"Orderly Liquidation Authority" Under

The United States Congress's Misdirected Attempt to Ban Wall Street Bailouts

By James H.M. Sprayregen
Kirkland & Ellis LLP
Chicago, USA

& Stephen E. Hessler
Kirkland & Ellis LLP
New York, USA

In the wake of the United States government's recent ad hoc actions (and in some cases inaction) to combat the financial crisis, one cry for reform has rallied Americans across the political spectrum: "No more taxpayer bailouts for Wall Street banks." Although understandable (and justified), the directive is far more simply stated than implemented. For example:

- What constitutes a state-sponsored "bailout"? If the government takes steps that succeed in saving a corporation, but in doing so significantly impair creditors and wipe out equity holders, who actually has been bailed out? And from a moral hazard perspective, is a U.S. Federal Reserve loan guarantee equally problematic as the U.S. Treasury Department taking a sizable or even majority equity stake in a private corporation?
- In what circumstances do "taxpayers" foot the bill for bailouts and the legislative aftermath? Of course when public funds are used, but what about when the increased costs of doing business under stricter regulatory requirements are passed on to customers?
- Lastly, does it make sense to focus the proscription on "Wall Street banks," when the largest bank in the United States is headquartered in Charlotte, North Carolina (Bank of America), and the recipients of the most government aid in 2008-09 included an insurance conglomerate (AIG) and two of the Big Three domestic automakers (General Motors and Chrysler)?

Given these ample interpretive challenges, the U.S. Congress's response to the meltdown in financial markets has, unsurprisingly, divided Democrats and Republicans almost uniformly along party lines. After months of contentious debates and myriad razor-thin votes, the resultant "Dodd-Frank Wall Street Reform and Consumer Protection Act," named after the chairmen of the U.S. Senate Banking and U.S. House Financial Services Committees, was signed into law by President Obama on July 21, 2010.

A key component of the approximately 2,300-page bill targets the so-called "too big to fail" dilemma; i.e., that some financial companies are so large and integral to the economy that a threat of their imminent demise essentially requires the U.S. government to commit or spend massive amounts of public funding towards emergency recapitalization (e.g., Bear Stearns, Citigroup) or suffer the destabilizing systemic consequences of a free-fall bankruptcy filing (e.g., Lehman Brothers). The Dodd-Frank Act's solution is to provide federal regulators with the discretion to "liquidate failing financial companies that pose a significant risk to the financial stability of the United States in a manner that mitigates such risk and minimizes moral hazard."

Whether the "orderly liquidation authority" set forth at Title II of the Act utilizes the most effective possible tools to preclude future Wall Street bailouts has been and will continue to be the focus of extensive study – including pursuant to the bill's own terms, as explained below. But of particular note to insolvency professionals, it is already clear that enactment of the Dodd-Frank Act means certain distressed financial firms could soon find themselves in very foreign territory: being forced to wind down in proceedings initiated and administered by federal regulators, entirely outside the established auspices of a U.S. Bankruptcy Court applying the U.S. Bankruptcy Code.

Designating "Covered" Financial Companies

The threshold issue, of course, is determining which firms are subject to the Dodd-Frank Act's alternate liquidation scheme. The touchstone concept of Title II "covered financial companies," which means U.S.-incorporated bank holding companies, non-bank financial companies supervised by the U.S. Federal Reserve Board of Governors, any company predominantly engaged in activities the Federal Reserve has determined are financial in nature, or the subsidiaries of any of these (but not including insured depository institutions) for which the U.S.

Treasury Secretary (in consultation with the President) has made a number of specific determinations. These include: the financial company is in default or danger of default on its obligations, with no viable private sector remedy, and its failure and resolution under otherwise applicable state or federal law (namely, the U.S. Bankruptcy Code) would have "serious adverse effects on financial stability in the United States" – whereas liquidation under Title II would avoid or mitigate detrimental impact on "the financial system, the cost to the general fund of the [United States] Treasury and the potential to increase excessive risk taking on the part of creditors, counterparties, and shareholders in the financial company."

