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The Dodd-Frank Act Orderly Liquidation Authority: A Preliminary Analysis and Critique — Part I

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This is the first part of a two-part article that provides a preliminary analysis and critique of one of the key provisions in the Dodd-Frank Wall Street Reform and Consumer Protection Act, the Orderly Liquidation Authority for nonbank financial companies. Part I discusses the background, theory and legislative history of the Orderly Liquidation Authority. Part II, which will appear in an upcoming issue, discusses the general terms and structure of, and recent rulemaking under, the Orderly Liquidation Authority.

THE PAST AS PROLOGUE

The recent (and now receding) financial crisis has prompted a searching scrutiny by some, and a fundamental rethinking by others, of the U.S. financial regulatory system. Observers both within and without the regulatory community have detected an endemic failure of the regulatory system, linked variously to an undue faith in the benign effects of the Great Moderation and to a general deregulatory spirit that has animated legislative and regulatory action (or rather inaction) since at least the late 1990s.[1] Many observers see

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the events simply as a confirmation of their long-held belief in "regulatory capture."[2] Is it possible that as late as April 2007 there were still calls by prominent government officials for "light touch" regulation, for principles-based rather than rules-based regulation, and for a greater reliance on the invisible hand of market discipline to reduce the need for direct oversight by the government?[3] Coming as they did just months before the onset of the financial crisis in August 2007, these calls have in hindsight acquired a quaintly anachronistic air.

Nonetheless, it would be too facile an argument to suggest that regulatory failure was the principal cause of the financial crisis. While acknowledging regulatory failure as a contributing factor, a number of observers have pointed to more fundamental macroeconomic and structural imbalances as the underlying causes of the financial crisis.[4] The Financial Crisis Inquiry Commission (the "FCIC") established by act of Congress in May 2009 to investigate the causes of the crisis issued its report in January 2011.[5] The majority of the FCIC concluded that widespread failures in regulation and supervision as well as a failure of corporate governance and risk management and a systemic breakdown in accountability and ethics in the markets were the key factors in causing the crisis.[6] In contrast the minority suggested that by focusing too narrowly on U.S. regulatory policy and supervision and by ignoring the global nature of the crisis, the majority reached unbalanced conclusions about the causes of the crisis.[7] One member of the minority plaintively raised the question why the Congress had bothered to authorize the FCIC at all since without waiting for any insights from the work of the FCIC, the Congress in July 2010 passed the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), purporting to address the causes of the financial crisis.[8]

The answer to the question posed by the minority member of FCIC is that as with any catastrophic event, the instinct for action precedes the instinct for study and reflection. In this case the financial crisis prompted immediate calls for action in the U.S. and round the world. In November 2008 the heads of state of the Group of Twenty issued an action plan calling for reform of the global financial markets.[9] Meanwhile in the United States observers proclaimed the need not simply for financial reform, but more fundamentally for a financial "reformation."[10] While relying on something less

than the 95 theses that provided the basis for one of the great prior calls for reformation,[11] the call for financial reformation nonetheless rested on its own set of theses. One of the principal theses was the need for a new form of regulation that looks at risk to the financial system as a whole, *i.e.*, systemic risk, and not simply at the risk to individual financial institutions or even individual sectors.[12]

The concept of systemic risk and its corollary, the too-big-to-fail phenomenon, are not new, at least to the U.S. banking sector. One of the objectives of the Federal Deposit Insurance Corporation Improvement Act of 1991 ("FDICIA") was to address systemic risk and the too-big-to-fail problem, perceived as they were at that time as principally pertaining to the banking system.[13] Subsequent events have in fact confirmed that the concepts of systemic risk and too big to fail now extend well beyond the banking system to other large financial entities.[14] In their day, the drafters of FDICIA sought to address the too-big-to-fail problem by amending the Federal Deposit Insurance Act (the "FDIA") to require the Federal Deposit Insurance Corporation (the "FDIC") to adopt the least-cost resolution of any troubled insured depository institution and to direct the FDIC not to take any action that would increase the losses to the insurance fund by protecting depositors for more than the insured portion of their deposits or by protecting non-depositor creditors.[15] The amendments made by FDICIA, however, contained an exception to the least-cost test for cases involving systemic risk. Upon the written recommendation of two-thirds of the Board of Governors of the Federal Reserve System (the "Board of Governors" or "Federal Reserve Board") and two-thirds of the directors of the FDIC, the Secretary of the Treasury (after consultation with the President) could determine that compliance with the least-cost test would have serious adverse effects on economic conditions or financial stability and that notwithstanding the least-cost test the FDIC should be authorized to take action or provide assistance as necessary to avoid or mitigate these effects.[16]

Some observers believed that the amendments made by FDICIA had effectively addressed the too-big-to-fail problem in the banking system.[17] Other observers were not quite so sanguine, concluding that the mere enactment of legislation was unlikely to alter market or regulatory behavior.[18] While the FDICIA amendments appeared on the surface to address the too-big-to-fail

problem, the too-big-to-fail phenomenon as a practical matter spread (to use a recent analogy) like a large plume below the surface. As the recent financial crisis unfolded, the extent of the market reliance on the too-big-to-fail phenomenon was revealed. It encompassed not merely the largest banking institutions, but also the largest investment banks, insurance companies, money market funds and other financial intermediaries.

Imposing appropriate market discipline in a regulated environment can be a challenge even in normal times; it is an insuperable task in the midst of a global financial panic. The solution must first be to restore calm in the short term and then seek to re-instill market discipline in the longer term. Through a well-chronicled set of actions, the Treasury, the Federal Reserve Board and the FDIC helped to restore relative calm in the financial markets in 2008 and 2009.[19] The focus of the federal government then turned to addressing the conditions that were thought to have permitted the crisis to develop and spread. The centerpiece of this effort was the financial reform legislation proposed by the Obama administration in March 2009 and ultimately enacted as the Dodd-Frank Act in July 2010.[20] This article discusses one of the key provisions in the Dodd-Frank Act aimed at addressing systemic risk and the too-big-to-fail phenomenon, the Orderly Liquidation Authority for nonbank financial companies. Part I discusses the background, theory and legislative history of the Orderly Liquidation Authority. Part II, which will appear in an upcoming issue, discusses the general terms and structure of, and recent rulemaking under, the Orderly Liquidation Authority.

AN OVERVIEW OF THE DODD-FRANK ACT

The Dodd-Frank Act has been described as the most wide-ranging financial reform measure since the Great Depression. It was designed to address many of the perceived causes of, and contributing factors to, the financial crisis. The various titles of the Dodd-Frank Act catalogue the areas of identified concern and mandated reform, including such areas as hedge funds, over-the-counter derivatives, payment and clearing systems, credit rating agencies, executive compensation, securitizations, and consumer financial products.[21] Practices in each of these areas were thought to have contributed to the crisis in varying degrees and to present ongoing elements of risk to the financial sys-

tem. In addition, the Dodd-Frank Act contains two titles that are designed to deal with systemic risk on a broader basis. Title I creates a new framework to deal with systemic risk through heightened regulation of systemically important financial companies. Title II creates a new regime in the form of the Orderly Liquidation Authority to deal with the potential failure and resolution of financial firms that pose a serious risk to U.S. financial stability. The construct of these two titles reflects the belief that addressing systemic risk requires at a minimum a two-pronged approach: The first prong as represented by Title I is an *ex ante* regulatory regime with heightened regulatory requirements for systemically important financial institutions. The purpose of this regime is to lessen the risk (or consequences) of a failure of a systemically important financial institution through enhanced capital, liquidity, and other risk management measures. The second prong as represented by Title II is a new resolution regime, the Orderly Liquidation Authority, designed to permit the orderly liquidation of a systemically important financial company in a manner that contains the risk to the rest of the financial system but also avoids the need for a federal "bail-out" of the company or its creditors.

Précis of Title I

Title I of the Dodd-Frank Act establishes a broad framework for identifying, regulating, and, if necessary, limiting the size and activities of systemically important financial institutions. It also establishes a framework designed to identify emerging risks, both national and international, that cut across sectors or markets. To implement this new systemic regulatory regime, the Dodd-Frank Act creates a new Financial Stability Oversight Council (the "Council") to identify systemic risks and systemically important financial institutions and empowers the Federal Reserve Board to regulate and supervise these systemically important financial institutions (certain of which are already subject to Federal Reserve Board jurisdiction).[22] Title I requires that all bank holding companies with $50 billion or more in consolidated assets be treated for supervisory purposes as systemically important and be subjected to enhanced supervision by the Federal Reserve Board.[23] In addition, Title I provides the Council with power to designate certain nonbank financial companies for comprehensive supervision by the Federal Reserve Board as

systemically important financial institutions.[24] The designation of nonbank financial companies for supervision by the Federal Reserve Board is one of the most important functions of the Council.

Title I requires the Federal Reserve Board to impose a set of enhanced prudential standards on these designated nonbank financial companies as well as on the bank holding companies with consolidated assets of $50 billion or more.[25] These enhanced prudential requirements include capital, liquidity, concentration, credit exposure, stress test and overall risk management requirements as well as possible enhanced disclosure requirements and short-term debt limits. As noted above, these enhanced prudential requirements are intended to lessen the risk or consequences of the failure of a systemically important financial institution. It has also been suggested that these heightened regulatory requirements will create incentives for existing firms to reduce their size or complexity and disincentives for other firms to grow to a size or complexity that make them systemically important.

In addition to these general prudential requirements, there are provisions in the *ex ante* regulatory regime under Title I that are directly relevant to the implementation of the Orderly Liquidation Authority under Title II. For example, Section 165(d) of Title I requires bank holding companies with $50 billion or more in consolidated assets and other nonbank financial companies designated by the Council for supervision by the Federal Reserve Board to develop their own plans for rapid and orderly resolution in the event of material financial distress or failure (so-called "living wills").[26] Although a company designed resolution plan would not be binding upon the FDIC as receiver under Title II, it would provide important advance planning for the regulators generally and for the FDIC specifically if it were to face the prospect of appointment as a receiver.[27] Section 165(d) directs the Federal Reserve Board and the FDIC to issue joint rules implementing the resolution plan requirements by January 2012.[28] In April 2011 the Federal Reserve Board and the FDIC issued a joint notice of proposed rulemaking implementing the resolution plan (and credit exposure report) requirements of Section 165(d).[29] The proposed rule requires covered companies to submit a resolution plan demonstrating in detail how the companies could be reorganized or liquidated under the Bankruptcy Code "within a reasonable period of time and in a manner that substantially mitigates the risk that the

failure of the [company] would have serious adverse effects on the financial stability in the United States."[30] Development of such a resolution plan will require a detailed business, operational and legal analysis of each of the core business lines and critical operations of the covered company and its subsidiaries, both domestic and foreign.[31] The resolution planning process holds obvious implications for use in any ultimate resolution or liquidation of a financial company under the Bankruptcy Code or under Title II. It also holds implications for the current operations of a large complex financial company. A potential outcome of the resolution planning process may be a regulator-imposed requirement that operations be reorganized to protect systemically important functions from the risks affiliated with other operations and to provide greater legal insulation and transparency of key operations.[32] Thus, the resolution plan requirement will be a key element not only to the possible resolution of a systemically important company, but also potentially to the future configuration or architecture of large complex financial companies.

