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Victoria Prussen Spears

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Cross-Border Resolution of Banking Groups: International Initiatives and U.S. Perspectives—Part V

By Paul L. Lee*

This multi-part article traces the development of new legal regimes for the cross-border resolution of banking groups since the time of the global financial crisis in 2007–2009. This Part discusses Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act. Title II establishes a new regime, the Orderly Liquidation Authority, as an alternative to and substitute for the Bankruptcy Code, for the resolution of systemically important financial institutions. There is currently an active debate whether Title II should be repealed. This Part discusses the arguments made for and against the enactment of Title II. It also discusses developments since the enactment of Title II, such as the conceptualization of the single-point-of-entry strategy and the notion of total loss-absorbing capacity.

The events of the 2007–2009 financial crisis produced high-level calls for a re-examination of the resolution regimes for cross-border banking groups, particularly for those perceived to be systemically important.[1] In the minds of many official observers the events of the financial crisis confirmed that existing national legal regimes were inadequate to address the failure of systemically important financial institutions.[2] In response to this recognition, the Financial Stability Board (the "FSB") in 2011 promulgated its Key Attributes of Effective Resolution Regimes for Financial Institutions (the "FSB Key Attributes").[3] The

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[1] *See* The Group of Twenty, *Declaration: Summit on Financial Markets and the World Economy* 8 (Nov. 15, 2008), *available at* http://www.g20.utoronto.ca/2008/2008declaration1115.html.

[2] *See, e.g.,* International Monetary Fund and the World Bank, *An Overview of the Legal, Institutional, and Regulatory Framework for Bank Insolvency* (Apr. 17, 2009), *available at* http://www.imf.org/external/np/pp/eng/2009/041709.pdf; Basel Committee on Banking Supervision, *Consultative Document, Report and Recommendations of Cross-border Bank Resolution Group* (Sept. 2009), *available at* http://www.bis.org/publ/bcbs162.htm.

[3] Press Release, FSB, FSB Issues International Standard for Resolution Regimes (Nov. 4,

FSB Key Attributes are designed to promote more effective national resolution regimes for financial institutions and to facilitate international convergence of such regimes. A number of major jurisdictions, including Switzerland, the United Kingdom, and the member states of the European Union, have adopted new bank resolution regimes incorporating many of the FSB Key Attributes.[4]

In the United States, the perceived inadequacy of existing resolution regimes for systemically important U.S. financial institutions led to the enactment of Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") in 2010.[5] Title II of the Dodd-Frank Act provides a new resolution regime, the so-called Orderly Liquidation Authority, to facilitate the resolution of a financial company whose failure could adversely affect U.S. financial stability. If invoked, Title II would be used in lieu of the Bankruptcy Code to resolve the troubled financial company.

The Orderly Liquidation Authority involves an administrative receivership process, modeled on the existing bank receivership process in the Federal Deposit Insurance Act (the "FDIA").[6] Title II provides for the appointment of the Federal Deposit Insurance Corporation (the "FDIC") as the receiver for the troubled financial company. The FDIC as receiver would then resolve the troubled institution, using powers and procedures modeled on those that the FDIC has for many years used to resolve insured depository institutions under the FDIA.[7] The FDIC has made implementation of Title II one of its top priorities, engaging in significant rulemaking processes, consultation with market participants, and ongoing coordination with foreign regulatory and resolution authorities relating to the new resolution authority.

THE UNCERTAIN FUTURE OF TITLE II

Title II was controversial at the time of its enactment and it remains controversial today. The Dodd-Frank Act was passed along party lines with only three House Republicans and three Senate Republicans voting in favor of its passage in 2010. Since the enactment of the Dodd-Frank Act, the House

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2011), *available at* www.financialstabilityboard.org/press/pr_111104dd.pdf.

[4] The FSB monitors the progress that its member jurisdictions have made in adopting resolution regimes conforming to the FSB Key Attributes. *See*, *e.g.*, FSB, *Ten years on—taking stock of post-crisis resolution reforms*, *Sixth Report on the Implementation of Resolution Reforms* (July 2017), *available at* http://www.fsb.org/wp-content/uploads/P060717-3.pdf.

[5] Pub. L. No. 111-203, 124 Stat. 1376 (2010).

[6] *See* 12 U.S.C. §§ 1821(d)–(q) & 1823 (c)–(e).

[7] The powers and procedures for the resolution of insured depository institutions under the FDIA are discussed in Part IV of this article.

Republicans have continued to assail Title II and oppose its use.[8] In 2016 House Republicans introduced a bill, the Financial CHOICE Act of 2016, to repeal Title II as well as other prominent provisions in the Dodd-Frank Act.[9] At the time of the introduction of the bill in the House in June 2016, the prospects for action on it seemed dim. The November 2016 election results, however, changed the political prospects for revision or possible repeal of certain provisions in the Dodd-Frank Act, including Title II. In June 2017 the House passed a modified version of the 2016 bill as the Financial CHOICE Act of 2017 (without a single Democratic vote in favor).[10] The prospects for an omnibus bill like the Financial CHOICE Act in the Senate appear much dimmer. There may be Democratic support in the Senate for some revisions to the Dodd-Frank Act, but not for a repeal of Title II.

Even if there were to be no repeal of Title II, its future remains uncertain. President Trump in April 2017 issued a Presidential Memorandum (the "Presidential Memorandum") directing the Secretary of the Treasury to conduct a thorough review of the Orderly Liquidation Authority.[11] One of the propositions in the Presidential Memorandum is that the existence of the Orderly Liquidation Authority itself may encourage excessive risk taking in the financial system. The Presidential Memorandum states that it is critical to acknowledge the "potentially adverse consequences" of the availability and use of the Orderly Liquidation Authority.[12] The tenor of the Presidential Memorandum suggests that the new Administration would be unlikely to authorize

[8] *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* https://repcloakroom.house.gov/news/documentsingle.aspx?DocumentID=193034 (arguing that Title II would perpetuate bailouts and advocating that instead of adopting Title II, Congress should enact "an enhanced form of bankruptcy for large financial firms"). *See also* Republican Staff of the H. Comm. on Financial Services, 113th Cong., Failing to End "Too Big To Fail": An Assessment of the Dodd-Frank Act Four Years Later 64 (July 2014) [hereinafter 2014 House Report], *available at* https://financialservices.house.gov/UploadedFiles/071814_TBTF_Report_FINAL.pdf (asserting that four years after its passage, the effectiveness of Title II "remains seriously in doubt").