In other words, unlike conventional American bankruptcies, which may be commenced (voluntarily or involuntarily) by a relatively limited universe of parties in interest (a debtor or its creditors) for the relatively limited purpose of enforcing their respective rights, liquidations under the Dodd-Frank Act may be justified by the U.S. government's desire to defend the greater good of non-parties in interest or to influence the economic behavior of market actors. It is not difficult to imagine how this discretion could be used unevenly. Will the government be equally inclined to liquidate a covered financial company if the "excessive risk taking" investors that are exposed to major losses are union pension funds or public university endowments, instead of other Wall Street counterparties or foreign sovereign wealth funds? Or what if the covered financial company is Citigroup or AIG, and among the major shareholders to be wiped out is the U.S. government itself?

Federal Deposit Insurance Corporation (FDIC) as Liquidator

Under the Dodd-Frank Act, the regulatory body with primary responsibility for administering the liquidation of a covered financial company is the Federal Deposit Insurance Corporation (FDIC). The FDIC is a U.S. federal government agency whose mission is to "preserve and promote confidence in the U.S. financial system" by insuring deposits in banks and thrift institutions for at least USD $250,000, and by seizing and selling the deposits of a failing bank or thrift to another institution. Notably, the FDIC's regulatory purview (and experience) historically has been focused on banks whose customers are individual depositors, not investment banks and other large Wall Street financial institutions.

A liquidation proceeding under the Dodd-Frank Act would begin as follows. Upon a determination by the U.S. Treasury Secretary that a firm qualifies as a covered financial company, the firm and the FDIC are notified. If the firm consents, the FDIC is appointed as receiver. If not, the Treasury Secretary shall petition the U.S. District Court for the District of Columbia for an order authorizing the FDIC's appointment. Within only 24 hours after receipt of the petition, filed under seal, there will be a hearing at which the company may object (but not creditors, who will not have received notice), and the District Court shall rule or the petition is automatically granted, with rights of further expedited appeal to the U.S. Court of Appeals for the District of Columbia and the U.S. Supreme Court.

Importantly, once the FDIC's appointment as receiver is final, liquidation of the covered financial company shall proceed exclusively under Title II, and no provision of the U.S. Bankruptcy Code shall apply. Conversely, for financial companies that are designated to be "covered" financial companies, the Bankruptcy Code, and not the provisions of the Dodd-Frank Act, shall continue to govern.

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Once installed as receiver, the FDIC assumes complete financial and operational control of the covered financial company, including the authority to manage, sell, transfer or merge all assets. The FDIC also has the ability to provide funds needed for orderly liquidation, including for direct loans to the covered financial company or its subsidiaries, the purchase or guarantee of debt obligations, and payments to creditors.

This assistance shall come from a separate fund to be established in the U.S. Treasury and populated initially by assessments on creditors of the covered financial company, to the extent they received more than the liquidation value of their claims, and then, if needed, by assessments on other financial companies with at least USD $50 billion in total assets. (The U.S. Federal Reserve also may lend to covered financial companies, but only if they are solvent and have collateral sufficient to secure the loans – an unlikely source of help for

firms already found to be distressed enough to require liquidation.)

In other words, the FDIC has broad discretion to deploy capital to facilitate liquidation, but all costs ultimately will be paid by counterparties of the liquidating firm, and possibly by other major financial companies as well. Lest there be any ambiguity on this point, the bill expressly states that "[t]axpayers shall bear no losses from the exercise of any authority under" Title II of the Dodd-Frank Act.

Claims Process and Liquidation Priorities

The process of liquidating under the Dodd-Frank Act to some extent resembles doing so under the U.S. Bankruptcy Code, but with key distinctions. Within only 60 days after its appointment as receiver, the FDIC must file a report with the U.S. Congress detailing its plan for winding down the covered financial company. The FDIC shall administer a claims process that includes publication and mailing notice to creditors, a bar date, and guidelines for the allowance and disallowance of claims. Although the Dodd-Frank Act is less than precise about whether and how FDIC determinations are subject to judicial review, it does provide that holders of disallowed claims may file suit on their claim in the U.S. federal district court where the covered financial company's principal place of business is located.