Title I also provides for the implementation of another relatively new concept in systemic risk regulation, the concept of contingent capital or "bail-in" instruments. Title I requires the Council to conduct a study of the feasibility, costs, and benefits of requiring systemically important firms to issue contingent capital, i.e., debt instruments that would convert into equity at a time of financial stress.[33] This study is required to be completed by not later than July 2012. After considering the recommendations of the study, the Federal Reserve Board would be authorized to impose contingent capital requirements on systemically important financial institutions.[34] There is already substantial international interest in the concept of contingent capital and "bail-in" instruments. In August 2010 the Basel Committee on Banking Supervision issued a consultative paper proposing specific requirements for the regulatory capital recognition of convertible or contingent capital instruments at internationally active banks.[35] In November 2010 the Financial Stability Board released a policy framework for reducing moral hazard posed by systemically important financial institutions.[36] Part of the framework includes measures for higher loss absorbency by systemically important financial institutions. The Financial Stability Board indicated that this higher absorbency could be drawn from a combination of a capital surcharge, a quantitative requirement for contingent capital instruments, and a share

of debt instruments represented by "bail-in" claims. The Financial Stability Board will examine the legal, operational and market issues relating to the issuance of "bail-in" instruments and report on its findings and recommendations by mid-2011.[37] The Swiss regulatory authorities, acting through a commission of experts, have advanced even further than other national or international authorities by proposing specific contingent capital requirements for their two systemically important financial institutions, Credit Suisse and UBS.[38] Under the proposal the two institutions would be subject to a total capital requirement of 19 percent of risk-weighted assets as calculated under Basel III, with 10 percent to be held in the form of common equity, disclosed reserves and retained earnings and with nine percent eligible to be held in the form of contingent convertible bonds. These bonds would automatically convert into common equity when the bank's common equity ratio falls below a predefined level.[39] Contingent capital and bail-in instruments have rapidly become part of the international discussion agenda for dealing with systemically important financial institutions. They may become a significant item in the dialogue in the U.S., but at the moment they warrant only a placeholder in Title II.[40]

Finally, Title I requires the Federal Reserve Board in consultation with the Council and the FDIC to develop regulations for the early remediation of financial distress at a systemically important financial institution.[41] The stated purpose of this early remediation regime is to require specific remedial actions by the company "to minimize the probability that the company will become insolvent."[42] The Dodd-Frank Act early remediation requirement has an analog in the more detailed "prompt corrective action" requirements of the FDIA.[43] The "prompt corrective action" requirements in the FDIA, however, are keyed to the capital levels of an insured depository institution. For many of the larger institutions that failed (either functionally or legally) in the recent crisis, capital levels were not an accurate indicator of financial stress. In implementing the early remediation provisions of Title I, the Federal Reserve Board is directed to develop a broader set of forward-looking indicators of financial distress.[44] The remedial steps envisioned by the early remediation provisions in Title I include a range of actions, beginning with limits on capital distributions, acquisitions and asset growth, and culminating in required capital raises, management changes, asset sales and restrictions

on transactions with affiliates.[45] Presumably, other remedial actions could be based on or linked to the early steps in an institution's own recovery and resolution plan.

Précis of Title II

Title II provides for a new orderly liquidation regime for systemically significant financial companies that encounter financial distress.[46] Title II is designed as an alternative to and a substitute for a bankruptcy proceeding, avoiding the "disorderly" fire sale process that some observers argue attended the Lehman Brothers bankruptcy. The Orderly Liquidation Authority in Title II involves a bank-like receivership proceeding and is modeled on the existing bank receivership provisions in the FDIA. Like the existing FDIA provisions for a bank receivership, the Orderly Liquidation Authority would operate essentially as an administrative proceeding with only limited judicial review of certain decisions and no ongoing judicial oversight. The FDIC as receiver would be able to take virtually all actions authorized by Title II without prior court approval or approval by creditors. There is thus no role for a creditors' committee or trustee in a Title II proceeding. Title II specifically provides for the liquidation, not the reorganization or rehabilitation of the company.[47] It is envisioned that under Title II the FDIC would provide for an orderly wind-down of a systemically significant nonbank company using many of the special powers that have historically been applied to the liquidation of insured depository institutions under the FDIA.

As part of the legislative process in the Senate, certain elements from the Bankruptcy Code were engrafted on Title II with the result that while the Orderly Liquidation Authority largely follows the procedural elements of bank receiverships under the FDIA, it incorporates certain substantive creditor protection elements from the Bankruptcy Code. For example, Title II provides that a creditor in any orderly liquidation proceeding will in no event receive less than the amount it would have received in a liquidation under Chapter 7 of the Bankruptcy Code.[48] This creates a statutory floor or minimum recovery amount for creditors under Title II. This provision could have the effect of negating other provisions in Title II that provide the FDIC with special powers in a receivership. At the same time, Title II permits the

FDIC as receiver to treat similarly situated creditors differently if necessary to maximize the value of assets or minimize the amount of losses on assets or if necessary to continue the operations of the receivership or any bridge financial company, provided that all similarly situated creditors receive at least the minimum recovery amount.[49] This provision has no analog in the Bankruptcy Code although it has an analogue in the FDIA.

Another distinguishing feature of the Orderly Liquidation Authority is the provision for the FDIC as receiver to establish a "bridge financial company" to which assets and liabilities of the failed firm can be transferred.[50] Such a transfer could be used to ensure the continuity of systemically important functions or to maximize the going concern value of other functions for the benefit of the overall estate. Assets and liabilities not transferred to or assumed by the bridge financial company would be left behind in the receivership proceeding. The ultimate means of implementation of this bridge authority by the FDIC in the event of a failure of a systemically important firm will be a key element in the success of the Orderly Liquidation Authority.

The most significant feature that distinguishes the Orderly Liquidation Authority from other resolution regimes is the authority in Title II for the FDIC and the Treasury to provide funding to the receivership or to the bridge financial company to assist its operations pending sale or wind-down.[51] This funding is to be repaid initially from the failed company's assets, with any shortfall ultimately being paid by assessments made by the FDIC on certain creditors who receive "additional payments" in the Title II proceeding and on other large financial companies.[52] The authority to provide funding to facilitate the sale or wind-down of a systemically important company is viewed by some commentators as the key feature of the new Orderly Liquidation Authority that may help to address the potential systemic consequences of the failure of such a company.[53]

Although Title II is modeled on the bank receivership precedent, there is no precedent for the application of the FDIA receivership provisions to a nonbank financial company. Likewise, while the bridge financial company concept is modeled on the bridge bank concept in the FDIA (which the FDIC has actually used), there is no precedent for the application of the bridge company concept to a nonbank financial company. Moreover, the FDIC's historical experience has generally been with insured depository institutions that

are significantly smaller (with the possible exception of Washington Mutual) and less complex than the systemically important financial companies that are the intended targets of Title II. There is limited precedent even under the FDIA receivership provisions for the liquidation of a bank with significant foreign operations. Title II itself applies only to a company organized under federal or state law and is uncertain in its application to foreign assets of such a company.[54] Many of the largest U.S. financial institutions have significant foreign operations. The application of the Orderly Liquidation Authority to a complex international financial conglomerate will present challenging issues. In all events the significant differences between the fact patterns that the FDIC has historically faced in resolving insured depository institutions under the FDIA and the fact patterns that the FDIC would face in resolving a systemically important firm under Title II suggest that the FDIC will have to expand its approach and thinking in fundamental ways.

Risks of Regulatory Change

New regulatory regimes such as those represented by Title I and Title II present a range of risks. One obvious risk is that the new regime may over-compensate for the perceived failings of the prior regulatory regime. In the legislative world, Newton's *Principia* do not apply. For every action there is not necessarily an equal and opposite reaction, but often a significant overreaction. Various financial industry groups and commentators have decried what they perceive to be the overreaction of the Dodd-Frank Act.[55] Another risk is that the regulators, despite their best efforts, will not be able to meet all the expanded expectations reflected in the new regulatory scheme and in particular will not be able to discern far enough in advance the shifting shape of the next financial crisis. Estimable observers have cautioned that the regulators are no more likely to be able to predict the precipitating events for the next financial crisis than the general mass of forecasters.[56] Finally, measured against the maxim, "first do no harm," there is also a risk that a newly devised scheme may compound the problems it purports to solve. Opponents of the Dodd-Frank Act assert that Titles I and II will actually have the perverse effect of reinforcing systemic risk and the too-big-to-fail phenomenon.[57] These opponents argue that by having the government designate firms as systemically significant under Title I so that

they can be subjected to heightened prudential standards, the Dodd-Frank Act in effect codifies the too-big-to-fail concept and signals to the market that these firms will be supported by the government.[58] These opponents also argue that the Orderly Liquidation Authority in Title II will simply perpetuate the current practice of bailing out creditors of too-big-to-fail firms. The opponents cite the provisions in Title II that grant the FDIC the ability to pay off selected creditors and counterparties at 100 cents on the dollar and to the broad authority of the FDIC under Title II to borrow from the Treasury to pay off the creditors of a failing financial company.[59] A contrarian member of the regulatory community has publicly asserted that notwithstanding the Dodd-Frank Act, the largest U.S. financial firms are still too big to fail.[60] It seems clear that the basic policy debate surrounding the Dodd-Frank Act's approach to systemic risk and too big to fail will continue unabated even as the regulators proceed with the rulemaking processes to implement these Titles.[61] The next section of this article discusses the policy arguments that surrounded the new Orderly Liquidation Authority during the legislative process of the Dodd-Frank Act and that will continue to underlie the debate about the Orderly Liquidation Authority in its implementation process.

HISTORY OF TITLE II

The Treasury Proposal for a New Resolution Authority

The proposal for a new resolution regime for systemically significant financial firms emerged as a key topic early in the discussion of comprehensive financial reform. Indeed, the desirability of a new resolution regime to facilitate the orderly unwinding of systemically important financial companies had been generally noted by government officials even before the Lehman bankruptcy.[62] The market events following the Lehman bankruptcy filing instilled a new sense of urgency to the task of designing a special legal regime for handling the resolution of large financial companies. The Treasury Department in the Obama administration signaled the importance that it attached to this element of reform by releasing a detailed legislative proposal for a new resolution authority in March 2009 well in advance of the legislative drafts for other parts of its reform package.[63]

In its March 2009 press release, proposing the new resolution authority, the Treasury Department stated that its legislative proposal would fill a significant void in the existing financial regulatory structure for dealing with nonbank financial companies, a void that had been highlighted during the financial crisis.[64] The Treasury Department said that the events of the financial crisis had demonstrated that when a large, interconnected nonbank financial company encountered severe financial distress, there were only two options for the company: (1) obtain outside capital or funding from the federal government as in the case of AIG; or (2) file for bankruptcy and undergo a "disorderly" failure that threatened the stability of the U.S. financial system as in the case of Lehman Brothers.[65] Faced with the choice between these two "untenable" options, the government chose to use the Federal Reserve Board's lending authority under Section 13(3) of the Federal Reserve Act to avoid disorderly failures of Bear Stearns and AIG.[66]

The Treasury Department said that the government needed another option for dealing with the resolution of a systemically significant nonbank financial firm and that this option should take the form of a resolution authority that paralleled the speed and flexibility of the resolution authority for insured depository institutions under the FDIA. The Treasury press release asserted that if the government had had the authority provided for in the proposed resolution authority, it could have resolved AIG in an orderly manner that would have shared losses among equity and debt holders in a way that maintained confidence in AIG's ability to fulfill its obligations to its insurance policyholders and "other systemically important customers."[67] According to the Treasury press release, the new resolution authority would allow the FDIC to sell or transfer assets and liabilities of the company without court order or counterparty consent, to renegotiate or repudiate contracts, and to address the derivatives portfolio. The Treasury Department's initial draft legislation released along with the press release envisioned a new resolution authority that would allow the FDIC to act as a conservator or receiver for a firm deemed to be systemically significant, with powers comparable to those available to the FDIC for insured depository institutions and with the additional authority to provide various forms of financial assistance, including equity purchases, to stabilize the financial firm.[68] In its broad outline and in its specific provisions the draft legislation proposed by the Treasury gener-

ally tracked the provisions of the FDIA dealing with the conservatorship and receivership of insured depository institutions.