[9] Financial CHOICE Act of 2016, H.R. 5983, 114th Cong. (2016). *See* H. Comm. on Financial Services, 114th Cong. The Financial Choice Act Creating Hope and Opportunity for Investors, Consumers, and Entrepreneurs 18 (Jan. 23, 2016) ("far from ending bailouts, the Dodd-Frank Act institutionalized them and made them a permanent feature of the regulatory toolkit, in the form of the 'Orderly Liquidation Authority' set forth in Title II of the Act").

[10] Financial CHOICE Act of 2017, H.R. 10, 115th Cong. (2017).

[11] Presidential Memorandum for the Secretary of the Treasury on Orderly Liquidation Authority (Apr. 21, 2017), *available at* https://www.whitehouse.gov/the-press-office/2017/04/21/presidential-memorandum-secretary-treasury-0.

[12] *Id.* at 2.

the use of the Orderly Liquidation Authority even if Title II were not to be repealed.

The Presidential Memorandum also notes that it is important to evaluate the extent to which other legislative changes, such as changes to the Bankruptcy Code, could fulfill the Orderly Liquidation Authority's objectives "in a more effective manner."[13] The Presidential Memorandum specifically directs the Secretary of the Treasury to consider whether a new chapter in the U.S. Bankruptcy Code for resolving a failed financial firm would be a superior method for the resolution of financial firms than Title II.[14] Bills providing for the addition of a new Subchapter V to Chapter 11 of the Bankruptcy Code for large financial institutions have actually passed the House in recent years. The Financial CHOICE Act as passed in the House in June 2017 includes provisions for the new Subchapter V to Chapter 11 of the Bankruptcy Code, but, unlike the bills previously passed in the House providing for the new Subchapter, the Financial CHOICE Act of 2017 also provides for a repeal of Title II.[15] Various commentators have suggested that adding a new Subchapter V for financial firms to the Bankruptcy Code would be helpful, but most of these commentators have urged that Title II be retained as a backstop even if a new Subchapter for financial firms were to be added to the Bankruptcy Code.[16]

The prospect of a repeal of Title II, or of an avowed reluctance on the part of the current Administration to use Title II, has significant implications for domestic and international policy. Since 2010 much of the domestic and international planning to deal with future financial crises has been based on specially designed resolution regimes as envisioned in the FSB Key Attributes. A repeal of Title II, even if only as a backstop to a new Subchapter in the Bankruptcy Code, would represent a major retreat from the policies and protocols that have been developed among international supervisors.

The debate over Title II, initially joined in 2009 and 2010 as the Dodd-Frank Act was being considered, and now re-invigorated as a repeal of Title II is being actively promoted, presents important issues for the future of

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[13] *Id.*

[14] *Id.* at 3.

[15] Financial CHOICE Act of 2017, H.R. 10, 115th Cong. § 111 (2017).

[16] *See, e.g.,* John Heltman, *The perils of repealing FDIC resolution powers*, AM. BANK., May 19, 2017, https://www.amercianbanker.com/news/the-perils-of-repealing-fdic-resolution-powers; Lalita Clozel, *Can FDIC resolution powers be reformed instead of axed?*, AM. BANK., June 6, 2017, https://www.americanbanker.com/news/can-fdic-resolution-powers-be-reformed-instead-of-axed.

the financial institutions sector. This Part of the article analyzes the contending views on Title II. It discusses the arguments originally made for and against its enactment and use. This Part also discusses the steps that the FDIC has taken since the enactment of Title II to address certain of the original concerns expressed by the Congressional opponents of Title II. It also discusses the important conceptual work that the FDIC has undertaken to facilitate the use of Title II. The most significant conceptual element in the work of the FDIC is the development of the so-called "single point of entry" ("SPOE") strategy. Although the SPOE strategy was first conceptualized in the context of Title II, the strategy has now been endorsed by many bankruptcy practitioners as a concept that could be successfully applied in a Bankruptcy Code case as well, particularly if changes are made to the Bankruptcy Code to facilitate the mechanics of an SPOE approach.

As discussed below, an SPOE strategy envisions that a legal resolution would occur only at the top-tier holding company, thus avoiding to the greatest extent possible the need for the initiation of resolution proceedings at the level of the operating subsidiaries. This approach minimizes the complexities and conflicts that would invariably arise if multiple proceedings in home and host countries had to be commenced at the level of the operating subsidiaries. A successful SPOE process, for example, would obviate the need for the FDIC to initiate a receivership process under the FDIA for a large bank subsidiary of the holding company, avoiding the difficulties and complexities discussed in Part IV of this article.

The SPOE approach represents a significant conceptual breakthrough in resolution thinking. Planning for its implementation is now a high priority for both U.S. regulatory authorities and regulatory authorities in other major jurisdictions. This Part of the article discusses the implementation of an SPOE strategy, as well as the integrally related concept of total loss-absorbing capacity ("TLAC"). Part VI of this article will discuss the extension of the SPOE mechanism to a bankruptcy process and the proposed changes to the Bankruptcy Code to provide a special Subchapter for the resolution of financial companies.

