. These disfavored contracts will continue to be subject to special treatment in bankruptcy, including the bankruptcy cases of nonfinancial firms, where the justifications for special treatment are implausible. See Stephen J. Lubben, Derivatives and Bankruptcy: The Flawed Case for Special Treatment, 12 U. Pa. J. BUS. L. 61 (2009). Moreover, many of these disfavored derivatives are the types of contracts that can be used to give “normal” supply contracts special treatment under the Code. See generally In re MBS Mgmt. Serv., Inc., 432 B.R. 570 (Bankr. E.D. La. 2010).}
But I should make clear at the outset that I do not argue that these gaps must be filled with the Bankruptcy Code. Rather, the point is that the various systems for resolving financial distress among financial firms must be integrated so that the result of financial distress is clear and predictable. Integrating all under the Bankruptcy Code is an option, but not the only way to achieve such clarity.

The first Part of this Article sketches the several existing systems for resolving financial distress in financial firms, including the new resolution authority created by the Dodd-Frank Act. By my count, there are at least six systems at work here, not counting state-by-state variations. Part II examines the coverage of these systems and the uncertainty created by the interaction of the same. For example, under current law, a large hedge fund might be “resolved” under chapter 11 of the Bankruptcy Code, or it might not be. The decision rests with the systemic risk counsel. Therefore, the fund’s counterparties will be unable to determine ahead of time which set of rules is incorporated into their contracts with the hedge fund. Undoubtedly, both will be priced with a further discount for the uncertainty. That is unlikely to be the optimal solution.

Part III of the Article then considers the ways in which the divide between finance and bankruptcy could be narrowed, if not eliminated. Ultimately, I doubt the plausibility of solving these issues with some grand solution like drafting a unified bankruptcy law. The political realities involved in getting a major piece of legislation through Congress are so daunting nowadays that it is something of a wonder that even Dodd-Frank, with all its limitations, passed. A unified system of financial distress, which would implicate both state and federal interests, seems almost more unlikely. Given this reality, I suggest incremental ways to move the myriad existing systems together. These suggestions exploit the new Financial Stability Oversight Counsel’s power to recommend changes in regulation to fill gaps left by the Dodd-Frank Act.

It is important throughout to maintain a realistic approach; blind regulation will more often than not simply encourage new innovation, often in ways that are apt to be even more inefficient, less transparent, or both. But only by overcoming the divide between banking and bankruptcy will the systemic risks presented by the existing patchwork be ameliorated.

14. For the argument that the Bankruptcy Code should be expanded to fill such gaps, see generally Samuel L. Bufford, Increasing Scope of Bankruptcy Code, 4 AM. BANKR. INST. L. REV. 500 (1996).
15. See David Zaring, A Lack of Resolution, 60 EMORY L.J. 97, 99 (2010) (“Resolution authority is the polite term for seizing failing financial institutions and either shutting them down or selling them off for the best possible price.”).
orated. Ultimately, this is a matter that will require coordination between the alienated worlds of banking and bankruptcy.

I. RESOLUTION REGIMES

Historically, the United States has taken an inconsistent approach to the division between banking and bankruptcy, in part reflecting vague notions that banks were unlike other businesses, and also reflecting the tension between those who argued for local creation of banks and those, lead initially by Alexander Hamilton, who favored integration of the national economy at the federal level. For example, the 1841 Bankruptcy Act applied to bankers and those who underwrote insurance policies. But while the statute initially included banks—the entity as opposed to the individual—and all other corporations among those who could file bankruptcy, the provision was removed on “states’ rights” grounds before the Act received final approval. The 1867 Bankruptcy Act split the difference; federally chartered banks could not file under the Act, while state-chartered banks and insurance companies could and did.

By the time of the first permanent American bankruptcy law in 1898, it was widely accepted that banks and insurance companies were sufficiently different from other companies that they should be excluded from the normal bankruptcy process. Of course, most big business was excluded from the Bankruptcy Act, so the exclusion of financial companies was consistent with the broader tendency to specialize the law of large enterprise.