In what could be seen in hindsight as a potential political misstep, the Treasury Department noted in its press release that the new authority was modeled on the FDIC's existing resolution authority for depository institutions and on the Federal Housing Finance Agency's resolution authority for government sponsored entities. The indirect allusion to the conservatorship treatment of Fannie Mae and Freddie Mac exposed the Treasury Department to the criticism that its proposal would provide a source of ongoing federal assistance to other companies on financial life-support. It was clear from the press release that the Treasury Department envisioned the possibility of the use of a conservatorship to restore an institution "to a position of solvency so that it can carry on its business."[69] Among the powers that the conservator would have would be "to fundamentally restructure the institution by, for example, replacing its board of directors and its senior officers."[70] In subsequent testimony in support of the legislative proposal, a senior Treasury official expanded on the advantages that the conservatorship or receivership provisions of the new resolution authority would have over the options that were available to the government during the financial crisis in 2008. This Treasury official cited four specific advantages:

(1) swifter replacement of board and senior management by the FDIC;

(2) a temporary stay of counterparty termination and netting rights on derivative contracts to mitigate the adverse consequences to a company's liquidation;

(3) the ability to provide the company with financing to fund its liquidity and capital needs during conservatorship or receivership and thus mitigate the "knock on" effects of a firm's failure; and

(4) the ability to create one or more "bridge" financial companies to preserve the business franchise, deal with counterparty claims, and protect viable assets of stronger subsidiaries pending their sale.[71]

Various aspects of the original Treasury legislative proposal were revised in the House and Senate mark-up process. One significant change to the

Treasury draft made as part of the House legislative process was to remove the conservatorship option and to require a liquidation of any company made subject to the authority.[72] Amendments were also made in the House process to require that any federal government assistance provided as part of the liquidation process be repaid in full from non-taxpayer funds, i.e., from assessments on other financial companies.[73] In its legislative proposal, the Treasury Department contemplated that the U.S. government would be authorized to provide a number of different forms of financial assistance to stabilize a company, such as making loans to the company, purchasing assets or obligations of the company, guaranteeing liabilities of the company, or purchasing an equity interest in the company. As the proposed legislation progressed in the House, the authority to purchase an equity interest was removed, consistent with the other changes that the House made to require liquidation rather than conservatorship or rehabilitation. The general authority for the FDIC to provide funding and other financial assistance to an institution undergoing an orderly liquidation, however, was retained in the legislation. The Treasury press release indicated that the proposed legislation would create an appropriate mechanism for funding the exercise of the new resolution powers, including repaying any government funding or other financial assistance that might be required as part of an orderly resolution. According to the press release the funding would come in the first instance from the general fund of the Treasury, but would be repaid through an *ex ante* or *ex post* assessment scheme on financial institutions. The initial legislative draft submitted by the Treasury in March 2009 envisioned an *ex post* assessment mechanism. The subsequent House-passed version of reform legislation, H.R. 4173, called for an *ex ante* assessment mechanism to source a $150 billion fund.[74] As finally enacted, the Dodd-Frank Act reverted to an *ex post* assessment mechanism.[75] The assessment mechanism for the new resolution authority proved one of the most contentious issues in the debate over Title II.

Legislative Hearing Process

The hearing process in the House and the Senate provided a range of federal and state regulators, industry trade groups, and other commentators with the opportunity to offer their views on the Treasury reform proposals.

A series of hearings in the House and Senate focused specifically on the topic of systemic risk and the proposed resolution authority. The testimony at these hearings revealed fundamental policy differences among commentators over the concept of a new resolution authority to displace the Bankruptcy Code. Substantial reservations were also expressed over certain of the proposed terms of the new resolution authority even by those who supported the concept in principle.

Perhaps not surprisingly, the federal regulatory agencies supported the concept of a new resolution authority for nonbank financial companies. Chairman Bernanke testified in favor of such a resolution authority, noting that after the Lehman and AIG experiences, there could be little doubt that the government needed "a third option between the choices of bankruptcy and bailout."[76] He also observed that new resolution authority would be needed to help mitigate the moral hazard implicitly arising from the identification of systemically significant financial firms under the Administration's reform proposal.[77] Chairman Mary Schapiro of the Securities and Exchange Commission spoke in her testimony of the Hobson's choice confronting the government when a large interconnected financial company was teetering on the brink of failure.[78] She too spoke in favor of a third option, but she like Chairman Bernanke noted the risk in designing such an option:

> A credible resolution regime can help address these risks by giving policy makers a third option: a controlled unwinding of the institution over time. Structured correctly, such a regime could force market participants to realize the full costs of their decisions and help reduce the "too-big-to-fail" dilemma. Structured poorly, such a regime would strengthen market expectations of government support, as a result fueling "too-big-to-fail" risks.[79]

The most vocal proponent of the new resolution authority was Chairman Sheila Bair of the FDIC. In her testimony before the House she called for an end of the too-big-to-fail policy through the establishment of a credible mechanism for the orderly resolution of financial companies presenting systemic risk.[80] She cast her argument in the following terms:

> The notion of too big to fail creates a vicious circle that needs to be broken. Large firms are able to raise huge amounts of debt and equity and are given access to the credit markets at favorable terms without consideration of the firms' risk profile. Investors and creditors believe their exposure is minimal since they also believe the government will not allow these firms to fail. The large firms leverage these funds and become even larger, which makes investors and creditors more complacent and more likely to extend credit and funds without fear of losses. In some respects, investors, creditors, and the firms themselves are making a bet that they are immune from the risks of failure and loss because they have become too big, believing that regulators will avoid taking action for fear of the repercussions on the broader market economy.[81]

In testimony before the Senate Chairman Bair pointed to the severe market disruption resulting from the Lehman bankruptcy filing and offered two explanations for the severity of the market reaction. The first explanation was that investors thought that the government would not let Lehman declare bankruptcy because "the protracted proceedings of a Chapter 11 bankruptcy were not viewed as credible prior to the [Lehman] bankruptcy filing" and hence investors were willing to make "moral hazard" investments in high-yielding commercial paper of companies like Lehman.[82] The second explanation was that the legal features of the bankruptcy filing itself triggered fire sales of assets and destroyed the liquidity of a large share of the claims against Lehman.[83] In this latter regard, Chairman Bair focused in particular on the systemic risk posed by derivatives. Noting that under the Bankruptcy Code, counterparties on derivatives can terminate and net-out positions and sell any pledged collateral to pay off the net claims, she observed that the exercise of these rights during periods of general market instability can increase systemic risk. This legal regime makes financial firms more prone to "market runs" with a cycle of increasing collateral demands before a firm fails and collateral dumping after it fails.[84] She sketched the following picture of a failing financial firm:

> If a bank holding company or non-bank financial holding company is forced into, or chooses to enter, bankruptcy for any reason, the following is likely to occur. In a Chapter 11 bankruptcy, there is an automatic

> stay on most creditor claims — with the exception of specified financial contracts (futures and options contracts and certain types of derivatives) that are subject to immediate termination and netting provisions. The automatic stay renders illiquid the entire balance of outstanding creditor claims. There are no alternative funding mechanisms, other than debtor-in-possession financing, available to remedy this problem. On the other hand, the bankrupt's financial market contracts are subject to immediate termination — and cannot be transferred to another existing institution or a temporary institution, such as a bridge bank. In bankruptcy, without a bridge bank or similar type of option, there is really no practical way to provide continuity for the holding company's or its subsidiaries' operations. Those operations are based principally on financial agreements dependent on market confidence and require continuity through a bridge bank mechanism to allow the type of quick, flexible action needed. The automatic stay and the uncertainties inherent in the judicially-based bankruptcy proceedings further impair the ability to maintain these key functions. As a result, the current bankruptcy resolution options available — taking control of the banking subsidiary or a bankruptcy filing of the parent organization — make the effective resolution of a large, systemically important financial institution, such as a bank holding company, virtually impossible.[85]

Another senior official of the FDIC in testimony before the House offered other reasons why he thought that the Bankruptcy Code was not well suited to the resolution of large financial firms.[86] First, the bankruptcy process focuses on resolving creditor claims and not the protection of the broader public interest. While the Bankruptcy Code might be appropriate for most insolvencies, for a large financial company the creditors should not determine the shape of the resolution. Second, a resolution of a large financial firm requires pre-planning and cannot depend on administration by a debtor in possession, a recently appointed trustee, or a creditors' committee. Speed and pre-planning are essential elements to any resolution of a large financial firm which must be done on a virtually overnight basis. Third, the resolution of a large financial firm requires the ability for the resolver to act decisively to take over the business, preserve systematically significant operations and

provide continuity of critical financial functions. This could be accomplished through the establishment of a bridge institution to which financial market contracts (*e.g.*, derivatives) could be transferred without triggering netting and liquidation rights. This bridge institution could also continue other systemically significant functions, such as payment processing, securities lending, and settlement of ongoing government securities transactions. The creation of a bridge institution would also permit a more orderly bidding process by possible bidders for the institution or at least parts of it. Finally, the new resolution authority would provide the necessary liquidity to continue the systemically significant functions through a secure government funding mechanism, whereas in the Lehman case the lack of debtor-in-possession financing may have driven certain Lehman entities into Chapter 7 liquidations rather than Chapter 11 reorganizations.[87]

In her testimony in support of the new resolution authority, Chairman Bair also introduced one particularly controversial idea. She suggested that consideration be given to imposing limits on the ability of financial institutions to use collateral to mitigate credit risk.[88] More specifically, she suggested that the receiver for a systemically important financial company be allowed to "haircut" by up to 20 percent secured claims against the failing institution.[89] She observed that the ability to fully collateralize credit risks removed a lender's incentive to underwrite exposures by assessing the counterparty's ongoing ability to perform.[90] A form of this "haircut" proposal was included in H.R. 4173, the House-passed version of the financial reform legislation. The relevant provision in H.R. 4173 would have permitted the FDIC as receiver to haircut by an amount of up to 10 percent any security interest under a qualified financial contract with an original term of 30 days or less secured by collateral other than securities issued by the U.S. government, agencies, or government sponsored enterprises.[91] The Dodd-Frank Act does not include a comparable provision. Instead, it directs the Council to conduct a study to evaluate whether a haircut on secured creditors could improve market discipline.[92]

Other commentators provided qualified support for the new resolution authority. The major industry trade groups voiced general support for the concept of a new resolution authority for systemically important financial firms, but expressed significant concerns about many of the specific terms of the new resolution authority as contained in the Treasury draft bill. One

particular area of concern related to the possible difference of treatment of creditors under the Bankruptcy Code and the new resolution authority. Each of the major industry trade groups expressed the view that it was important that there be clarity of treatment of creditors and that to the maximum extent possible, the new resolution authority should be aligned with the rights and procedures under the Bankruptcy Code. For example, the Financial Services Roundtable noted that while certain special procedures under the FDIA might be needed in a bank insolvency to protect the interests of insured depositors, these procedures would not be appropriate in the case of a failure of a holding company.[93] The Roundtable commented that holding company creditors should be given the same rights and protections available under federal bankruptcy law, including the ability to challenge valuations of assets and to seek judicial review of determinations.[94] The American Bankers Association in expressing its concerns with several elements of the new resolution authority echoed the concern for the treatment of creditors:

> Rules for creditors [sh]ould be developed in advance based on existing bankruptcy principles, which would provide clarity and predictability to financial markets on transactions.[95]

The Securities Industry and Financial Markets Association ("SIFMA") provided perhaps the most detailed testimony on the proposed resolution authority. Like the other trade groups, SIFMA supported the idea of a resolution authority for systemically important financial companies, but objected to various provisions in the Treasury legislative proposal.[96] The testimony from SIFMA acknowledged the possible tensions that would likely arise between the government's objective of resolving large financial firms to avoid systemic risk and the market's desire for clarity, predictability and equality of treatment. The SIFMA testimony points to one of the fundamental tensions:

> [The] core resolution powers [in the Treasury draft legislation] are designed to overcome the weaknesses in the bankruptcy process by providing a way for the systemically critical parts of a non-bank financial company's assets and liabilities to be preserved in the most cost-effective way, regardless of whether creditors within the same class are treated equally.