THE DODD-FRANK ACT APPROACH TO SYSTEMIC RISK

The Dodd-Frank Act was designed as a measure to expand and reorder the U.S. financial regulatory system. At the core of the Dodd-Frank Act lie various provisions intended to address systemic risk in the U.S. financial system. The most important provisions in this respect are those contained in Titles I and II of the Dodd-Frank Act. Title I establishes a new framework to deal with systemic risk through heightened regulation of systemically important financial

institutions.[17] Title II provides a new resolution regime to deal with the failure of financial firms that pose a serious risk to U.S. financial stability.[18] The construct of these two Titles reflects a 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 regulation and supervision. The second prong as represented by Title II is an *ex post* resolution regime, 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 government "bailout" of the company or its creditors. Supporters of the Dodd-Frank Act argue that these Titles mitigate systemic risk and its corollary, the too-big-to-fail phenomenon. Opponents of the Dodd-Frank Act argue that these Titles actually have the perverse effect of promoting systemic risk and reinforcing the too-big-to-fail phenomenon.[19]

Title I requires in effect 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 prudential measures by the Federal Reserve Board.[20] Title I also provides the Financial Stability Oversight Council (the "FSOC") with authority to designate nonbank financial companies as systematically important and to subject such companies to prudential supervision by the Federal Reserve Board.[21] The enhanced prudential measures include capital, liquidity, concentration limits, credit exposure, stress tests and overall risk management requirements.

Title I also imposes another particularly important prudential requirement on these companies, a resolution plan (or so-called "living will") requirement. Bank holding companies with $50 billion or more in consolidated assets and nonbank financial companies designated by the FSOC are required to periodically submit to the Federal Reserve Board and the FDIC a plan for "rapid and orderly resolution in the event of material financial distress or

[17] Dodd-Frank Act, §§ 101–176 (codified at 12 U.S.C §§ 5311–5374 (2015)).

[18] Dodd-Frank Act, §§ 201–217 (codified at 12 U.S.C §§ 5381–5394 (2015)).

[19] *See* sources cited *supra* note 8. For a general critique of the Dodd-Frank Act approach to systemic risk, see Paul H. Kupiec, *Is systemic risk a Dodd-Frank fallacy?,* Am. Bank., May 5, 2017, https://www.americanbanker.com/opinion/is-systemic-risk-a-dodd-frank-fallacy.

[20] Dodd-Frank Act, § 165(a)(1) (codified at 12 U.S.C. § 5365(a)(1)).

[21] *Id.*, § 113(a) & (b) (codified at 12 U.S.C. § 5323(a) & (b)).

failure."[22] The resolution plan required under Title I must be reviewed by the Federal Reserve Board and the FDIC to determine whether the plan is credible and would facilitate an orderly resolution of the company under the Bankruptcy Code (not Title II).[23]

There is a seeming paradox between the Bankruptcy Code test in the Title I resolution plan requirement and the conception of Title II. The Treasury Department and other proponents of Title II argued that the new resolution authority reflected in Title II was needed because the events of the financial crisis had demonstrated that during a crisis a systemically important financial company could not be resolved in an orderly manner under the Bankruptcy Code. Notwithstanding the apparent premise underlying Title II, the resolution plan requirement in Title I provides that the resolution plan must be judged solely against the Bankruptcy Code. The seeming conflict in the premises underlying the Bankruptcy Code test in the Title I resolution plan requirement and the need for Title II can perhaps be explained by the desire of the authors of the Dodd-Frank Act to confirm that bankruptcy remained the preferred resolution framework notwithstanding the addition of Title II. The authors of the requirement that a resolution plan must be tested against the Bankruptcy Code and not Title II may also have believed that the test would ultimately force the largest and most complex financial institutions to reduce their size and complexity in order to produce a credible plan for resolution under the Bankruptcy Code. As will be discussed in Part VI of this article, the requirement in Title I that a resolution plan must provide a credible plan for an orderly resolution under the Bankruptcy Code has had important consequences. It has in fact produced significant changes in the structure and operations of the largest U.S. bank holding companies. It has also produced pressure for changes to be made to the Bankruptcy Code to facilitate its use in the orderly resolution of a large U.S. bank holding company, including changes to facilitate in particular an SPOE approach.

THE CASE FOR TITLE II AND THE NEW RESOLUTION REGIME

The Treasury Proposal

When the Obama Administration took office in January 2009, one of its top priorities was the development of a proposal for comprehensive financial reform legislation. A key element of the financial reform legislation was the proposal for a new resolution regime for systemically important financial institutions. In

[22] *Id.*, § 165(d)(1) (codified at 12 U.S.C. § 5365(d)(1)).

[23] *Id.*, § 165(d)(4) (codified at 12 U.S.C. § 5365(d)(4)).

a March 2009 press release proposing the new resolution regime, the U.S. Treasury Department stated that its proposal for a new regime would fill a significant void in the existing financial regulatory structure for dealing with large nonbank financial companies that had been highlighted during the financial crisis.[24] The Treasury Department said that the events of the financial crisis demonstrated that when a large, interconnected nonbank financial company encountered severe financial distress, there were only two options for the company: (1) obtain capital or other funding from the federal government as in the case of American International Group, Inc. ("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 Holdings Inc. ("Lehman").[25] Faced with the choice between these two options, the federal government in September 2008 chose to use the Federal Reserve Board's lending authority under section 13(3) of the Federal Reserve Act to provide assistance to AIG and so avoid a disorderly failure of AIG, much as it had done in March 2008 for Bear Stearns. These actions were criticized at the time by many observers as a "bailout" of the institutions.

In light of these experiences, the Treasury Department concluded that the federal government needed another option for dealing with the resolution of a systemically important financial firm. The Treasury Department said that this option should take the form of a resolution authority that replicated the speed and flexibility of the resolution authority for insured depository institutions under the FDIA.[26] Since its enactment in 1933, the FDIA has provided a durable regime for the resolution for FDIC-insured depository institutions.[27] The resolution regime proposed by the Treasury Department (and Title II as ultimately adopted) would not displace or substitute for the FDIA resolution regime for insured depository institutions. An insured depository institution would remain subject to resolution under the provisions of the FDIA. Rather, the new proposed resolution regime would apply to the holding company of an insured depository institution (displacing the Bankruptcy Code as to the holding company) and to other systemically important nonbank financial companies, such as broker-dealer companies like Lehman or insurance compa-

[24] 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.