17. An act to establish a uniform system of bankruptcy throughout the United States, ch. 9, 5 Stat. 440 (1841), repealed by an act to repeal the Bankruptcy Act, ch. 82, 5 Stat. 614 (1843).
18. SAMUEL OWEN, A TREATISE ON THE LAW AND PRACTICE OF BANKRUPTCY 11–12 (1842).
19. F. REGIS NOEL, A HISTORY OF THE BANKRUPTCY LAW 136–37, 140–42 (1919); CHARLES WARREN, BANKRUPTCY IN UNITED STATES HISTORY 66–67 (1935). Implicit in the states’ rights argument was a fear that northern banks would be the only banks left standing if western and southern institutions were subject to bankruptcy petitions. Id.
22. An act to establish a uniform system of bankruptcy throughout the United States, ch. 541, 30 Stat. 544 (1898).
23. It is often asserted that the United States is unique in this regard, but that does not appear to be true. See, e.g., Stephanie Ben-Ishai, Bankruptcy in Canada: A Comparative Perspective, 25 BANKING & FIN. L. REV. 59, 64–65 (2009).
25. It is important to note that this was the era before FDIC insurance or the Glass-Steagall Act’s separation of banking functions, so that bankers often engaged in activities that we would now ascribe to broker-dealers or investment banks. This was especially true during the Gilded Age, when the growth of large railroads led to a concomitant growth of high finance. See generally THE RAILROADS: THE NATION’S FIRST BIG BUSINESS (Alfred D. Chandler, Jr. ed., 1981).
More recently, the key bankruptcy mechanism for dealing with large corporations is chapter 11 of the Bankruptcy Code. In addition, the United States has a number of different specialized insolvency regimes, including the Federal Deposit Insurance Act of 1950 (FDIA) provisions that apply to banking organizations and the Securities Investor Protection Act (SIPA) provisions that apply to broker-dealers.26

Furthermore, insurance regulation is entirely exempted from federal regulation. This exemption resulted from the McCarran-Ferguson Act of 1945, which was Congress’s response to the Supreme Court’s decision in United States v. South-Eastern Underwriters Ass’n.27 Thus, insurance company insolvencies are a matter of state law by virtue of the combined effects of McCarran-Ferguson and an express exemption from the Bankruptcy Code.28

* * *

Chapter 11 is probably the best known of these various insolvency systems. State corporate law sets the rules for how a corporation or other entity initiates a chapter 11 proceeding. Thereafter, the process is entirely federal, taking place under the oversight of a federal bankruptcy court. The debtor’s board retains ultimate control over the process as “debtor in possession,” and the process works toward a reorganization plan. Creditors have a right to vote on the plan unless they are being paid in full or not paid at all, and the plan can provide for either the liquidation or recapitalization of the debtor.29 While the statute itself does not express any particular congressional aim, the main goal is understood to be the maximization of the debtor’s value in a way that is not possible in either a piecemeal or quick liquidation.30

Save for when the Dodd-Frank Act’s new resolution authority applies, chapter 11 remains the primary instrument for resolving financial institutions. Unless a specialized regime is in place, such as those for banks or insurance companies, chapter 11 will apply.31 Thus, hedge funds, private equity funds, and investment banks, as well as parent

26. And the Commodities Exchange Act provisions that apply to futures commission merchants, but I do not address these in this Article.
27. 322 U.S. 533 (1944) (holding the Sherman Act could apply to state-chartered insurance companies).
companies of banks and insurance companies, will all face resolution under chapter 11 unless the entity in question can be resolved under the new resolution authority and the Secretary of the Treasury decides to invoke the authority as described below.

The closest procedure to chapter 11 is the resolution of broker-dealers under SIPA. SIPA specifically provides for the application of chapters 1, 3, and 5 and subchapters I and II of chapter 7 of the Bankruptcy Code to the extent such provisions are not inconsistent with SIPA. Thus, both chapter 11 and SIPA proceedings draw on the same general parts of the Bankruptcy Code to resolve claims and define the basic elements of the process. But SIPA is strictly a liquidation procedure, which makes its outcome both more certain and less flexible than a chapter 11 case.

SIPA proceedings are typically commenced in district court and then removed to the local bankruptcy court. A trustee is appointed and directed to distribute securities to customers to the greatest extent practicable in satisfaction of their claims against the debtor. Through such distributions, the customers of a broker-dealer receive a priority over other general unsecured creditors who have to await a more bankruptcy-like distribution, if there are any assets to make such a distribution.