> This cherry-picking of assets and liabilities in the interest of systemic stability would normally be antithetical to established bankruptcy policies, which favor equality of treatment for similarly situated creditors. It is justified, however, in the case of systemically important non-bank financial companies because of the supervening policy goals of preserving the value of these entities and minimizing public costs.[97]

In its testimony, SIFMA appeared to accept the need for the core resolution process. It nonetheless objected to the fact that the Treasury proposal went beyond the creation of the core resolution function to replace "the Bankruptcy Code's transparent judicial claims process and neutral rules for left-behind assets and liabilities with the opaque administrative claims process and creditor-unfriendly rules" taken from the bank insolvency model in the FDIA.[98] As SIFMA noted in its testimony, the claims process under the FDIA was designed to favor the FDIC as creditor over other creditors because as the insurer of a bank's deposits, the FDIC is typically the largest creditor of a failed bank.[99] The various "superpowers" given to the FDIC as receiver under the FDIA reflect this basic fact. SIFMA observed that the FDIA rules for treatment of contingent claims, avoidance powers, setoffs, contract repudiation powers, and limitations on damages from repudiation, adopted in the context of bank insolvency are not necessarily appropriate in the context of a nonbank insolvency.[100]

Academicians and other commentators offered a variety of views on the proposed resolution regime for large financial companies. Some supported the notion of a new regime on the grounds that the bankruptcy process was not suitable for handling a large troubled financial company. One point cited against a bankruptcy process was that it would take too long — the financial business would "evaporate" while the company was in the proceeding — leading to a piecemeal liquidation with attendant loss of value.[101] A rather more significant concern related to the inherent risk that the bankruptcy process for a large financial company posed to the financial system as a whole:

> By definition, troubled systematically important financial institutions cannot be resolved in bankruptcy without threatening the stability of the financial system. The bankruptcy process stays payment of unse-

> cured creditors, while inducing secured creditors to seize and then possibly sell their collateral. Either or both outcomes could lead to a wider panic, which is why a bank-like restructuring process — which puts the troubled bank into receivership, allowing the FDIC to transfer the institution's liabilities to an acquirer or to a "bridge bank" — is necessary for non-bank SIFIs.[102]

For some observers another important point working against a bankruptcy process was that it could not assure the funding that would be needed to permit an orderly wind-down of a large financial institution.[103] The Treasury proposal sought to address this problem by providing the Treasury and the FDIC with authority to supply funding to the company as part of the resolution process. But this solution of government funding was itself perceived as a fundamental flaw in the Treasury proposal by various opponents.

A significant number of academicians and other commentators objected to the very notion of the new resolution authority. The basic criticism leveled at the resolution authority was that it would permit the regulators to continue to "bailout" troubled financial firms through the use of the power to provide funding and guarantees to the institution.[104] Various commentators asserted that the new resolution authority would "institutionalize" TARP or worse create a "supercharged" TARP.[105] These commentators argued most fundamentally that a bankruptcy process was needed to instill discipline in the market.[106] These commentators also worried about the wide degree of discretion provided to the regulators with respect to the use of the resolution authority, *e.g.*, in deciding whether an institution would receive the treatment and in deciding which creditors and counterparties might be protected under the rubric of systemic risk. In contrast to the proposed resolution authority, these commentators saw the bankruptcy process as relying on established rule of law rather than discretion and as treating creditors in a way understood by lenders and investors in advance.[107]

Many of the commentators who favored a bankruptcy approach over a new resolution authority nonetheless suggested that changes should be made to the Bankruptcy Code to address potential systemic issues. A theme common to many of these commentators was the need to revise the special treatment of derivatives, swaps and other financial contracts in the Bankruptcy

Code. The core provisions of the Bankruptcy Code relating to the automatic stay, limitations on preferential and fraudulent transfers, and restrictions on *ipso facto* clauses are limited in their application to derivatives and other financial contracts.[108] The exclusion of these financial contracts from the automatic stay and *ipso facto* provisions of the Bankruptcy Code allows counterparties on such contracts to terminate or close-out the contracts with the debtor upon a bankruptcy event and immediately liquidate any collateral.[109] The exclusion also protects the counterparty from a preference or constructive fraudulent conveyance claim on settlement payments, margin payments and other collateral postings made during the periods specified in the relevant sections of the Bankruptcy Code.[110] In addition, a counterparty under a master netting agreement may net its exposure on a wide range of financial contracts with a debtor, thus avoiding the risk of "cherry picking" to which other creditors with executory contracts with a debtor are exposed in bankruptcy.[111] The combined effect of these special exclusions and rights for counterparties to financial contracts is to exclude whole markets and counterparties in those markets from the traditional provisions of the Bankruptcy Code and to provide them with protection not generally available to other creditors of a debtor.[112]

The Lehman bankruptcy provided the occasion for commentators to reevaluate the policies and consequences of the special treatment of financial contracts in a bankruptcy proceeding. The lead bankruptcy lawyer for Lehman Brothers testified that the exclusion from the Bankruptcy Code's automatic stay for derivatives, swap and other securities transactions had caused "a massive destruction of value for Lehman."[113] Other observers even before the Lehman bankruptcy had warned that the special treatment for financial contracts could be a source of systemic risk in a bankruptcy proceeding of a large financial institution.[114] The irony that the special treatment of derivatives and other financial contracts was originally justified on the theory that it would protect against systemic risk was not lost on observers.[115] The stated legislative purpose of the original exclusion from the automatic stay was to prevent the domino effect of the insolvency of a commodities or securities firm spreading to other firms and threatening the larger market.[116] The exclusion from the automatic stay was to permit a counterparty to liquidate its contracts with the bankrupt immediately and minimize the ongoing market

risk in the position. But it now appears to various observers that the exclusion may have the unintended effect of generating another form of systemic risk, i.e., the risk of a wholesale "run" by derivative counterparties.[117]

The combined experience with Long-Term Capital Management ("LTCM") and Lehman have caused some observers to re-consider the effects of the special provisions for financial contracts. The complexity of the situation was identified by the President's Working Group in 1999 in its report on LTCM (the "PWG Report").[118] The PWG Report noted that the President's Working Group was generally in favor of proposed amendments to the Bankruptcy Code to clarify and further expand the protections afforded financial contracts under the Bankruptcy Code. At the same time the PWG Report acknowledged the risks that this special treatment could present:

> [I]n certain circumstances, a simultaneous rush by the counterparties of a defaulting market participant to replace their contracts could put pressure on market prices. To the extent that the default was due to fluctuations in market prices in these contracts, this pressure might tend to exacerbate those fluctuations, at least in the near term. This problem could be significant where the defaulting debtor had large positions relative to the size of the market.[119]

However, the PWG Report concluded on balance that the inability to exercise close-out netting rights "could well have resulted in an even worse market situation if the LTCM fund had filed for bankruptcy than the exercise of such rights in this situation."[120]

Other observers have drawn different lessons from the LTCM experience. These observers have concluded that the exercise of close-out rights in the LTCM case would not have avoided the risk of a chain reaction of insolvencies, but rather would have exacerbated that risk.[121] They posit the following proposition:

> [W]holesale liquidation of LTCM's assets would have benefited few counterparties (prices would have collapsed long before most had a chance to liquidate their positions) and could have had serious "knock-on" effects because other counterparties and other financial firms held positions sim-

> ilar to LTCM's. Thus, counterparties could have suffered large losses and been forced to default on their own obligations to other parties, resulting in precisely the same "chain reaction of insolvencies" that Congress sought to avoid by exempting derivatives from the stay. This explains why LTCM's counterparties did not attempt to close out their positions and seize collateral when LTCM entered financial distress.[122]

Instead, the largest counterparties formed a consortium to acquire control of LTCM and recapitalize LTCM so that they could unwind LTCM's derivative positions in an orderly fashion.[123] In testimony on the LTCM events, Chairman Alan Greenspan appeared to acknowledge the risk of a disorderly fire-sale:

> It was the judgment of officials at the Federal Reserve Bank of New York, who were monitoring the situation on an ongoing basis, that the act of unwinding LTCM's portfolio in a forced liquidation would not only have a significant distorting impact on market prices but also in the process could produce large losses, or worse, for a number of creditors and counterparties, and for other market participants who were not directly involved with LTCM. In that environment, it was the FRBNY's judgment that it was to the advantage of all parties — including the creditors and other market participants — to engender if at all possible an orderly resolution rather than let the firm go into disorderly fire-sale liquidation following a set of cascading cross defaults.[124]

At LTCM the potential for systemic consequences arising from the exercise of the special rights for counterparties led the major counterparties themselves to avoid a situation in which such rights would have to be exercised.

In light of both the LTCM and Lehman experience, the concern now is that the exclusion of financial contracts from the automatic stay permits or even promotes a run on the debtor's assets as counterparties demand additional collateral and then terminate their contracts and sell collateral into a falling market with "knock on" effects for other parties holding the same assets.[125] This unintended consequence of the original exclusion has been amplified because the original exclusion has been serially expanded through

amendments in 1982, 1984, 1990, and 2005 to cover an ever broader set of derivatives, financial contracts and master netting arrangements.[126] The amendments in 2005 were opposed by some commentators at the time because the amendments were seen to expand the breadth of the exclusion in inappropriate ways.[127] For example, the 2005 amendments expanded the types of repurchase agreements that enjoyed the exemption from the automatic stay from those involving U.S. government and U.S. agency securities to include various types of mortgage and mortgage related securities as well.[128] One bankruptcy expert who testified on the financial crisis in 2008 noted that the expanded categories of securities covered by the 2005 amendment were the "very types of investments that have proved to be toxic in the current crisis."[129] This expert also criticized the 2005 amendment that greatly expanded the definition of "swap agreement" because it has prompted the redrafting of loan agreements into the form of swap agreements so that those contracts would enjoy the exclusions from the Bankruptcy Code and the benefit of master netting agreements.[130] Behavior during the financial crisis provides further support for the view that the special Bankruptcy Code treatment of derivatives and swaps creates a significant incentive for banks and other financial institutions to structure financing arrangements as swap agreements.[131]

Various suggestions have been made to address the concern with the treatment of derivatives and other financial contracts under the Bankruptcy Code. The broadest proposal would be simply to remove the special provisions from the Bankruptcy Code.[132] A narrower proposal would invalidate the provision in derivatives contracts that makes bankruptcy an event of default.[133] Another approach would be to distinguish between types of derivative contracts, *e.g.*, making the automatic stay applicable to credit default swaps, but not, for example, to interest rate or currency swaps.[134] Still another approach would be to amend the Bankruptcy Code to provide that the special exemptions for derivatives and other financial contracts would not apply to a case in which a financial company is the debtor.[135] This latter approach was adopted by the House Republicans in their proposed financial reform measure, H.R. 3310, introduced in 2009.[136] Title I of H.R. 3310 would have created a new Chapter 14 to the Bankruptcy Code for non-bank financial institutions as debtors. H.R. 3310 defined a "non-bank" financial institution as an institution the business of which is engaging in financial activities but is not an insured deposi-

tory institution.[137] In a Chapter 14 case, the special provisions for derivatives and other financial contracts would not have automatically applied. Instead, the bankruptcy court would make a specific determination upon a motion by debtor whether the debtor and the estate should be exempt from any or all special provisions in the Bankruptcy Code for derivatives and other financial contracts.[138] In making that determination, the bankruptcy court would be directed to "balance the interests of both debtor and creditors while attempting to preserve the debtor's assets for prepayment and reorganization of the debtor's obligations, or to provide for a more orderly liquidation."[139] H.R. 3310 failed to gain any traction in the House and no action was taken on it. However, the notion that the Bankruptcy Code might be amended to make it more effective in dealing with the reorganization or liquidation of financial companies ultimately found sufficient favor that the Congress provided in Title II of the Dodd-Frank Act for three separate studies of the matter.[140]

House, Senate, and Conference Action

As the hearing process on the Treasury proposal proceeded in the House and the Senate, House and Senate committees produced their own drafts of reform legislation. Representative Barney Frank, then chairman of the House Financial Services Committee, produced a draft of reform legislation in October 2009 that incorporated most of the elements of the Treasury legislative draft, including provisions for a new resolution authority. The House passed its version of financial reform legislation as H.R. 4173 in December 2009.[141] As noted above, as part of the legislative process in the House, certain revisions to the Treasury legislative draft of the resolution authority were made. One revision was to eliminate the conservatorship option and to authorize only receivership and liquidation.[142] A corresponding change was also made to remove the authority of the FDIC and the Treasury to provide equity financing to a financial company as part of the resolution process, although debt financing and guarantees could still be provided.[143] Most significantly, the assessment provision was revised to require an *ex ante* assessment on financial companies with consolidated assets of $50 billion or more and on financial companies that manage hedge funds with $10 billion or more of assets under management.[144] These *ex ante* assessments would have been used to create a Systemic Dissolu-

tion Fund of $150 billion.[145] This fund was intended to assure that any funding needed in connection with the liquidation of a covered financial company would come from other large financial companies.