Properly perfected secured claims, proven to the satisfaction of the FDIC, shall be allowed in full, except for any under-secured portion that exceeds the fair market value of the collateral securing the claim, which will be treated as unsecured. Unsecured claims shall have priority in the following order: (i) administrative claims, (ii) any amounts owed to the United States, (iii) unpaid wages or benefits owed to non-executive employees earned in the six months prior to the date the receiver is appointed (up to USD $11,725), (iv) contributions owed to employee benefits plans, (v) other general unsecured claims, (vi) subordinated claims, (vii) any wages or benefits owed to senior executives and directors, and (vii) equity interests.

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Here as well, this major grant of discretion results in the significant potential for selective application. The U.S. Bankruptcy Code generally requires that claims with rights of a similar legal nature be placed in the same class, and that no class of junior creditors may receive any recovery unless and until each class of senior creditors receives payment in full (but no more than that) of its claims. In contrast, the Dodd-Frank Act expressly provides that similarly situated creditors may receive dissimilar treatment. Specifically, the FDIC "may take any action" that "does not comply" with the above distribution priorities, including making payments, if the FDIC determines doing so is necessary to maximize value and minimize loss – provided that similarly situated unsecured creditors receive "not less than" they would have in a liquidation under Chapter 7 of the U.S. Bankruptcy Code or otherwise applicable state law. But so long as that minimum threshold is satisfied for all co-equal claimants, the FDIC may favor certain creditors over others.

Otherwise, the Dodd-Frank Act confers on the FDIC at least analogous versions of many of the rights and protections provided to debtors by the U.S. Bankruptcy Code. For instance, the FDIC may repudiate pre-appointment contracts, debt obligations, and leases; litigation against the covered financial company may be stayed, but only upon request by the FDIC and only for up to 90 days; and the FDIC has robust avoidance powers to claw back fraudulent or preferential transfers.

Dismissal and Liability for Management

The Dodd-Frank Act's treatment of management merits special mention. While not unexpected, given the prevailing public and political animus towards Wall Street, to say Title II's provisions are especially tough on executives is an understatement.

The bill specifies that "management responsible for the condition of the financial company will not be retained," and the FDIC and other agencies "will take all steps necessary and appropriate" to ensure that management (and third parties) "bear losses consistent with their responsibility" for the failure of the covered financial company, including via "actions for damages, restitution, and recoupment of compensation and other gains not compatible with such responsibility." More specifically, the FDIC may recover from any culpable current or former senior executive or director "any compensation" received within two years of the FDIC appointment date, or without time limitation in the case of fraud. And compensation is to be construed as broadly as possible, "to mean any financial remuneration, including salary, bonuses, incentives, benefits, severance, deferred compensation, or golden parachute benefits, and any profits realized from the sale of the securities of the covered financial company". The FDIC also may seek to ban senior executives or directors from participating in the "affairs of any financial company," for a period of no less than two years for violating laws or regulations, engaging in "any unsafe or unsound" practices, or breaching their fiduciary duties.

Further Studies Needed

One of the most salient criticisms of the Dodd-Frank Act is that, because the U.S. Congress has not yet finished diagnosing the causes of the last financial crisis, it is premature to attempt to legislate the measures that will prevent the next one. Specifically, in May 2009, the U.S.

Congress established the Financial Crisis Inquiry Commission to investigate and recommend remedies on this front. But the Commission will not release its final report until later this year, which has led many to question the wisdom, both fiscal and political, of enacting the widest-ranging Wall Street reforms since the Great Depression right now, instead of waiting a mere few months and acting on the Commission's findings. It is therefore particularly ironic that the Dodd-Frank Act itself requires multiple follow-up studies into a series of issues about which one would logically assume Congress wants clarity *before* mandating Wall Street firms shall be wound down in an extra-judicial process that offers only some of the predictability of the U.S. Bankruptcy Code and none of the protection of a U.S. Bankruptcy Court.