Bank resolution proceedings similarly involve a favored class of creditors, but take place in a completely nonjudicial forum. Since the creation of deposit insurance in the New Deal, the FDIC has been the receiver for national banks and, increasingly, state-chartered institutions. The FDIC operates under an overriding mandate to reduce the cost of insolvency to the FDIC insurance fund. Moreover, the National Depositor Preference statute gives payment priority to depositors in all

35. SIPA itself is only applicable to broker-dealers required to register under the 1934 Exchange Act, leaving small, intrastate broker-dealers and certain foreign broker-dealers subject to certain specialized provisions of chapter 7 of the Bankruptcy Code. By all accounts, these exceptions are a small minority of broker-dealers.
38. Id. § 78fff-3(a) (2010).
40. Id. § 1811 (2006).
41. Id. § 1823(c)(4)(A) (2010); 12 C.F.R. § 360.1 (2010). There is also a prohibition on benefiting other creditors, 12 U.S.C. § 1823(c)(4)(E), or the bank’s shareholders (i.e., the parent holding company), id. § 1821(a)(4)(B).
insolvency proceedings, and states that the FDIC may assert their rights as subrogee when depositors have been paid from the insurance fund. In most cases, the preference statute has the effect of eliminating any recovery for unsecured creditors and shareholders, as the largest proportion of claims against a failed institution typically are those of insured depositors.

Under the FDIA, the FDIC, acting as receiver or conservator, succeeds to the rights of the institution and proceeds to marshal its assets. Shareholders and managers cease to have operational control of the bank. As receiver, the FDIC can liquidate the institution, organize a new bank or a temporary bridge bank, take over some or all of the assets and liabilities of the failed institution, or arrange a merger or purchase of assets and assumption of liabilities.

The bridge bank process is not unlike the 363 sale process used in the recent automotive chapter 11 cases, but all FDIC receivership proceedings are under the sole control of the FDIC, with the role of the courts strictly constrained. Moreover, the bank receivership process is initiated by a regulator or chartering authority—either state or federal—and the concept of a “voluntary” receivership is little more than a theoretical possibility. In short, a bank receivership is a much more “internal” process as compared with a chapter 11 case, which must play out in the public forum of a federal bankruptcy court.

In this respect, an insurance company resolution is more like the other nonbank systems that have been discussed to this point. Although there are state-by-state variations, in general, a distressed insurance company is placed in receivership after a petition from the home-state insurance regulator. The presiding judge will typically issue injunctions or stays to prevent the dismemberment of the company during its resolution, although the enforcement of these stays is sometimes complicated by the more limited jurisdiction of a state court as compared with a federal district or bankruptcy court.

As with banks, appointment of a receiver suspends the powers of management and places the control of the company in the hands of the

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45. Id. § 1821(d)(2)(A).
46. Id. §§ 1821(d), (n).
47. Id. § 1821(j).
48. Id. § 1821(c)(10).
49. E.g., N.Y. INS. L. §§ 7403, 7417 (McKinney 2000).
50. E.g., id. § 7419.
receiver. \textsuperscript{51} Claims are fixed as of the date of the appointment. An insurer’s policies are typically deemed cancelled on appointment of a receiver. \textsuperscript{52} The estate is not liable for future losses, but policyholders have valid claims for losses incurred to that point. In many cases, the policyholders will also have claims for breach of contract against the estate. The receiver may be responsible for either conducting the insurer’s business with an eye towards rehabilitation or for conserving and protecting the insurer’s assets for the ultimate end of liquidation. Ultimately, the state insurance regulator, as receiver, has a good deal of discretion, not unlike the FDIC acting in bank insolvency proceedings.

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Until relatively recently, this fragmentation of insolvency law typically meant that a large financial institution would be subjected to chapter 11 plus one specialized regime when it failed. \textsuperscript{53} For example, a large banking institution would have its insured subsidiaries resolved under an FDIC process while the holding company filed a chapter 11 petition. The Washington Mutual holding company filed under chapter 11 in September 2008, one day after the bank subsidiary was taken over by the FDIC. \textsuperscript{54}

This dual-process arrangement is unlikely to result in optimization of the troubled company’s assets because the specialized procedures favor speed and a protected class of creditor, not the maximization of the overall value of the company. The FDIC has little incentive to maximize the value of the chapter 11 debtor’s key asset—the bank subsidiary—once there is enough value to clear the costs of administration and the claims of depositors. Similarly, since most insurance regulators can avoid the insurance company’s future claims by simply canceling them, there is little need to preserve the going concern value of what may be the holding company debtor’s key asset. A simple liquidation will often suffice. The specialized procedures undoubtedly benefit the protected creditors, but perhaps at the expense of overall welfare.