Senator Christopher Dodd, then chairman of the Senate Banking Committee, developed his own versions of financial reform legislation in 2009 and in 2010 on the Senate side. The Senate passed a version of financial reform legislation in May 2010.[146] The Senate-passed version of the orderly liquidation authority differed from the House-passed version of the dissolution authority in a number of respects. For example, the Senate-passed version provided for a prior court approval for the appointment of the FDIC as receiver (if the covered company did not consent to the appointment).[147] It also introduced a set of special provisions for the treatment of a broker-dealer that is a member of the Securities Investor Protection Corporation ("SIPC").[148] It required the FDIC in consultation with the Council to adopt rules to implement Title II and in adopting such rules to the extent possible to harmonize them with the insolvency laws that would otherwise apply to the financial company.[149] The Senate-passed version also made certain substantive changes to the liquidation rules to incorporate provisions more closely aligned to provisions in the Bankruptcy Code, such as provisions relating to the provability of contingent claims, the power to avoid fraudulent transfers, and the exercise of set-off rights.[150] The Senate-passed version included a general provision that a creditor would in no event receive less than the amount the creditor would be entitled to receive in a Chapter 7 proceeding.[151] The Senate-passed version did not include the "haircut" provision on short-term secured debt as was contained in the House-passed version.

The Senate-passed version also differed from the House-passed version in its provisions for financial assistance. It placed a cap on the amount of assistance available to the financial company and required the FDIC to develop an orderly liquidation plan acceptable to the secretary of the treasury that covers the provision of financial assistance.[152] The Senate-passed version provided for an assessment of financial companies to reimburse the costs of financial assistance. However, the Senate-passed version differed from the House-passed version in not requiring assessments in advance and in not establishing a specific amount of the orderly liquidation fund.[153]

A Conference Committee composed of members from the House and Sen-

ate met in June to reconcile the House- and Senate-passed versions of H.R. 4173. The Conference Committee worked from a version of a bill based on the Senate-passed bill. With regard to the Title II provisions for the Orderly Liquidation Authority, the Conference Committee Report made a number of substantive changes to the Senate-passed bill. One change was made to the special provisions for the treatment of insurance companies.[154] Additional clarifying changes were made to the provisions for the orderly liquidation of a SIPC member broker-dealer.[155] The Conference Committee Report also revised the Senate-passed version to provide for a one business day delay (versus a three business day delay as contained in the Senate-passed version) for the exercise of certain rights on derivatives and other financial contracts.[156] The Conference Committee Report added language requiring a mandatory repayment plan with a specific schedule to repay any government assistance provided in connection with an orderly liquidation.[157] The repayment plan must demonstrate that the proceeds to the FDIC from the liquidation of the assets of a covered financial company and from the assessments on other financial companies will be sufficient to repay principal and interest on all government funding within a required time period. Finally, the Conference Committee Report revised the factors to be considered in establishing the assessment process.[158] Under the Conference Committee Report, the Council was required to recommend a risk matrix to be used by the FDIC in establishing the assessment mechanism. The Conference Committee Report also expanded the factors to be taken into account in constructing the risk matrix.[159]

The House approved the Conference Report on June 30, 2010, the Senate approved the Conference Report on July 15, 2010, and the president signed the Dodd-Frank Act into law on July 21, 2010.[160] The FDIC has made implementation of the Orderly Liquidation Authority under the Dodd-Frank Act one of its top priorities. Part II of this article will detail the actions taken by the FDIC to implement the Authority.

NOTES

[1] *See, e.g.*, Janet L. Yellen, vice chair, Bd. of Governors of the Fed. Reserve Sys., Macroprudential Supervision and Monetary Policy in the Post-Crisis World (Oct. 11, 2010), *available at* http://www.federalreserve.gov/newsevents/speech/

yellen2010011a.html; Sheila C. Bair, chairman, Federal Deposit Insurance Corporation, Statement on the Causes and Current State of the Financial Crisis before the Financial Crisis Inquiry Commission, 2-3 (Jan. 14, 2010), *available at* http://www.fdic.gov/news/news/speeches/chairman/spjam/410.html; Willem H. Buiter, Lessons from the global financial crisis for regulators and supervisors, 3 & 13 (May 8-9, 2009), *available at* http://www.nber.org/~wbuiter/asp.pdf.

[2] George Stigler is regarded as providing one of the early expositions of the theory of regulatory capture. *See* George J. Stigler, *The theory of economic regulation*, 2 Bell. J. Econ. Man. Sci. 3 (1971). Recent commentary has posited "regulatory capture" as an important factor behind the recent financial crisis. *See*, *e.g.*, Andrew Baker, *Restraining regulatory capture? Anglo-America, crisis politics and trajectories of change in global financial governance*, 86 Int'l Aff. 647 (2010). *See also* Buiter, *supra* note 1, at 39 (discussing "cognitive regulatory capture"); Simon Johnson, *The Quiet Coup*, The Atlantic, May 2009, *available at* http://www.theatlantic.com/magazine/print/2009/05/the-quiet-coup/7364/; Thomas Frank, *Obama and 'Regulatory Capture'*, Wall St. J., June 24, 2009, at A13.

[3] Ben S. Bernanke, Chairman of the Bd. of Governors of the Fed. Reserve Sys., Speech at the New York University Law School: Financial Regulation and the Invisible Hand (Apr. 11, 2007) (*available at* http://www.federalreserve.gov/newsevents/speech/bernanke20070411a.htm); Henry M. Paulson, Jr., secr. of treas., Opening Remarks at Treasury's Capital Markets Competitiveness Conference at Georgetown University (Mar. 13, 2007) (*available at* http://www.treasury.gov/press-center/press-releases/Pages/hp306.aspx). The Financial Services Authority in the United Kingdom, the leading proponent of "light touch" regulation, continued to support the notion even after the onset of the crisis. *See* REUTERS, *FSA chief committed to light-touch regulation* (Oct. 17, 2007), http://uk.reuters.com/assets/print?aid=UKL1756080220071017.

[4] *See*, *e.g.*, Raghuram G. Rajan, Fault Lines: How Hidden Fractures Still Threaten the World Economy (2010); Carmen M. Reinhart & Kenneth S. Rogoff, This Time is Different: Eight Centuries of Financial Folly (2009).

[5] As part of the Fraud Enforcement and Recovery Act of 2009, the Congress established the Financial Crisis Inquiry Commission (the "FCIC") with a bipartisan composition to examine the causes of the financial crisis in the United States, specifying a long list of possible causes to be considered, including global financial imbalances, fiscal imbalances in various countries, monetary policy, fraud and abuse in the financial sector, and regulatory inadequacies. *See* Fraud Enforcement and Recovery Act of 2009, Pub. L. No. 111-21, § 5, 123 Stat. 1617 (2009). Press reports indicated that significant tension developed among the members of the FCIC. *See* Joe Nocera, *Explaining the Crisis with Dogma*, N.Y. Times (Dec. 17, 2010) at B1

(discussing a partisan rift within the FCIC); Shahien Nasiripour, *Financial Crisis Panel in Turmoil as Republicans Defect; Plan to Blame Government For Crisis*, Huffington Post (Dec. 14, 2010), http://www.huffingtonpost.com/2010/12/14/financial-crisis-panel-wall-street_n_796839.html (reporting that the Republican members voted in favor of banning the words "Wall Street," "shadow banking," "interconnection," and "deregulation" from the final report).

[6] Financial Crisis Inquiry Commission, Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States xviii-xxii (2011) [hereinafter FCIC Report].

[7] FCIC Report, *supra* note 6, at 413-416 (dissenting statement of Commissioners Keith Hennessey, Douglas Holtz-Eakin, and Bill Thomas).

[8] FCIC Report, *supra* note 6, at 443 (dissenting statement of Commissioner Peter J. Wallison). Commissioner Wallison might take some solace from the knowledge that financial reform efforts at the time of the Great Depression followed a similar pattern. During the course of the Pecora Commission hearings in 1933 and 1934, the Congress enacted the Banking Act of 1933, the Securities Act of 1933, and the Securities Exchange Act of 1934. The Pecora Commission issued its report only after the enactment of these statutes. *See* S. Rep. No. 1455, 73rd Cong. 2nd Sess., at 3 (1934).

[9] Leaders of the Group of Twenty, Declaration: Summit on Financial Markets and the World Economy (Nov. 15, 2008), *available at* http://www.g20.org/pub_communiques.aspx.

[10] *See, e.g.*, Henry Kaufman, The Road to Financial Reformation (2009).

[11] *See Disputation of Doctor Martin Luther on the Power and Efficacy of Indulgences, in* Works of Martin Luther 29-38 (Adolph Spaeth et al. trans. & eds., 1915).

[12] *See, e.g.*, Kenneth R. French et al., The Squam Lake Report: Fixing the Financial System 35-43 (2010); Viral V. Acharya et al., *A Bird's-Eye View, in* Restoring Financial Stability: How to Repair a Failed System 29-35 (Viral V. Acharya & Matthew Richardson eds., 2009).

[13] Pub. L. No. 101-311, § 141(a), 105 Stat at 2273-2274 (codified at 12 U.S.C. § 1823(c)(4)). Discussions of systemic risk and too-big-to-fail issues generally focused on the banking sector at that time. *See*, *e.g.*, Richard J. Herring & Robert E. Litan, Financial Regulation in the Global Economy 95-107 (1995) (discussing systemic risk specifically in the context of previous bank failures). *But see* Kaufman, *supra* note 10, at 79-94 (identifying in the 1980s excessive leverage in the financial system and the implicit extension of the federal safety net to nonbank entities as a source of systemic risk).

[14] The government "promoted" rescue of Long-Term Capital Management has been cited as a prominent example of the extension of the too-big-to-fail concept

to a nonbanking entity. *See*, *e.g.*, Kevin Dowd, Too Big to Fail? Long-Term Capital Management and the Federal Reserve (Cato Institute Briefing Papers No. 52, 1999), *available at* http://www.cato.org/pub_display.php?pub_id=1491. *See also Hedge Fund Operations: Hearing Before the H. Comm. on Banking and Financial Services*, 105th Cong. (1998) [hereinafter *Hearing on Hedge Fund Operations*] (testimony of William J. McDonough, president, Fed. Res. Bank of N.Y.), *available at* http://newyorkfed.org/newsevents/speeches/1998/mcd981001.html. In explaining the decision of the Federal Reserve Bank of New York to promote a private-sector rescue of Long-Term Capital Management, then Chairman Alan Greenspan used the following words:

> [I]t was the FRBNY's judgment that it was to the advantage of all parties — including creditors and other market participants — to engender if at all possible an orderly resolution rather than let the firm go into disorderly fire-sale liquidation following a set of cascading cross defaults.