[25] *Id.*

[26] *Id.*

[27] The operation of the resolution regime in the FDIA for insured depository institutions is discussed in Part IV of this article.

nies like AIG (displacing the Bankruptcy Code or other statutory liquidation regimes that would normally apply to such companies).

In testimony in support of the Treasury proposal, a senior Treasury official described the advantages that the new resolution authority would have over the options that were available to the government during the financial crisis in 2008.[28] The first advantage derived from a different focus between the new resolution authority and the Bankruptcy Code. The focus of the Bankruptcy Code is to reorganize or liquidate a failing firm for the benefit of its creditors. The focus of the new resolution authority would be to manage the failure of a systemically important financial company in a way that protects taxpayers, the broader economy, and the stability of the financial system. Given the special focus of the new resolution authority (which might be seen to be in some derogation of the creditor protections provided by the Bankruptcy Code), the senior Treasury official stated that the new resolution authority was to be used very sparingly and was not intended "to replace bankruptcy in any but the rarest circumstances."[29] In addition to this broader objective of protecting the stability of the financial system, the Treasury official identified four specific advantages that the new resolution authority would have over a Bankruptcy Code approach. The new resolution authority would:

(1) be essentially an administrative process rather than a judicial process and so would provide the necessary speed to deal with a failing financial firm;

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

(3) allow the federal government to provide the failing company with financing to fund its liquidity needs during the resolution process and thus mitigate the "knock on" effects of its failure, such as the fire-sale of assets; and

(4) provide for the use of one or more "bridge" financial companies to preserve the business franchise, deal with counterparty claims, and protect the viable assets of stronger subsidiaries pending their sale.[30]

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[28] *See Too Big to Fail: The Role for Bankruptcy and Antitrust Law in Financial Regulation Reform (Part I): Hearing before the Subcomm. on Commercial and Administrative Law of the H. Comm. on the Judiciary*, 111th Cong. 20 (Oct. 22, 2009) [hereinafter *House Subcommittee Hearing on Regulatory Reform*] (statement of Michael S. Barr, Ass't Sec'y of the Treasury).

[29] *Id*. at 23.

[30] *Id*. at 25.

Support from the Bank Regulators

The federal regulatory agencies enthusiastically supported the Treasury proposal for a new resolution authority for systemically important financial companies. Chairman Ben Bernanke of the Federal Reserve Board, for example, testified in favor of the proposal for a new resolution authority, noting that after the Lehman and AIG experiences, there could be little doubt that the federal government needed a "third option between the choices of bankruptcy or bailout."[31] Chairman Mary Shapiro of the Securities and Exchange Commission (the "SEC") likewise testified in favor of the proposal, noting the Hobson's choice that confronted the government when a large, interconnected financial company was teetering on the brink of failure and thus the need for another real option.[32]

The most vocal advocate for the new resolution authority among the federal regulators was Chairman Sheila Bair of the FDIC. Chairman Bair 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.[33] In support of the new resolution regime, she pointed to the severe market disruption resulting from the Lehman bankruptcy filing and offered two explanations for the severity of the market reaction.[34] 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.[35] The second explanation was that the legal features of the bankruptcy process itself triggered the fire sale of assets and destroyed the liquidity of a large share of the claims against Lehman. In respect of the fire sale of assets, Chairman Bair focused in

[31] *See Regulatory Perspectives on the Obama Administration's Financial Regulatory Reform Proposals (Part II): Hearing Before the H. Comm. on Financial Services*, 111th Cong. 84 (July 24, 2009) (statement of Ben S. Bernanke, Chairman, Federal Reserve Board).

[32] *See Establishing a Framework for Systemic Risk Regulation: Hearing Before the S. Comm. on Banking, Housing and Urban Affairs,* 111th Cong. 73 (July 23, 2009) (statement of Mary L. Schapiro, Chairman, SEC).

[33] *See Regulatory Perspectives on the Obama Administration's Financial Regulatory Reform Proposals, Part II: Hearing Before the H. Comm. on Financial Services*, 111th Cong. 57 (July 24, 2009) (statement of Sheila C. Bair, Chairman, FDIC).

[34] *See Regulation and Resolving Institutions Considered "Too Big To Fail": Hearing Before the S. Comm. on Banking, Housing and Urban Affairs*, 111th Cong. 51 (May 6, 2009) [hereinafter "*Too Big To Fail" Hearing*] (statement of Sheila C. Bair, Chairman, FDIC).

[35] *Id*.

particular on the 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 could 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. Chairman Bair said that under either of the above explanations for the fall-out of the Lehman failure, the answer must be the establishment of a new resolution process.[36]

Another senior official of the FDIC expanded on the reasons why a bankruptcy process was not well suited to the resolution of large financial firms.[37] He noted a fundamental difference between large financial firms and large commercial firms, namely, that large financial firms perform critical functions in settling payments and intermediating liquidity for individuals and markets. The freezing of these functions at a large interconnected financial firm would lead to cascading consequences for counterparties, customers, and even whole markets. The critical role of a large financial company's settlement and liquidity intermediation function for customers and markets effects the speed (and hence the process) with which such a company must be resolved.[38] The resolution of such a firm would have to be handled virtually overnight or at least over a "resolution weekend." This time constraint limits the process (and the participants in the process) as has long been the case with the resolution of banking entities under the FDIA. The resolution process for a large financial institution cannot depend upon administration by a debtor in possession, a recently appointed trustee, or a set of creditors' committees. The resolution process instead requires pre-planning by the resolving authority, using a staff that is experienced in the financial operations of large financial firms.[39] The resolution of a large financial firm requires the resolver to act decisively to take over the business, preserve systematically significant operations, and provide continuity of critical financial functions. This process in turn requires special tools like a "bridge company" mechanism to which financial market contracts (*e.g.*, derivatives) can be transferred without triggering netting and close-out rights and without the consent of the counterparties.[40] This bridge company

[36] *Id.*

[37] *House Subcommittee Hearing on Regulatory Reform*, *supra* note 28, at 29 (statement of Michael H. Krimminger, Special Advisor for Policy, FDIC).