Any inefficiency that existed in the system in the twentieth century was undoubtedly amplified by the effective repeal of Glass-Steagag in

\textsuperscript{51} E.g., id. § 7409.
1999 and the subsequent creation of a kind of “universal banking” model in the United States. Where once a financial institution might implicate two insolvency systems, new entities like Citibank, Bank of America, and JPMorgan-Chase would trigger three or four insolvency procedures within the United States alone if they faced insolvency. Given the competing goals of these procedures, creating a single forum for resolving a financial institution seemed like a natural goal of the Dodd-Frank legislation. But it was only partially achieved.

The resolution authority established by the Dodd-Frank Act is apparently meant to address two goals: the elimination of taxpayer bailouts and the end of “too big to fail.” Both are said to come from the inadequacies of current insolvency law, particularly chapter 11 and its inability to deal with a systemic crisis.

The new law partially supersedes chapter 11 as applied to financial companies, granting the Treasury Secretary the authority to appoint the FDIC as receiver of a systemically important financial company, with certain important limitations that will be discussed in Part II.

To understand Dodd-Frank, one has to abandon any hopes that the Act will show internal consistency. In particular, the categories of firms that are subjected to heightened regulation because of their perceived systemic importance have but a loose relationship to the categories of firms that are subject to the new resolution authority. For example, only bank holding companies with more than $50 billion in assets can be regulated as systemically important, while any bank holding company can be placed into resolution authority.

In general, a financial institution is subject to the new resolution authority in two instances. First, bank holding companies, as defined in § 2(a) of the Bank Holding Company Act, are automatically subject to the new resolution authority. In addition, if the new systemic risk over-

55. Section 101 of Gramm-Leach-Bliley Act of 1999 amended the Banking Act of 1933, commonly known as the Glass-Steagall Act, by repealing § 20, which prohibited any Federal Reserve member bank from affiliating with an entity engaged in securities activities. The same section of the Gramm-Leach-Bliley Act also repealed § 32 of Glass-Steagall, which prohibited interlocking management between a member bank and any securities firm.


59. Compare id. § 165, with id. §§ 201(a)(11), 203(b).


61. Dodd-Frank Act § 201(a)(11). The “Hotel California” provision in Dodd-Frank requires any bank holding company with $50 billion or more in assets as of January 1, 2010, that received assistance or participated in the capital purchase program under the Troubled Asset Relief Program
sight panel determines that a company is primarily engaged in financial activities, then the company can be subjected to the new resolution authority.\textsuperscript{62} Companies previously deemed “systemically important non-bank financial institutions” and subjected to heightened regulation are automatically included in this second category—no additional determination is required.\textsuperscript{63}

Also included are subsidiaries of the two foregoing categories of financial companies, excluding subsidiaries that are insured depository institutions or insurance companies.\textsuperscript{64} In addition, the Act purports to include broker-dealers that are members of the Securities Investor Protection Corporation (SIPC), but, as discussed in Part II, the significance of this inclusion is unclear given other provisions of the Act. And insurance companies cannot be placed into receivership under the Act.\textsuperscript{65}

For purposes of determining whether a company is predominantly engaged in financial activities, the Act establishes an 85% test. Under the test, 85% of the total consolidated revenues of the company must come from activities the oversight panel deems financial in nature, or more than 85% of the firm’s consolidated assets must be financial in nature.\textsuperscript{66} This same 85% requirement applies to a determination that a nonbank financial institution is systemically important, and thus subject to heightened regulation and automatic eligibility for the resolution authority.\textsuperscript{67}

Upon a determination by the appropriate federal regulators that the financial company is in default or in danger of default, a financial company may become subject to FDIC receivership, which is modeled on the FDIC’s traditional bank receiverships.\textsuperscript{68} Chapter 11, or another relevant insolvency procedure, remains the default,\textsuperscript{69} but the new resolution authority largely trumps that procedure when activated.\textsuperscript{70}

The Treasury Secretary, consulting with the President, will decide to invoke the resolution procedure upon a two-thirds vote of both the Federal Reserve Board and the FDIC Board or the SEC. The Secretary’s decision is subject to limited, confidential review by the D.C. District Court, a tribunal not known for its extensive experience with insolvency to be treated as a systemically important nonbank financial institution, and thus subject to the resolution authority, even if it subsequently ceases to be a bank holding company. \textit{Id.} § 117.