Hearing on Hedge Fund Operations (testimony of Alan Greenspan, chairman, Bd. of Governors of the Fed. Reserve Sys.), *available at* http://www.federalreserve.gov/boarddocs/testimony/1998/19981001.htm. The themes of "orderly resolution" and "disorderly fire-sale liquidation" were to be revived in the discussion of the Dodd-Frank Act.

Other potential sources of systemic risk had also been identified prior to the Long-Term Capital Management event. The General Accounting Office identified the over-the-counter derivatives market as a potential source of systemic risk in a 1994 report. U.S. General Accounting Office, GAO/GGD-94-133, Financial Derivatives: Actions Needed to Protect the Financial System 10-12 (1994). This report occasioned a response by a noted economist and financier. *See* Myron S. Scholes, *Global Financial Markets, Derivative Securities, and Systemic Risks*, 12 J. Risk & Uncertainty 271 (1996). When Myron Scholes wrote that article, he was a professor of finance at Stanford Business School and a principal of Long-Term Capital Management. Long-Term Capital Management itself became the putative source of systemic risk two years after the Scholes article.

[15] Pub. L. No. 101-311, § 141(a), 105 Stat at 2273-2276 (codified at 12 § 1823(c)(4)(A) & (E)).

[16] Pub. L. No. 101-311, § 141(a), 105 Stat at 2275-2276 (codified at 12 U.S.C. § 1823(c)(4)(G)). The systemic risk exception in Section 13(c)(4)(G) was used for the first time since its enactment during the recent financial crisis in connection with a proposed assisted take-over transaction for Wachovia, an assistance package provided to Citigroup, and the Temporary Liquidity Guarantee Program implemented by the FDIC. For a detailed discussion of the use of the systemic risk exception in the recent financial crisis, see U.S. Gov't Accountability Office, GAO-10-100, Federal Deposit Insurance Act: Regulators' Use of Systemic Risk Exception Raises

MORAL HAZARD CONCERNS AND OPPORTUNITIES EXIST TO CLARIFY THE PROVISION (2010).

[17] *See* GARY H. STERN & RON J. FELDMAN, TOO BIG TO FAIL: THE HAZARDS OF BANK BAILOUTS XII (2004) ("We later heard from equally distinguished audience members that, in fact, there was not a TBTF problem in the United States. Legislation passed in the early 1990s had eliminated the problem, and other countries could easily adopt the same reforms."). *See also* GREGORY PULLES, ROBERT WHITLOCK & JAMES HOGG, FDICIA: A LEGISLATIVE HISTORY AND SECTION-BY-SECTION ANALYSIS 141-10 (1995) ("New FDIA subparagraph 13(c)(4)(E) eliminates the too big to fail doctrine as of December 31, 1994").

[18] STERN & FELDMAN, *supra* note 17, at 77-79.

[19] *See*, *e.g.*, DAVID WESSEL, IN FED WE TRUST: BEN BERNANKE'S WAR ON THE GREAT PANIC (2009).

[20] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

[21] The September 2010 issue of *The Banking Law Journal* contains a comprehensive discussion of the various titles of the Dodd-Frank Act.

[22] The Council is comprised of ten voting members: the treasury secretary (who serves as chairperson of the council); the chairpersons of the Federal Reserve Board, the FDIC, the Securities and Exchange Commission, the Commodity Futures Trading Commission, and the National Credit Union Administration Board; the comptroller of the currency; the director of the Federal Housing Finance Agency; the director of the new Consumer Financial Protection Bureau (created under Title X of the Dodd-Frank Act); and an independent member appointed by the president with the advice and consent of the Senate, who has insurance expertise. The Council also has five nonvoting members: the director of the new Office of Financial Research in the Treasury Department; the director of the new Federal Insurance Office in the Treasury Department; a state insurance commissioner; a state banking supervisor; and a state securities commissioner (each of the latter three serving for a two-year term). Pub. L. No. 111-203, § 111, 124 Stat. at 1392-1393 (to be codified at 12 U.S.C. § 5321).

[23] Pub. L. No. 111-203, § 165, 124 Stat. at 1423-1432 (to be codified at 12 U.S.C. § 5365).

[24] *Id.*, § 113, 124 Stat. at 1398-1402 (to be codified at 12 U.S.C. § 5323).

[25] *Id.*, § 165, 124 Stat. at 1423-1432 (to be codified at 12 U.S.C. § 5365).

[26] *Id.*, § 165(d)(1), 124 Stat. at 1426 (to be codified at 12 U.S.C. 5365(d)(1)). The Financial Services Authority in the U.K. appears to have been a first-mover on "living wills." In 2009 it initiated a pilot program for major U.K. banking groups to develop "recovery and resolution plans." *See* Financial Services Authority, Turner Review

Conference Discussion Paper (Oct. 2009) 41 & Annex 1, *available at* http://www.fsa.gov.uk/pubs/discussion/dp09_04.pdf.

[27] Pub. L. No. 111-203, § 165(d)(6), 124 Stat. at 1427 (to be codified at 12 U.S.C. § 5365(d)(6)).

[28] *Id.*, § 165(d)(8), 124 Stat. at 1427 (to be codified at 12 U.S.C. § 5365(d)(8)).

[29] *See* Resolution Plans and Credit Exposure Reports Required, 76 Fed. Reg. 22648 (Apr. 22, 2011) (to be codified at 12 C.F.R. pt. 252). In May 2010 the FDIC under the authority of the FDIA issued a separate notice of proposed rulemaking to require insured depository institutions with more than $10 billion in total assets owned by depository holding companies with more than $100 billion in total assets to prepare contingent resolution plans. *See* Special Reporting, Analysis and Contingent Resolution Plans at Certain Large Depository Institutions, 75 Fed. Reg. 27464 (May 17, 2010). The FDIC has indicated that it plans to coordinate this rulemaking under the FDIA with the rulemaking under § 165(d) of the Dodd-Frank Act.

[30] 76 Fed. Reg. at 22649 (footnote omitted).

[31] *Id.*

[32] Section 165(d)(5) provides specific authority for the Federal Reserve Board and the FDIC to impose more stringent capital, leverage, and liquidity requirements, and growth or activity resolutions on, a company that submits a deficient resolution plan and does not thereafter resubmit a revised resolution plan that remedies the deficiencies. §165(d)(5)(A), 124 Stat. at 1427 (to be codified at 12 U.S.C. §5365(d)(5)(A)). If the company fails to resubmit an acceptable revised resolution plan within two years after the imposition of these more stringent regulatory requirements, the Federal Reserve Board and the FDIC in consultation with the Council may order the company to divest such assets or operations as are specified by the Federal Reserve Board and the FDIC. §165(d)(5)(B), 124 Stat. at 1427 (to be codified at 12 U.S.C. §5365(d)(5)(B)). It is likely that a company will negotiate an outcome with the Federal Reserve Board and the FDIC in response to any indication of a deficiency rather than face the prospect of differential capital or other regulatory requirements and most particularly the ultimate prospect of a order of divestiture of operations or assets. Chairman Sheila Bair of the FDIC has espoused robust use by the federal regulators of the powers contained in the Dodd-Frank Act to require restructuring of the largest financial institutions. *See*, e.g., Sheila C. Bair, chairman, FDIC, We Must Resolve to End Too Big to Fail, Remarks at 47th Annual Conference on Bank Structure and Competition Sponsored by the Federal Reserve Bank of Chicago (May 5, 2011) ("[T]he FDIC and the Fed must be willing to insist on organizational changes that better align business lines and legal entities well before a crisis occurs. Unless these structures are rationalized and simplified in advance, there is a real danger that their complexity could make a SIFI resolution far more costly and more difficult than it

needs to be.").

[33] Pub. L. No. 111-203, § 115(c), 124 Stat. at 1404-1405 (to be codified at 12 U.S.C. § 5325(c)). The study is to consider the benefits to financial stability of a contingent capital requirement as well as the costs to the companies, the effects on structure and operation of the credit and financial markets, and the effects on international competitiveness of companies subject to the requirement and the prospects for international coordination in establishing such a requirement. *Id.*

[34] *Id.*, § 165(c), 124 Stat. at 1425-1426 (to be codified at 12 U.S.C. § 5365(c)).

[35] Basel Committee on Banking Supervision, Consultative Document, *Proposal to ensure the loss absorbency of regulatory capital at the point of non-viability* (Aug. 2010), *available at* http://www.bis.org/publ/bcbs174.htm. In issuing the proposal, the Basel Committee on Banking Supervision noted that during the recent crisis many regulatory capital instruments did not in fact absorb losses when public sector injections of capital were made. The proposal was designed to require that convertible, subordinated or other contingent instruments issued in the future have contractual terms that require them to be written off or converted into common equity when the relevant regulatory authority determines that the write-off is appropriate or that a public injection of capital is necessary. In January 2011 the Basel Committee issued a press release adopting minimum requirements to ensure loss absorbency incorporating various elements of the August proposal. *See* Press Release, Basel Committee issues final elements of the reforms to raise the quality of regulatory capital, and Annex (Jan. 13, 2011), *available at* http://www.bis.org/press/p110113.pdf. The Annex document provides that the requirements for loss absorbency can be met if the jurisdiction of the issuing bank has in place laws that require tier 1 and tier 2 capital instruments be written off or otherwise require such instruments to fully absorb losses before taxpayers are exposed to loss. A peer group review process will be used to confirm whether the laws of a particular jurisdiction meet these requirements. *Id.*

[36] Financial Stability Board, *Reducing the moral hazard posed by systemically important financial institutions, FSB Recommendations and Time Lines* (Oct. 20, 2010), *available at* www.financialstabilityboard.org/publications/r_101111a.pdf.

[37] *Id.* at 6. In July 2011 the Financial Stability Board endorsed a proposal from the Basel Committee on Banking Supervision that a higher capital requirement for global systemically important banks should be met with tier 1 common equity only and not with contingent capital. *See* Basel Committee on Banking Supervision, Consultative Document, Global systemically important banks: Assessment methodology and the additional loss absorbency requirement ¶ 88 (July 2011), *available at* http://www.bis.org/publ/bcbs 201.htm. The Basel Committee on Banking Supervision continues to support the use of contingent capital to meet higher

national loss absorbency requirements other than the higher global requirement. *Id.* at ¶ 89.

[38] Swiss State Secretariat for International Financial Matters, *Commission of Experts submits package of measures to limit "too big to fail" risks* (Oct. 4, 2010), *available at* http://www.sif.admin.ch/dokumentation/00514/00519/00592/index.html?lang=en.

[39] *Id.*

[40] In making a determination under Section 203 to invoke the Orderly Liquidation Authority with respect to a company, the secretary must determine that "a Federal regulatory agency has ordered the financial company to convert all of its convertible debt instruments that are subject to the regulatory order." Pub. L. No. 111-203, § 203(b)(6), 124 Stat. at 1451 (to be codified at 12 U.S.C. § 5383(b)(6)). This appears to be a reference to one possible type of "bail-in" instrument.

[41] *Id.*, § 166(a), 124 Stat. at 1432 (to be codified at 12 U.S.C. § 5366(a)).

[42] § 166(b), 124 Stat. at 1432 (to be codified at 12 U.S.C. § 5366(b)).

[43] *See* 12 U.S.C. § 1830o (2006).

[44] Pub. L. No. 111-203, § 166(c)(1), 124 Stat. at 1432 (to be codified at 12 U.S.C. § 5366(c)(1)).

[45] *Id.*, § 166(c)(2), 124 Stat. at 1432 (to be codified at 12 U.S.C. § 5366(c)(2)).