[38] *Id.* at 30.

[39] *Id.* at 35.

[40] *Id.* at 36.

must also be in a position to continue to perform systemically significant functions, such as payment processing, securities lending, and settlement of ongoing government securities transactions.[41] The concept of a bridge company in the new resolution authority was based on the concept of a bridge bank, which can be used under the FDIA to resolve an insured depository institution.[42] Likewise, the concept of transferring financial markets contracts such as derivatives without triggering netting and close-out rights and without the consent of counterparties was based on comparable provisions in the resolution regime for insured depository institutions under the FDIA.[43] In addition, the new resolution regime must be in a position to provide the necessary liquidity to the bridge company to continue systemically important functions through a secure government-funding mechanism.[44] The concept of providing a funding mechanism in the new resolution regime was based in its broad outlines on the funding authority that the FDIC uses under the FDIA in its resolution of failed depository institutions.[45]

Position of Financial Industry Groups and Other Commentators

The major financial industry trade groups voiced general support for the concept of a new resolution authority for systemically important financial firms, but expressed concerns about certain of the terms of the new resolution authority contained in the Treasury draft of the legislation. One area of concern

[41] *Id.* at 37.

[42] *See* 12 U.S.C. § 1821(n) (2015). The use of bridge banks under the FDIA is discussed in Part IV of this article.

[43] The FDIA imposes a one business-day stay on the exercise by a counterparty of any right to terminate, liquidate or net a qualified financial contract "solely by reason of or incidental to the appointment of a receiver for the depository institution (or the insolvency or financial condition of the depository institution for which the receiver has been appointed)." This stay remains in effect until 5:00 p.m. (Eastern time) on the business day following the day of the appointment of the receiver (or the counterparty has received notice that the contract has been transferred by the receiver under the specific transfer provisions for qualified financial contracts in the FDIA). 12 U.S.C. § 1821(e)(10)(B). This provision is designed to provide the FDIC as receiver with time to arrange a possible transfer of the book of qualified financial contracts of the failed bank to a bridge bank or perhaps even a third-party acquirer, ideally over a "resolution weekend." The FDIA also provides that the FDIC as receiver may transfer any asset or liability to a bridge bank (or other acquirer) without any approval or consent (except any federal banking agency approval that may otherwise be required). 12 U.S.C. § 1821(d)(2)(G)(i) & (n)(3)(A)(iv). These provisions are replicated in Title II.

[44] House Subcommittee Hearing on Regulatory Reform, *supra* note 28, at 37 (statement of Michael H. Krimminger).

[45] *See* 12 U.S.C. §§ 1821 (n)(7) & 1823(c) for the FDIA provisions relating to the use of funds from the Deposit Insurance Fund in the resolution of insured depository institutions.

related to the possible difference in treatment of creditors under the Bankruptcy Code and the new resolution authority. The major financial 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.

The Securities Industry and Financial Markets Association ("SIFMA"), for example, supported the idea of a resolution authority for systemically important financial companies, but objected to various provisions in the Treasury legislative proposal. The testimony from the SIFMA representative acknowledged the 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.[46] In its testimony, SIFMA appeared to accept the need for a new 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 resolution model in the FDIA.[47]

A number of academicians and other commentators supported the idea of a new regime on the grounds that the bankruptcy process was not suitable for handling a large, troubled financial company. These commentators observed that a bankruptcy process for a large complex financial institution would take too long—the financial business would "evaporate" while the company was in the proceeding—leading to a piecemeal liquidation of assets with attendant loss

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[46] *Systemic Regulation, Prudential Matters, Resolution Authority and Securitization: Hearing Before the H. Comm. on Financial Services*, 111th Cong. 188 (Oct. 29, 2009) [hereinafter *Systemic Regulation Hearing*] (statement of T. Timothy Ryan, President and Chief Executive Officer, SIFMA. The SIFMA representative pointed 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.

Id. at 198–199.

[47] *Id.* at 199–200.

of value.[48] These commentators specifically called for a new resolution authority similar to the authority that the FDIC has for insured depository institutions. An equally important concern for some commentators 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 systemically important financial institutions cannot be resolved in bankruptcy without threatening the stability of the financial system. The bankruptcy process stays payment of unsecured 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.[49]

The reference in this quote to secured creditors seizing and possibly selling collateral is presumably a reference to the special treatment accorded derivatives and other financial contracts under the safe harbor provisions in the Bankruptcy Code discussed further below. Another commentator supporting the idea of a new resolution regime was more explicit in his objection to the Bankruptcy Code's treatment of derivatives and other financial contracts. He characterized the cross-default provisions in such contracts as essentially "poison-pills that make large institutions too costly to fail."[50]

For many observers another critical point working against a bankruptcy process was its inability to provide the funding that would be needed to permit an orderly resolution of a large financial institution.[51] 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.

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[48] *See, e.g.,* "*Too Big To Fail*" *Hearing*, *supra* note 34, at 102 (statement of Raghuram G. Rajan, Professor, University of Chicago Booth School of Business); *House Subcommittee Hearing on Regulatory Reform*, *supra* note 28, at 98 (testimony of David Moss, Professor, Harvard Business School).