For instance, of specific relevance to readers of this publication, the Act provides for a study on how to increase and make more effective "international coordination relating to the resolution of systemic financial companies under the United States Bankruptcy Code and applicable foreign law". The issues to be reported on within one year after the Act becomes effective include: "the extent to which international coordination currently exists," "current mechanisms and structures for facilitating international cooperation," "barriers to effective international coordination," and "ways to increase and make more effective international coordination of the resolution of financial companies, so as to minimize the impact on the financial system without creating moral hazard."

Further, while it is encouraging the Dodd-Frank Act calls for a study into whether and how to amend the Bankruptcy Code to better facilitate the resolution of distressed financial companies, there is reason to be sceptical this will lead to further reform that supplants Title II. Most significantly, in passing the Dodd-Frank Act, the U.S. Senate already rejected a proposal by the ranking member of the Judiciary Committee to establish a new Chapter 14 of the U.S. Bankruptcy Code to handle the cases of non-bank financial institutions within the conventional U.S. Bankruptcy Court process, but with accommodations for the distinct issues posed by large financial institutions (such as modifying the safe harbors that exempt the counterparties of certain financial contracts from the automatic stay).

Conclusion

Perhaps just having the "orderly liquidation authority" set forth in Title II of the Dodd-Frank Act will result in the U.S. government never actually exercising this discretion, as the largest financial firms may moderate their risk-taking to safeguard against default, or regulators may opt to allow a failing covered financial company simply to file for bankruptcy. Indeed, Sheila Bair, the current chair of the FDIC, and thus the head liquidator if Title II is invoked, has described her sweeping new authority as "a kind of nuclear bomb that you hope never to have to use. [But,] the fact that it's there, I think, is going to be important. And if we have to use it, we will."

So will the Dodd-Frank Act's orderly liquidation authority succeed in precluding future taxpayer bailouts of Wall Street? Insofar as the Act expressly requires that "all financial companies put into receivership under [Title II] shall be liquidated" and "no taxpayer funds shall be used to prevent the liquidation of any financial company under this title," then, yes, public funds will not be used to "bail out" a failing covered financial company. But lenders care primarily (if not exclusively) about being repaid, they are not myopically concerned with whether the borrower survives or who funds the repayment. And thus, more importantly, Title II of the Dodd-Frank Act should be understood to provide only superficial protection against another financial crisis.

Described very generally, the "moral hazard" that the U.S. Congress seeks to minimize results from creditors being incentivized to make risky loans because the current legal and regulatory regimes have effectively operated to privatize gains but socialize losses. Put simply, investors will engage in increasingly speculative behavior if they are reasonably assured they will enjoy outsize profits if an investment succeeds, but the government will shield them from outsize harms if it fails.

Again, the Dodd-Frank Act expressly authorizes the dissimilar treatment of similarly situated creditors. And because any excess costs of liquidation will be funded by assessments on major Wall Street firms, the Dodd-Frank Act essentially authorizes the unlimited ability to pay creditors whatever amounts are deemed necessary to stabilize the economy, according to whatever political and regulatory priorities hold sway at that time. The combined effect of these provisions, unfortunately, may be the failure to discourage further reckless behavior by market actors that will internalize the following new reality: while financial ***firms*** may no longer be too big to fail, certain ***creditors*** of those firms may still be too important (or at least too politically influential) to let fail (or suffer large losses).

To some extent, every attempt at financial reform is an exercise in futility, as no legislation can eliminate entirely the boom and bust cycles that bookend every era in financial history. But while it may be unrealistic to expect governments to devise the perfect solution in this context, it is not too much to hope they will choose the best available option. To that end, the biggest weakness of Title II of the Dodd-Frank Act is that it does not restrict the direct consequences of insolvency to a debtor and its creditors (and equity holders), with resolution to be administered under clear rules applied by an impartial tribunal. Maybe after further study, Congress will amend the U.S. Bankruptcy Code to adopt proposed Chapter 14 and further improve a resolution framework that already is among the most tested and effective in the world. But until then, one should anticipate further adverse effects of perpetuated moral hazard – and the potential liquidation of major Wall Street firms under the "nuclear" option of Title II.