\textsuperscript{62} Dodd-Frank Act §117.

\textsuperscript{63} This heightened regulation includes risk-based capital and liquidity requirements, leverage limits, concentration limits, and resolution plan requirements. \textit{Id.} § 165.

\textsuperscript{64} \textit{Id.} § 201(a)(11)(iv).

\textsuperscript{65} \textit{Id.} § 203(e).

\textsuperscript{66} \textit{Id.} § 201(b).

\textsuperscript{67} \textit{Id.} § 102(a)(6).

\textsuperscript{68} \textit{Id.} § 203.

\textsuperscript{69} \textit{Id.} § 203(a)(2)(F).

\textsuperscript{70} \textit{Id.} § 208.
law. And even this review will not happen if the firm’s board consents to the resolution process; one can expect that future boards will be subject to extreme pressure in this regard.

The FDIC’s resolution powers allow it to transfer all or any portion of the assets or liabilities of the financial company to a third party. If a third-party buyer cannot be found, the FDIC has the authority to establish a temporary bridge financial company. The bridge company will hold any part of the business worth preserving until it can be sold to a third party at fair value or otherwise liquidated in an orderly fashion.

The FDIC is given near unilateral authority to review claims and either allow or disallow them. Any challenge to the claims resolution process must be filed in the district court where the financial company is located, a court that is not likely to have any knowledge or special interest in the resolution process.

The Act provides that the FDIC can incur interim debt obligations to fund a liquidation that can later be recovered through assessments on the financial sector. The Act prevents the use of taxpayer funds to pay for the receivership process, although the Treasury clearly faces some risks that it will ultimately bear the cost if financial institutions are unable to pay the FDIC’s *ex post* assessments. That is, while the statute can say taxpayers shall incur no losses, that does not necessarily make it so.

And remember this new system only applies with certainty to bank holding companies. For other financial companies, the resolution authority is an alternative to the joint implementation of chapter 11 and the various specialized insolvency systems. The implications of this and other potential gaps in the overall insolvency system are explored in the next Part of this Article.

## II. THE SCOPE OF THE NEW ORDER

Following Dodd-Frank, a distressed bank holding company and its bank subsidiary will now be addressed in a single forum. Maybe.

Maybe, because the new resolution authority is a process that must be invoked by regulators, and thus might be subject to delay or even neglect if the regulators disdain the new procedures.

Delayed assertion of the new resolution authority may present a bigger problem than no assertion of the authority because it has the po-
tential to create greater uncertainty. Dodd-Frank expressly provides that a subsequently commenced FDIC resolution proceeding can displace the bankruptcy court already hearing a chapter 11 case regarding the same company.77 Not only will this create uncertainty for the players in the chapter 11 case, but there is also some risk of forum shopping. The government may find it convenient to bring a quick end to a chapter 11 case that has not gone in its favor.

And the FDIC’s many roles in even the simplest cases present some problems. While in bank resolution the FDIC is sometimes considered the “residual claimant,” and thus properly in charge of the proceedings, they are really better analogized to a senior lender who has little incentive to maximize the bank’s asset value once that value clears the claims of priority deposit holders.78 More realistically, if we assume that a failed bank resolution carries some risk for the FDIC, the agency will have incentives to simply get the process over as soon as possible. This may result in the sale of bank assets at below value to subsidize and thus encourage a prospective purchaser. All of this has serious consequences for the resolution of the holding company where its equity stake in the bank may be sacrificed to promote FDIC’s other interests.

More broadly, there is a problem with the coverage of the new resolution authority. As noted, the resolution authority automatically applies to bank holding companies—a group that now includes the major investment banks.79 But after that, coverage becomes vague.

The other big group of firms subject to the resolution authority are those that get more than 85% of their revenues from finance activities. For some companies, namely those who are purely financial firms, it will be obvious that resolution authority might apply. But whether it will still remains uncertain.