[49] "*Too Big To Fail*" *Hearing*, *supra* note 34, at 100 (statement of Martin N. Baily, Senior Fellow, Brookings Institution).

[50] "*Too Big To Fail*" *Hearing*, *supra* note 34, at 106 (statement of Raghuram G. Rajan).

[51] *See, e.g.*, *House Subcommittee Hearing on Regulatory Reform*, *supra* note 28, at 64 (statement of Harvey R. Miller, bankruptcy counsel to Lehman). This witness cited the lack of liquidity as one of the primary sources of the disorderly Lehman liquidation, but as noted *infra* he concluded that with an appropriate expansion of government authority to lend to financially distressed companies in exigent 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.

As ultimately adopted, Title II provided for government debt funding or guarantees to be provided to the receivership or any bridge company that the FDIC might establish as part of the resolution process.[52] Any such funding must be repaid on a priority basis from the proceeds of the Title II process or, if necessary, from an assessment on large financial companies.[53] While the supporters of the new resolution regime saw government funding (at least for short-term liquidity purposes) as essential to the operation of the new resolution authority, opponents of Title II saw the provision for government funding as an inherent flaw in Title II. To these opponents, such government funding was tantamount to a "bailout."[54] This remains perhaps the most fundamental criticism of the Title II approach even today.

THE CASE AGAINST TITLE II AND THE NEW RESOLUTION REGIME

Criticism from Bankruptcy Practitioners and Academicians

A number of bankruptcy practitioners, academicians, and commentators objected to the basic notion of the new resolution authority. They contrasted the new proposed resolution process unfavorably to a bankruptcy process, which they saw as open and transparent and administered according to clear rules and settled precedent. But more fundamentally as noted above, they feared that the new resolution authority would permit the regulators to "bailout" troubled financial firms through the use of the power to provide debt funding and guarantees to the failing institution or the successor bridge company.[55] These commentators argued that a bankruptcy process was needed to instill discipline in the market.[56] These commentators also sought to refute the "Lehman Myth," namely, the idea that it was the Lehman bankruptcy that

[52] Dodd Frank Act, § 204(d) (codified at 12 U.S.C. § 5384(d)).

[53] Dodd Frank Act, § 210(n) & (o) (codified at 12 U.S.C. § 5390(n) & (o)).

[54] *See, e.g.,* sources cited *supra* note 8 and *infra* note 55.

[55] *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. 63-66 (July 21, 2009) (statement of Paul G. Mahoney, Dean, University of Virginia School of Law); *Experts' Perspective on Systemic Risk and Resolution Issues: Hearing Before the H. Comm. on Financial Services*, 111th Cong. 67–71 (Sept. 24, 2009) (statement of Jeffrey A. Miron, Senior Lecturer, Harvard University); *Systemic Regulation Hearing*, *supra* note 46 (statement of Phillip Swagel, Visiting Professor, McDonough School of Business, Georgetown Univ.); *House Subcommittee Hearing on Regulatory Reform*, *supra* note 28, at 136 (statement of David Steel, Professor, University of Pennsylvania Law School).

[56] *Id.*

precipitated the financial panic in September 2008 and the idea that the events in the Lehman bankruptcy cast doubt on the efficacy of the bankruptcy process itself.[57] These commentators saw more fundamental problems in the regulators' handling of large financial institutions as the cause of the financial crisis.

The opponents of the new resolution authority 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 mitigating systemic risk.[58] In contrast to the proposed resolution authority, these commentators saw the bankruptcy process as relying on established rule of law rather than administrative discretion and as treating creditors in a way understood by lenders and investors in advance, including in particular the "absolute priority rule."[59] The more moderate opponents saw the new resolution authority as unnecessary. The more virulent opponents saw the new resolution authority as pernicious.

Acknowledgment of Concerns with the Bankruptcy Code

Some of the commentators who favored a bankruptcy approach over the new resolution authority nonetheless recommended that changes be made to the Bankruptcy Code to address potential systemic concerns.[60] These commentators pointed in particular to a need to revise the "safe harbor" treatment accorded 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 restricted in their application to derivatives and other financial contracts.[61] The exclusion of these financial contracts from the automatic stay

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[57] *See, e.g., House Subcommittee Hearing on Regulatory Reform*, *supra* note 28, at 132 (statement of David Steel, Professor, University of Pennsylvania Law School).

[58] *Id*.

[59] *See, e.g., Too Big to Fail: The Role for Bankruptcy and Antitrust Law in Financial Regulation Reform (Part II): Hearing Before the Subcomm. on Courts and Competition Policy of the House Comm. on the Judiciary*, 111th Cong. 49 (Nov. 17, 2009) (statement of Edwin E. Smith, partner, Bingham McCutchen LLP on behalf of the National Bankruptcy Conference).

[60] *See, e.g., House Subcommittee Hearing on Regulatory Reform*, *supra* note 28, at 138 (statement of David Steel) & at 78 (statement of Harvey R. Miller).

[61] 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

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.[62] 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.[63] 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.[64] As noted above, the FDIA deals with derivatives and other financial contracts by imposing a one business-day stay on the exercise of contractual netting and close-out rights to allow for the possibility of a bulk transfer of such contracts to a bridge bank or other acquiror.

The Lehman bankruptcy provided a ready occasion for commentators to reevaluate the policies and consequences of the special treatment of financial contracts in a bankruptcy proceeding. Harvey Miller, the late dean of the bankruptcy bar and the lead bankruptcy lawyer for Lehman, testified that the exclusion from the Bankruptcy Code's automatic stay for derivatives, swaps, and other securities transactions had caused a "massive destruction" of value for Lehman.[65] In his words, the exclusions in the Bankruptcy Code exposed Lehman to the "ravages of counterparties" in respect of its securities and structured finance contracts.[66] Some experts had warned even before the

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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).

[62] *See* 11 U.S.C. §§ 362(b)(6), (7), (17) & (27); 555, 556, 559, 560 & 561.