[46] *Id.*, §§ 203-205, 124 Stat. at 1450-1458 (to be codified at 12 U.S.C. §§ 5383 to 5385).

[47] *Id.*, § 204(a), 124 Stat. at 1454 (to be codified at 12 U.S.C. § 5384(a)).

[48] *Id.*, § 210(a)(7) & (d)(2) & (3), 124 Stat. at 1469 & 1495 (to be codified at 12 U.S.C. § 5390(a)(7) & (d)(2) & (3)).

[49] *Id.*, § 210(b)(4) & (d)(4), 124 Stat. at 1476 & 1494 (to be codified at 12 U.S.C. § 5390(b)(4) & (d)(4)).

[50] *Id.* § 210(h), 124 Stat. at 1496 (to be codified at U.S.C. 5390(h)).

[51] *Id.*, § 204(d), 124 Stat. at 1455-1456 (to be codified at U.S.C. § 5384(d)).

[52] *Id.*, § 210(o), 124 Stat. at 1509-1512 (to be codified at 12 U.S.C. § 5390(o)).

[53] *See, e.g.*, Viral V. Acharya et al., *Resolution Authority, in* Regulating Wall Street: The Dodd-Frank Act and the New Architecture of Global Finance 227 (Viral V. Acharya et al. eds., 2011).

[54] Pub. L. No. 111-203, § 201(a)(11) (definition of "financial company" limited to a company that is incorporated or organized under federal law or state law), 124 Stat. 1443 (to be codified at 12 U.S.C. § 5381(a)(11)). Recognizing the territorial limitations of national resolution regimes and the need for international coordination, the Basel Committee on Banking Supervision has established a Cross-border Bank Resolution Group to develop recommendations for cross-border resolution and monitor progress in national implementation of the recommendations. *See* Basel

COMMITTEE ON BANKING SUPERVISION, *Report and Recommendations of the Cross-border Bank Resolution Group* (March 2010), *available at* http://www.bis.org/publ/bcbs169.pdf; & *Resolution policies and frameworks — progress so far* (July 2011), *available at* http://www.bis.org/publ/bcbs200.pdf. The Financial Stability Board has also undertaken a process to establish more effective arrangements for the resolution of systemically important financial institutions. *See* FINANCIAL STABILITY BOARD, Consultative Document, *Effective Resolution of Systemically Important Financial Institutions: Recommendations and Timelines* (July 2011), *available at* http://www.financialstabilityboard.org/publications/r_110719.pdf.

[55] *See*, *e.g.*, Press Release, American Bankers Association, 15 Jul 2010, "ABA Disappointed with Financial Regulatory Reform Bill," July 15, 2010, http://www.aba.com/Press+Room/071510RegReformBill.htm.
(the Dodd-Frank Act "contains a tsunami of new rules and restrictions for traditional banks that had nothing to do with causing the financial crisis in the first place").

[56] *See, e.g.*, Alan Greenspan, The Crisis (April 15, 2010), http://www.brookings.edu/~/media/Files/Programs/ES/BPEA/2010_spring_bpea_papers/spring2010_greenspan.pdf.

[57] *See, e.g.*, Statement of Republican Policy on H.R. 4173, the "Dodd-Frank Wall Street Reform and Consumer Protection Act" (June 30, 2010), *available at* http://repcloakroom.house.gov/news/DocumentSingle.aspx?DocumentID=193034.

[58] *Id.*

[59] *Id.*

[60] Thomas M. Hoenig, *Too Big to Succeed*, N.Y. TIMES, Dec. 1, 2010, at A37.

[61] The FDIC commenced its rulemaking process with respect to Title II in October 2010 by issuing a proposed rule covering a few select issues under Title II. *See* Notice of Proposed Rulemaking Implementing Certain Orderly Liquidation Authority Provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act, 75 Fed. Reg. 64173 (Oct. 19, 2010). In January 2011, the FDIC adopted an interim final rule covering these select issues. *See* Orderly Liquidation Authority Provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act, 76 Fed. Reg. 4207 (Jan. 25, 2011) (to be codified at 12 C.F.R. pt. 380). In March 2011 the FDIC initiated a second proposed rulemaking process, addressing an additional range of issues under Title II. *See* Orderly Liquidation Authority, 76 Fed. Reg. 16324 (March 23, 2011). The FDIC finalized the rule in July 2011. *See* Certain Orderly Liquidation Authority Provisions under Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act, 76 Fed. Reg. 41626 (July 15, 2011).

[62] Secretary of the Treasury Henry M. Paulson, Jr. referred to the desirability of a new resolution regime to permit the orderly liquidation of a systemically significant financial company in testimony in July 2008. *See Systemic Risk and the Financial*

Markets: Hearing Before the H. Comm. on Financial Services, 110th Cong. (July 10 & 14, 2008) [hereinafter *Hearing on Systemic Risk and the Financial Markets*] (testimony of Henry M. Paulson, Jr., sec'y of the treasury), *available at* http://www.treasury.gov/press-center/press-releases/Pages/hp1074.aspx. Chairman Ben S. Bernanke and then President of the Federal Reserve Bank of New York Timothy Geithner also testified in favor of consideration of a new resolution authority. *See Hearing on Systemic Risk and the Financial Markets* (testimony of Ben S. Bernanke), *available at* http://www.federalreserve.gov/newsevents/testimony/bernanke20080710a.htm; *Hearing on Systemic Risk and the Financial Markets* (testimony of Timothy F. Geithner), *available at* http://www.newyorkfed.org/newsevents/speeches/2008/GEI080724.html.

[63] Press Release, U.S. Dep't of the Treasury, Treasury Proposes Legislation for Resolution Authority (Mar. 25, 2009), *available at* http://www.treasury.gov/press-center/press-releases/Pages/tg70.aspx.

[64] *Id.*

[65] *Id.*

[66] *Id. See also* U.S. Dep't of the Treasury, Financial Regulatory Reform, A New Foundation: Rebuilding Financial Supervision and Regulation 76 (June 2009).

[67] Press Release, U.S. Dep't of the Treasury, Treasury Proposes Legislation for Resolution Authority (Mar. 25, 2009), *available* at http://www.treasury.gov/press-center/press-releases/Pages/tg70.aspx.

[68] *Id.*

[69] *Id.*

[70] *Id.*

[71] *See Too Big to Fail: The Role for Bankruptcy and Antitrust Law in Financial Regulatory Reform: Hearing Before the Subcomm. on Commercial and Administrative Law of the H. Comm. on the Judiciary*, 111th Cong. 6 (Oct. 22, 2009) [hereinafter *House Subcommittee Hearing on Regulatory Reform*] (testimony of Michael S. Barr, ass't sec'y of the treasury), *available at* http://judiciary.house.gov/hearings/hear_091022.html.

[72] Wall Street Reform and Consumer Protection Act of 2009, H.R. 1473, 111th Cong. § 1604(a)(l)(2009) (as passed by House, Dec. 11, 2009).

[73] *Id.* § 1609(n)(l)(A)(ii).

[74] *Id.* § 1609(n)(6)(D).

[75] Pub. L. No. 111-203, § 210(o), 124 Stat. at 1509 (to be codified at 12 U.S.C. § 5390(o)).

[76] *Regulatory Perspectives on the Obama Administration's Financial Regulatory Reform Proposals*: *Hearing Before the H. Comm. on Financial Services*, 111th Cong. 12 (July 12, 2009) (testimony of Ben S. Bernanke), *available at* http://financialservices.house.gov/media/file/hearings/111/testimony_of_chairman_bernanke.pdf.

[77] *Id.* at 8.

[78] *Establishing a Framework for Systemic Risk Regulation: Hearing Before the S. Comm. on Banking, Housing and Urban Affairs*, 111th Cong. 7 (July 23, 2009) (testimony of Mary L. Schapiro, Chairman, SEC), *available at* http://banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=4c3a14d4-ddee-4873-b56d-c7313cd55398.

[79] *Id.*

[80] *Regulatory Perspectives on the Obama Administration's Financial Regulatory Reform Proposals*: *Hearing Before the H. Comm. on Financial Services*, 111th Cong. 1 (July 24, 2009) (testimony of Sheila C. Bair, Chairman, FDIC), *available at* http://financialservices.house.gov/media/file/hearings/111/sheila_bair_-_fdic_(resubmitted).pdf.

[81] *Id.* at 1-2.

[82] *Regulating and Resolving Institutions Considered "Too Big To Fail": Hearing Before the S. Comm. on Banking, Housing and Urban Affairs*, 111th Cong. 12 (May 6, 2009) [hereinafter *"Too Big To Fail" Hearing*] (testimony of Sheila C. Bair, Chairman, FDIC), *available at* http://banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=4deb17aa-b8b8-4bc1-82ef-4c57388acf90.

[83] *Id.* at 13.

[84] *Id.* at 16.

[85] *Id.* at 15.

[86] *House Subcommittee Hearing on Regulatory Reform, supra* note 71 (testimony of Michael H. Krimminger, special advisor for policy, FDIC), *available at* http://judiciary.house.gov/hearings/pdf/Krimminger091022.pdf.

[87] *Id.* at 6-10.

[88] *"Too Big To Fail" Hearing*, *supra* note 82, at 16-17 (testimony of Sheila C. Bair, chairman, FDIC).

[89] *Id.*

[90] *Id.*

[91] Wall Street Reform and Consumer Protection Act of 2009, H.R. 1473, 111th Cong. § 1609(a)(4)(D)(iv) (2009).

[92] Pub. L. No. 111-203, § 215, 124 Stat. at 1518. The Council issued its report in July 2011, concluding that the combination of the Orderly Liquidation Authority and the new supervisory framework under Title I of the Dodd-Frank Act can be used to achieve the goals of market discipline and taxpayer protection without the need for a secured creditor haircut. *See* Financial Stability Oversight Council, Report to the Congress on Secured Creditor Haircuts 2 (July 2011), *available at* http://www.treasury.gov/initiatives/Documents/Report%20to%20Congress%20on%20Secured%20Creditor%20Haircuts.pdf.

[93] *Systemic Regulation, Prudential Matters, Resolution Authority and Securitization: Hearing Before the H. Comm. on Financial Services,* 111th Cong. 21 (Oct. 29, 2009) [hereinafter *Systemic Regulation Hearing*] (testimony of Scott Talbott, senior vice president for gov. affairs, Fin. Serv. Roundtable).
[94] *Id.*
[95] *Systemic Regulation Hearing*, *supra* note 93, at 8 (testimony of Edward L. Yingling, president and chief executive officer, Am. Bankers Ass'n).
[96] *Systemic Regulation Hearing*, *supra* note 93, at 10-22 (testimony of T. Timothy Ryan, president and chief executive officer, SIFMA).
[97] *Id.* at 11-12.
[98] *Id.* at 12-13.
[99] *Id.* at 14.
[100] *Id.* at 16.
[101] *"Too Big To Fail" Hearing*, *supra* note 82, at 6 (testimony of Raghuram S. Rajan, Professor, University of Chicago Booth School of Business); *House Subcommittee Hearings on Regulatory Reform, supra* note 71, at 1 (testimony of David Moss, professor, Harvard Business School).
[102] *"Too Big To Fail" Hearing*, *supra* note 82, at 14 (testimony of Martin N. Bailey, senior fellow, Economic Studies, The Brookings Institution).
[103] *See, e.g., House Subcommittee Hearing on Regulatory Reform*, *supra* note 71, at 5-6 (testimony of Harvey R. Miller, bankruptcy counsel to Lehman Brothers). This witness cited the lack of liquidity as one of the primary sources of the disorderly Lehman liquidation, but concluded that with an appropriate expansion of government authority to lend to financially distressed non-bank companies in urgent circumstances, the Bankruptcy Code could be used to provide for an orderly wind-down of a financial company rather than the new proposed resolution authority.
[104] *See, e.g., Systemic Risk: Are Some Institutions Too Big to Fail and If So, What Should We Do About It?: Hearing Before the H. Comm. on Financial Services*, 111th Cong. 1 (July 21, 2009) (testimony of Paul G. Mahoney, Dean, University of Virginia School of Law).
[105] *Experts' Perspective on Systemic Risk and Resolution Issues: Hearing Before the H. Comm. on Financial Services*, 111th Cong. 3 (Sept. 24, 2009) (testimony of Jeffrey A. Miron, senior lecturer and director of undergraduate studies, Department of Economics, Harvard University); *Systemic Regulation Hearing*, *supra* note 93, at 2 (testimony of Phillip Swagel, visiting professor, McDonough School of Business, Georgetown Univ.); *House Subcommittee Hearing on Regulatory Reform*, *supra* note 71, at 1 (testimony of John Taylor, professor, Stanford University); *House Subcommittee Hearing on Regulatory Reform*, *supra* note 71, at 2 (testimony of David Skeel, professor, University of Pennsylvania Law School).