For a small to mid-size hedge fund, whether the resolution authority applies or not might be context sensitive. In normal times, regulators might be willing to let the fund enter chapter 11, but in an economy like that experienced in late 2008 and early 2009, the answer might be quite different.80 Presumably, the fund’s stakeholders will have to price this uncertainty when dealing with the fund.

77. Id. § 208.
78. Hynes & Walt, supra note 43.
80. See generally Nicole M. Boyson et al., Hedge Fund Contagion and Liquidity Shocks, 65 J. FIN. 1789 (2010).
For other firms, the question of whether they are above or below the 85% mark may change from quarter to quarter. For a firm near the margin, the answer could vary with each new accounting statement.

In some cases, it may make sense to acquire a somewhat related nonfinancial business. Whatever inefficiencies this presents might be offset by lowering the cost of funding if creditors do indeed value certainty about how financial distress in the firm will be addressed. Committing to the transparency of a chapter 11 process, compared with the closed FDIC liquidation system, might have real value. For all the complaints about the automotive chapter 11 cases, the bankruptcy court hearings in those cases provide a degree of transparency totally lacking in AIG, Bearn Sterns, or Washington Mutual. 81

The foregoing raises the important connection between firm structure manipulation and the new resolution authority, especially for non-bank financial firms. As drafted, the Dodd-Frank Act appears to allow regulators to move down a firm’s organizational chart but not up. In particular, the new resolution authority is applicable if the firm in question and all of its subsidiaries derive either 85% of their annual gross revenues or 85% of their consolidated assets from activities that are “financial in nature” or incidental to a financial activity, or from the ownership or control of one or more insured depository institutions. 82 The Act also allows for the inclusion of subsidiaries in a resolution proceeding. 83 Thus, there are some temptations to fragment the financial activities of a firm and place them under nonfinancial activities in a company’s organizational chart, making it difficult for regulators to find any connected group of companies that are 85% engaged in finance.

Congress apparently gave regulators only indirect means of addressing this kind of manipulation. Namely, the systemic risk regulation provision of Dodd-Frank allows regulators to vote to regulate a company that it believes is attempting to evade regulation. 84 This designation could arguably be used to get the firm in question into the resolution authority, which itself has no anti-evasion rules. Obviously, the regulators would need to exhibit some dexterity if this approach were to be invoked on the


83. Id. § 201(a)(11)(iv).

84. Id. § 113(c)(1).
eve of a financial collapse at the financial institution, especially given a firm’s right to contest its designation as systemically important.85

* * *

These big picture issues will work in conjunction with some intentional gaps embedded in the new resolution authority. For instance, when an SIPC member, such as a broker-dealer, qualifies for the new resolution authority, the Dodd-Frank Act explicitly provides for the continued application of SIPA proceedings.86 As with many rules under Dodd-Frank, there are some notable and sometimes puzzling modifications.

First, the FDIC, as receiver of a covered broker or dealer, is to appoint SIPC as trustee for the liquidation of the covered broker or dealer.87 This contrasts with the normal practice of an SIPC appointing a private attorney as trustee.88 Note also that the appointment of SIPC as trustee happens without court involvement. In addition, SIPC, as trustee, shall have all powers and duties provided under SIPA and shall conduct the liquidation of the covered broker or dealer in accordance with the terms of SIPA, except that SIPC shall have no powers or duties with respect to assets and liabilities transferred by the FDIC from the covered broker or dealer to a bridge company. SIPA is in charge except when it isn’t.

The Dodd-Frank Act requires that customer net equity claims be discharged and satisfied as if the FDIC had never been appointed receiver of the broker or dealer.89 Moreover, the Dodd-Frank Act provides that the FDIC shall satisfy customer claims to the extent that a customer would have received more securities or cash had the covered financial company been subject to an SIPA proceeding without the appointment of the FDIC as receiver. SIPC, as trustee, is to allocate customer property and distribute customer name securities in accordance with § 78fff-2(c) of SIPA, but all other claims are to be paid in accordance with the priorities under § 210(b) of the Dodd-Frank Act.90 Essentially, customers still get SIPA-like treatment, but all other creditors are subject to Dodd-Frank’s distribution scheme.

In short, broker-dealers will be half in and half out of the new resolution procedure.