[63] *See* 11 U.S.C. §§ 546(e), (f), (g) & (j) & 548(d)(2).

[64] *See* 11 U.S.C. §§ 362(b)(27), 546(j), 548(d)(2)(E) & 561.

[65] *House Subcommittee Hearing on Regulatory Reform*, *supra* note 28, at 72 (statement of Harvey Miller).

[66] *Id*. at 67. Some analysts have challenged the notion that the safe harbor provisions in the Bankruptcy Code caused excessive damage in the Lehman bankruptcy process. *See, e.g.*, Kimberly Anne Summe, *Lessons Learned from Lehman Bankruptcy*, *in* Ending Government Bailouts As We Know Them 77–78 (Kenneth E. Scott et al. eds., Hoover Institution Press (2010); Kimberly Anne Summe, *An Examination of Lehman Brothers' Derivatives Portfolio Postbankruptcy: Would Dodd-Frank Have Made a Difference?, in* Bankruptcy NOT Bailout: A Special Chapter 14 94 (Kenneth E. Scott & John B. Taylor eds., Hoover Institution Press 2012); *cf.* Stephen J. Lubben, *Lehman's Derivative Portfolio: a Chapter 11 Perspective*, *in* Bank Failure: Lessons From Lehman Brothers 59-60 (Dennis Faber & Niels Vermunt eds., 2017); Michael J. Fleming & Asani

Lehman bankruptcy that the special treatment for financial contracts could be a source of systemic risk in a bankruptcy proceeding of a large financial institution.[67] The irony that the special treatment of derivatives and other financial contracts in the Bankruptcy Code was originally justified on the theory that it would protect against systemic risk was not lost on these observers.[68] 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. The exclusion from the automatic stay was to permit a counterparty to liquidate its contracts with the bankrupt entity immediately and minimize the ongoing market risk in the position. The Lehman experience, however, suggested to various observers that the exclusion from the automatic stay can have the unintended effect of generating another form of systemic risk, *i.e.,* the risk of a wholesale "run" by derivative counterparties.[69]

Harvey Miller nevertheless concluded that a new resolution regime for large financial companies was not needed. Instead, he concluded that the Bankruptcy Code could be used for distressed financial companies if two changes to law were made.[70] First, the Bankruptcy Code should be amended to eliminate the safe harbor provisions for derivatives and other financial contacts. Second, the government's authority to extend loans to distressed financial companies in exigent circumstances should be expanded. The latter recommendation flowed

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Sarkar, *The Failure Resolution of Lehman Brothers*, FRBNY ECONOMIC POLICY REVIEW 175 (Dec. 2014).

[67] *See, e.g.*, Franklin R. Edwards & Edward R. Morrison, *Derivatives and the Bankruptcy Code: Why the Special Treatment?*, 22 YALE J. REG. 91, 94 (2005); Robert R. Bliss & George G. Kaufman, *Derivatives and Systemic Risk: Netting, Collateral and Closeout*, 2 J. FIN. STAB. 55, 66–67 (2006); Frank Partnoy & David A. Skeel, Jr., *The Promise and Perils of Credit Derivatives*, 75 U. CIN. L. REV. 1019 (2007).

[68] *See* Edwards & Morrison, *supra* note 67, at 93.

[69] *See id*. at 94. In the wake of the financial crisis, there were renewed calls for changes to the safe harbor provisions in the Bankruptcy Code. *See, e.g.,* Stephen J. Lubben, *Repeal the Safe Harbors*, 18 AM. BANKR. INST. L. REV 319 (2010); Kenneth Ayotte & David A. Skeel, Jr., *Bankruptcy or Bailouts*, 35 J. CORP. L. 469 (2010); Mark J. Roe, *The Derivatives Market's Payment Priorities as Financial Crisis Accelerator*, 63 STAN. L. REV. 539 (2011). As discussed further below, at the urging of the FDIC, the Federal Reserve Board, and the FSB, the International Swaps and Dealers Association, Inc. adopted a protocol to provide for an amendment to its standard form agreements to provide a temporary stay on the exercise of netting, set-off and acceleration rights in the event of the insolvency of a financial institution. This contractual "work around" is intended to mitigate the risk presented by acceleration rights in derivative contracts under resolution regimes such as the Bankruptcy Code.

[70] *House Subcommittee Hearing on Regulatory Reform*, *supra* note 28, at 68–69 (statement of Harvey Miller).

from the observation that Lehman had suffered a liquidity failure and could not be reorganized or liquidated in an orderly fashion without an infusion of significant liquidity—which in the Lehman case was not forthcoming from the private sector.

Miller also pointed to another obstacle to the orderly bankruptcy process for Lehman that could not easily be remedied—the lack of any mechanism to achieve a coordinated international restructuring of the operations of the global enterprise.[71] He observed that the "global fragmentation that has characterized the international side of Lehman's bankruptcy is an inevitability that is not adequately addressed by the proposed [Title II] resolution regime."[72] He apparently thought it unnecessary to note that it is likewise not addressed by the Bankruptcy Code regime. This is not an issue that can be addressed by changes to either the Bankruptcy Code or Title II. A new approach to resolution, such as an SPOE strategy discussed below, would be needed to deal with the prospect (or "inevitability" in the words of Harvey Miller) of international fragmentation under the Bankruptcy Code or Title II.

CONGRESSIONAL REVISIONS TO THE PROPOSAL FOR A NEW RESOLUTION REGIME

The Treasury proposal for a new resolution regime underwent significant revisions in the legislative process in the House and the Senate. Title II as finally enacted differed from the original Treasury proposal in a number of significant respects.[73] For example, Title II provides for a judicial review process for the appointment of the FDIC as receiver of a systemically important financial company (if the company does not consent to the appointment).[74] Title II also includes a set of special provisions for the treatment of a broker-dealer that is a member of the Securities Investor Protection Corporation ("SIPC").[75] It requires that the FDIC in consultation with the FSOC adopt rules to implement Title II and to the extent possible harmonize these rules with the

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[71] *Id*. at 73.