[106] *Id.*
[107] *House Subcommittee Hearing on Regulatory Reform*, *supra* note 71, at 1 (testimony of John Taylor, professor, Stanford University); *House Subcommittee Hearing on Regulatory Reform*, *supra* note 71, at 7-8 (testimony of Edwin E. Smith, partner, Bingham McCutchen LLP); *Systemic Regulation Hearing*, *supra* note 93, at 6-9 (testimony of Peter Wallison, fellow, American Enterprise Institute).
[108] The basic categories of financial contracts that receive special treatment under the Bankruptcy Code are: commodity contracts (11 U.S.C.§ 761(4)), forward contracts (11 U.S.C.§ 101(25)), securities contracts (11 U.S.C.§ 741(7)), repurchase agreements (11 U.S.C.§ 101(47)), and swap agreements (11 U.S.C.§ 101(53B)). Amendments made to the Bankruptcy Code in 2005 significantly expanded the definitions of most of these terms. *See* Edward R. Morrison & Joerg Riegel, *Financial Contracts and the New Bankruptcy Code: Insulating Markets from Bankruptcy Debtors and Bankruptcy Judges*, 13 Am. Bankr. Inst. L. Rev. 641, 645 (2005). *See also* Rhett G. Campbell, *Financial Markets Contracts and BAPCPA*, 79 Am. Bankr. L. J. 696 (2005).
[109] 11 U.S.C. §§ 362(b)(6), (7), (17) & (27); 555, 556, 559, 560 & 561 (2006).
[110] 11 U.S.C. §§ 546(e), (f), (g) & (j) & 548(d)(2) (2006).
[111] 11 U.S.C. §§ 362(b)(27), 546(j), 548(d)(2)(E) & 561 (2006).
[112] Morrison & Riegel, *supra* note 108, at 643.
[113] *House Subcommittee Hearings on Regulatory Reform*, *supra* note 71, at 9 (testimony of Harvey Miller).
[114] *See*, *e.g.*, Franklin R. Edwards & Edward R. Morrison, *Derivatives and the Bankruptcy Code: Why the Special Treatment?*, 22 Yale J. on Reg. 91, 94 (2005).
[115] *Id.* at 93.
[116] Morrison & Riegel, *supra* note 108, at 642.
[117] Edwards & Morrison, *supra* note 114, at 94.
[118] The President's Working Group on Financial Markets, Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management (1999), *available at* http://www.treasury.gov/resource-center/fin-mkts/Documents/hedgfund.pdf.
[119] *Id.* at 26.
[120] *Id.* at 27.
[121] Edwards & Morrison, *supra* note 114, at 102.
[122] *Id.*
[123] *Id.*
[124] *Hearing on Hedge Fund Operations*, *supra* note 14, at 3 (testimony of Alan Greenspan, chairman of the Federal Reserve Board).
[125] Edwards & Morrison, *supra* note 114, at 102. *See also Lehman Brothers, Sharper Image, Bennigan's, and Beyond: Is Chapter 11 Bankruptcy Working? Before the Subcomm.*

on Commercial and Administrative Law of the H. Comm. on the Judiciary, 110th Cong. 2-3 (2009) [hereinafter *House Subcommittee Hearing on Bankruptcy*] (testimony of Jay Westbrook, professor, University of Texas School of Law).

[126] *See* Kenneth Ayotte & David A. Skeel, Jr., *Bankruptcy or Bailout?*, 35 J. OF CORP. LAW 469, 493-496 (2010).

[127] Edwards & Morrison, *supra* note 114, at 91.

[128] *See* Campbell, *supra* note 108, at 702-703.

[129] *House Subcommittee Hearing on Bankruptcy*, *supra* note 125, at 4 (testimony of Jay Westbrook).

[130] *Id.* at 5-6.

[131] *See* Markus K. Brunnermeier, Financial Crisis Report for Financial Crisis Inquire (sic) Commission, Part II: Special Section on Derivatives, Collateralized Lending and Complex Financial Instruments (2010), *available at* http://fcic.law.stanford.edu/videos/view/14 (discussing a financing in the form of a total return swap between Goldman Sachs and CIT to provide Goldman Sachs a "higher seniority").

[132] *See* Ayotte & Skeel, *supra* note 126, at 496.

[133] *Id.*

[134] *Id.*

[135] *House Subcommittee Hearing on Regulatory Reform*, *supra* note 71, at 10 (testimony of David Skeel, professor, University of Pennsylvania Law School). For a further discussion of possible approaches to amending the Bankruptcy Code to address derivatives, see DAVID SKEEL, THE NEW FINANCIAL DEAL: UNDERSTANDING THE DODD-FRANK ACT AND ITS (UNINTENDED) CONSEQUENCES 158-168 (2011).

[136] Consumer Protection and Regulatory Enhancement Act, H.R. 3310, 111th Cong. (2009).

[137] *Id.* § 102(a)(4).

[138] *Id.* § 102(f).

[139] *Id.*

[140] Section 202(e) of the Dodd-Frank Act provides that the Administrative Office of the United States Courts and the Comptroller General of the United States shall each conduct separate studies of the effectiveness of Chapter 7 or Chapter 11 of the Bankruptcy Code in facilitating the orderly liquidation or reorganization of financial companies. Pub. L. 111-203, § 202(e)(1) 124 Stat. at 1448 (to be codified at 12 U.S.C. § 5382(e)). The Government Accountability Office in July 2011 issued its first report pursuant to § 202(e). *See* U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-11-707, BANKRUPTCY: COMPLEX FINANCIAL INSTITUTIONS AND INTERNATIONAL COORDINATION POSE CHALLENGES (2011). Section 216(a) separately provides that the Federal Reserve Board in consultation with the Administrative Office of the United States Courts shall conduct a study of the resolution of financial companies under

Chapter 7 and Chapter 11 of the Bankruptcy Code. Pub. L. 111-203, § 216(a), 124 Stat. at 1519. The Federal Reserve Board issued its report pursuant to § 216(a) in July 2011. *See* BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, STUDY ON THE RESOLUTION OF FINANCIAL COMPANIES UNDER THE BANKRUPTCY CODE (July 2011). Like the other report, the Federal Reserve Board report does not make any recommendations for or against changes to the Bankruptcy Code. It merely serves as a "point of departure for further public debate." *Id.* at 1.

[141] Wall Street Reform and Consumer Protection Act of 2009, H.R. 1473, 111th Cong. (as passed by House, Dec. 11, 2009).

[142] *Id.* § 1604(a)(l).

[143] *Id.* § 1604(d).

[144] *Id.* § 1609(n)(6)(C).

[145] *Id.* § 1609(n)(6)(D).

[146] Restoring American Financial Stability Act of 2010, H.R. 4173, 111th Cong. (as passed by Senate, May 20, 2010).

[147] *Id.* § 202.

[148] *Id.* § 205.

[149] *Id.* § 209.

[150] *Id.* § 201(a)(4) (contingent claims), 210(a)(11) (avoidable transfers), and 210(a)(12)(set-offs).

[151] *Id.* § 210(a)(7)(B).

[152] *Id.* § 210(n)(6) & (9).

[153] *Id.* § 210(o). The Senate-passed version as incorporated in the Dodd-Frank Act creates an Orderly Liquidation Fund to support and carry out the responsibilities under the Orderly Liquidation Authority. The Orderly Liquidation Fund is to be funded in the first instance through borrowings by the FDIC from the Treasury, but ultimately through *ex post* assessments by the FDIC imposed on certain creditors who receive "additional" payments in an orderly liquidation proceeding and on certain other large financial companies. As a general rule, the FDIC is required to impose "risk-based" assessments to repay in full the obligations issued by the FDIC to the secretary of the treasury within 60 months of the date of issuance of the obligations. The FDIC with approval of the secretary of the treasury may extend the 60 month period if the FDIC determines it is necessary to avoid a serious adverse effect on the U.S. financial system. The assessment mechanism envisions two basic assessment processes. The first assessment process is on claimants who receive additional payments from the FDIC under the special authority contained in subsections (b)(4), (d)(4) or (h)(5)(E) of Section 210 (except for those payments necessary to initiate and continue operation of the receivership or any bridge financial company). If these assessments are insufficient to repay the FDIC funding, then the FDIC must impose

assessments on bank holding companies with total consolidated assets of $50 billion or more, nonbank financial companies supervised by the Federal Reserve Board under Title I, and other financial companies with total consolidated assets of $50 billion or more. As an overall matter, the FDIC is directed to impose assessments on a graduated basis with financial companies having greater assets and risk being assessed at a higher rate. Pub. L. No. 111-203, § 210(o), 124 Stat. at 1509-1511 (to be codified at 12 U.S.C. § 5390(o)).

[154] H.R. Rep. No. 111-517, § 203(a)(l)(C) at 77 (2010) (Conf. Rep.).

[155] *Id.,* § 205 at 82-85.

[156] *Id.*, § 210(c)(10)(B) at 118-119.

[157] *Id.*, § 210(n)(9) at 136.

[158] *Id.*, § 210(n)(4) at 138.

[159] In establishing the risk matrix the Council and the FDIC are directed to take into account a series of general and specific factors. One of the general factors to be taken into account is economic conditions generally affecting financial institutions so as to allow assessments to increase during more favorable economic conditions and to decrease during less favorable economic conditions. *Id.*, § 210 (0)(4)(A), 124 Stat. at 1510 (to be codified at 12 U.S.C. § 5390(0)(4)(A)). This countercyclical factor, which makes more sense in an *ex ante* mechanism than an *ex post* mechanism, originated in the House version of the bill. The risk matrix is also to take into account the differences in risk posed to financial stability by financial companies, the differences in liability structures of financial companies, and the different bases for other financial assessments that financial companies may be required to pay. *Id.*, § 210(0)(4)(B), 124 Stat. at 1510 (to be codified at 12 U.S.C. § 5390(0)(4)(B). The assessments to be taken into account are those paid by insured depository institutions under the FDIA, SIPC member broker-dealers under SIPA, insured credit unions under the Federal Credit Union Act, and insurance companies under applicable State law to cover the costs of rehabilitation, liquidation or other State insolvency proceedings. *Id.* The risk matrix is also to take into account a detailed list of financial characteristics presented by a financial company or category of financial company, such as the activities, liquidity, leverage, stability of funding, concentration of liabilities, and importance as a source of credit or liquidity as well as the risks presented by the financial company during the preceding 10-year period. *Id.*, § 210(0)(4)(C), 124 Stat. at 1511 (to be codified at § U.S .C. § 5390(0)(4)C).

[160] 156 Cong. Rec. 5261 (June 30, 2010) (House); 156 Cong. Rec. 5932-5933 (July 21, 2010) (Senate); Office of the President, Remarks on Signing the Dodd-Frank Wall Street Reform and Consumer Protection Act (July 21, 2010).