85. Id. § 113(e).
86. Id. § 205.
87. Id. § 205(a)(1).
89. Dodd-Frank Act § 205(f).
90. Id. § 205(g).
Similar problems arise with regard to insurance companies, which are largely excluded from the new resolution authority. The only power the FDIC obtains under Dodd-Frank is the ability to initiate a state court receivership if the state regulator fails to act.

Thus, the insurance company piece of a large financial company will be largely unaffected by the enactment of Dodd-Frank, while the parent company will be subject to the new resolution procedure. Given the realities of the McCarran-Ferguson Act, this aspect of Dodd-Frank will be especially difficult to address as explained in the next Part of this Article.

* * *

Overall, this analysis has shown two broad types of gaps in the overall insolvency structure. First, there is the uncertainty element created by overlaying a new procedure without having it entirely displace the prior structure. The Dodd-Frank FDIC structure might apply, but debtor firms have no ability to invoke the process themselves. With the decision to apply the new procedure left to the regulators, one procedure (chapter 11) may commence only to be supplanted by another (resolution authority) in an ad hoc manner.

Dodd-Frank also creates uncertainty by the use of a bright-line 85% rule. The use of such a rule recognizes the reality of “shadow banking,” the expansion of banking from traditional banks to other related areas, like money market funds, securitization, and private investment funds. Simply creating a resolution procedure for “banks” and bank holding companies would clearly fall short. But if the new resolution authority is designed to address perceived inadequacies with chapter 11, why is chapter 11 adequate for a firm that derives 84% of its revenue from finance?

In short, there is uncertainty across two planes: will the regulators invoke the procedure, and does the procedure even apply to the firm in question?

Consider a large money market mutual fund. If a run on the assets of the fund began, would the new resolution procedure be invoked? The fund likely meets the 85% test—more than 85% of its assets will be finance related. But is this fund important enough for the Secretary and the Systemic Risk Counsel to invoke resolution authority? Individually, maybe not, but if the run on this fund might prompt runs on other funds, the outcome becomes less certain. This uncertainty over how the gov-

91. Id. § 203(e).
92. See supra note 28 and accompanying text.
The second area in which gaps have been identified turns on the coverage of the new resolution authority. If the goal was to resolve a large financial firm in a single procedure, Dodd-Frank clearly failed. Given the international component of finance, it was unlikely to be fully successful. But as noted, even domestically large financial firms will continue to be subject to a variety of processes, especially with regard to broker-dealers and insurance companies.

There is also the question of whether the 85% rule can be manipulated to create gaps in the coverage of the new resolution authority. What if Apple decided to run what amounted to a technology-focused hedge fund out of an unincorporated division of the parent company? Enron reminds us that the example might not be totally implausible as we saw a “normal” energy company transformed into an energy trading firm seemingly overnight.

III. GOING FORWARD

Given that the new structure is subject to manipulation and creates uncertainty, both in terms of how the new system will work and which system will apply, there is obviously some room for improvement. But it seems unlikely that any such improvement will take the form of major legislative enactments. Thus, this Part focuses on the changes that can be made under existing law.

First, since the 85% rule in the resolution authority context is clearly subject to some manipulation, regulators will have to use their authority to combat such manipulation in the systemic risk context to also address manipulation in the resolution context. Namely, extra vigilance will be required on the systemic risk side to ensure that the new resolution authority remains available to regulators when and as appropriate. Only if a company has been made subject to systemic oversight will a firm with less than 85% of its activities in finance qualify for resolution.

Even if manipulation is put to one side, the uncertainty surrounding which resolution procedure will apply remains. Some of this is exacerbated by the fact that, while the FDIC will be in charge of the resolution process once initiated, it has limited authority over the commencement of the process. The key player in initiation is the Treasury Secretary, an inherently political actor who is unlikely to be able to make commitments that will last beyond any particular Secretary’s term in office. Thus, while a Secretary might commit to only using the resolution authority in times of systemic financial crisis, leaving chapter 11 and the other spe-
cialized regimes dominant in most instances, this commitment is of limited value.

The Federal Reserve Board might make such a commitment, using its power to authorize the Treasury Secretary to block a resolution proceeding except in specified instances. Ultimately, however, the amusingly complex mechanism for instituting a resolution proceeding—requiring the consent of the FDIC, the Federal Reserve, and the Treasury Secretary simultaneously—suggests that resolution proceedings will only be instituted when the entire financial-regulatory community is in agreement. In such instances, a prior commitment might be of little value.

Nonetheless, there could be some value in all of these regulators defining when they believe it would be appropriate to invoke the resolution authority. Creditors will still have to price two insolvency systems for most financial firms, but at least such a statement will provide some insight into the relative probabilities of each system’s use.

The Federal Reserve can bolster a credible commitment to use chapter 11 and the other specialized insolvency systems through its power to require systemically important institutions to file resolution plans. If these plans set forth a convincing scheme for resolving the company under chapter 11, other indications that the Dodd-Frank resolution authority will be used only as a last resort will be more credible. The prepackaged CIT bankruptcy case offers one model for how such a plan might work, although it should be conceded that CIT, however large, was substantially smaller than many of the systemically important institutions in this country. The key will be to require a good deal of specificity in such plans along with the input of reorganization professionals. In short, the banking lawyers will have to talk to the bankruptcy lawyers.

Moreover, the plans must be continually updated to ensure their relevance. A plan done once and filed away in a drawer obviously ignores the dynamic nature of the financial industry.

Minimizing the differences between the Dodd-Frank resolution process and the other insolvency systems can also reduce the uncertainty over which insolvency system will be invoked. Thus, rather than creating new rules for the resolution process, the comparable rules should be incorporated from the Bankruptcy Code or other relevant insolvency process. The consequences of rejecting a contract, for example, should


be the same regardless of the procedure used, unless there is a good reason for some deviation.

Similarly, the FDIC could use its rulemaking authority to commit to following a financial institution’s resolution plan even if that plan contemplated resolution under chapter 11. For example, if the plan calls for a quick sale of key assets under § 363 of the Bankruptcy Code, the FDIC could also commit to move the same assets into a bridge institution upon commencement of the resolution process. Thus, the basic outcome would be harmonized across the various possible resolution procedures.

CONCLUSION

All of this is feasible, and can narrow the gap between resolution processes. But is it likely? And what risks remain?

On the question of the probability of these changes happening, one has to be somewhat skeptical. Up to this point, the FDIC has shown little interest in engaging with the restructuring community and has moved to implement the new resolution authority with little input from those who understand chapter 11 in particular.

The risks that remain, even if existing procedures are used to narrow the gap among resolution procedures, stem from the simple fact that there still remains differences among systems, and the degree of those differences is often hard to evaluate ex ante.

For example, the new resolution process provides for a kind of “best interest of creditors” test like that found in chapter 11, which requires that creditors receive at least as much as they would have in a chapter 7 liquidation. But the Dodd-Frank version of the test provides no right to test the valuation of the debtor in court and no apparent right to appeal the FDIC’s determination in any respect. Thus, in chapter 11, the test will be founded on the testimony of the debtor’s valuation expert subject to cross-examination and competing valuation evidence. In the resolution authority, the FDIC will conduct the analysis without any obligation to disclose its methods or subject them to examination. From an ex ante perspective, an unsecured creditor can have no faith that these two procedures will result in the same recovery for creditors.

95. Dodd-Frank Act § 209.
And one drawback of reducing the use of Dodd-Frank’s resolution authority is that it will increase the uncertainty of how that system will play out when finally invoked. And there is no way to prevent use of the resolution authority in some number of extreme cases. In short, the limited number of Dodd-Frank resolution cases will make it harder to price the effects of the resolution authority.

In short, the differences between the various insolvency systems and creditors’ rights thereunder will continue to be a source of uncertainty and thus systemic risk. And while the FDIC and other regulatory authorities can attempt to minimize the gaps between the two systems, the inherent difference between an FDIC receivership, where the FDIC acts as both liquidator and bankruptcy court, and the more typical, court-centered bankruptcy process, with much greater rights of due process, means that the financial markets will have to come to grips with the new, flawed reality of the post-Dodd-Frank world.

On the other hand, I should be clear that the problems I identify do not inevitably point to the need to have chapter 11 dominate this entire field. Instead, I ultimately conclude that the missed opportunity of Dodd-Frank was the failure to come up with a single forum for resolving financial distress in financial institutions. That forum might be chapter 11, but it might also be the resolution authority. Each has its drawbacks, but Congress should have had the courage to pick one.