[72] *Id*. at 74.

[73] For a detailed discussion of the legislative process in the House and Senate that helped to shape the Dodd-Frank Act, see Robert G. Kaiser, Act of Congress: How America's Essential Institution Works, and How It Doesn't (2013).

[74] Dodd-Frank Act, § 202 (codified at 12 U.S.C. § 5382). In contrast, the receivership provisions in the FDIA provide only for after-the-fact judicial review of the appointment of the FDIC as receiver for an insured depository institution. 12 U.S.C. § 1821(c)(7).

[75] *Id.*, § 205 (codified at 12 U.S.C. § 5385).

insolvency laws that would otherwise apply to the financial company.[76] It also includes several specific provisions more closely aligned to provisions in the Bankruptcy Code, such as those relating to the provability of contingent claims, the power to avoid fraudulent transfers, and the exercise of set-off rights. Title II also includes a general provision that a creditor in a Title II proceeding shall in no event receive less than the amount the creditor would be entitled to receive in a Chapter 7 proceeding, the so-called "no creditor worse off than in bankruptcy" principle.[77] Title II places a cap on the amount of funding available to the financial company from the FDIC and the Treasury under Title II and provides for an *ex post* assessment of other financial companies, if necessary, to reimburse the government for the costs of assistance.[78] Title II requires a mandatory repayment plan with a specific schedule to repay any government funding assistance provided in connection with the Orderly Liquidation Authority.[79] The repayment plan must demonstrate that the proceeds to the FDIC from the liquidation of the assets of the failed financial company and from the assessments on other financial companies will be sufficient to repay principal and interest on any government funding provided as part of a Title II resolution.

Critics maintained that these changes made to Title II were merely palliatives and did not address the basic problem that Title II would be a non-transparent process and would not be administered according to a clear set of rules and settled precedents in contrast to the Bankruptcy Code.[80] These critics also maintained that the changes did not alter the fact that the federal government would be choosing which entities to resolve under Title II and which creditors to protect—with funding that would come from the federal government.[81]

GENERAL OPERATION OF THE ORDERLY LIQUIDATION AUTHORITY

Invocation of the Orderly Liquidation Authority

The Orderly Liquidation Authority in Title II can be invoked by the

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[76] *Id.*, § 209 (codified at 12 U.S.C. § 5389).

[77] *Id.,* § 210(a)(7)(B) (codified at 12 U.S.C. § 5390 (a)(7)(B)).

[78] *Id.,* § 210(n) & (o) (codified at 12 U.S.C. § 5390 (n) & (o)).

[79] *Id.,* § 210(n)(9) (codified at 12 U.S.C. § 5390 (n)(9)).

[80] *See, e.g.,* DAVID STEEL, THE NEW FINANCIAL DEAL: UNDERSTANDING THE DODD-FRANK ACT AND ITS (UNINTENDED) CONSEQUENCES 150–152 (2011).

[81] *See, e.g.,* Peter J. Wallison, *The error at the heart of the Dodd-Frank Act* (Sept. 6, 2011), http://www.aei.org/publication/the-error-at-the-heart-of-the-dodd-frank-act/.

Secretary of the Treasury and the applicable federal regulatory authorities in the event that a U.S. financial company encounters financial distress and the Secretary and the applicable federal regulatory authorities determine that resolution of the company under the Bankruptcy Code would have serious adverse effects on financial stability in the United States.[82] Upon making such a determination, the Secretary of the Treasury (after consultation with the President) is authorized to appoint the FDIC as receiver for the company. Title II is designed as an alternative to and substitute for a bankruptcy proceeding, avoiding the "disorderly" fire sale process that many observers assert attended the Lehman bankruptcy. Title II does not displace the Bankruptcy Code in general as the tool for handling the resolution of large financial institutions. However, if Title II were to be invoked with respect to a particular financial company (referred to in Title II as a "covered financial company"), it would displace the Bankruptcy Code with respect to that covered financial company.

The provisions of Title II apply exclusively to and govern all matters relating to the liquidation of a covered financial company for which the FDIC has been appointed a receiver.[83] No case or proceeding under the Bankruptcy Code may be commenced with respect to the covered financial company at any time that a Title II proceeding is pending.[84] If a case or proceeding under the Bankruptcy Code with respect to the covered financial company has been commenced prior to the appointment of the FDIC as receiver under Title II, the case or proceeding will be dismissed upon notice to the Bankruptcy Court.[85]

Financial Companies Subject to Title II

Title II can be invoked with respect to any "financial company" if the Secretary of the Treasury and the applicable federal regulatory authorities make a required systemic risk determination with respect to the company. The scope of potential application of Title II is established in the first instance by the definition of the term "financial company." The term "financial company" is defined in section 201(a)(11) of Title II to mean any company that is incorporated or organized under any provision of Federal law or the laws of any state and that is:

(i) a bank holding company as defined in section 2(a) of the Bank Holding Company Act of 1956 (the "BHCA");

(ii) a nonbank financial company supervised by the Federal Reserve

[82] Dodd-Frank Act, § 201(a)(11) & § 203 (codified at 12 U.S.C. § 5381(a)(11) & § 5383).

[83] *Id.*, § 202(c) (codified at 12 U.S.C. § 5382(c)).

[84] *Id.*, § 208(a) (codified at 12 U.S.C. § 5388(a)).

[85] *Id.*

Board pursuant to a designation under section 113 of Title I of the Dodd-Frank Act;

(iii) any company that is predominantly engaged in activities that the Federal Reserve Board has determined are financial in nature or incidental thereto for purposes of section 4(k) of the BHCA ("financial activities"); or

(iv) any subsidiary of any company described in clauses (i) through (iii) that is predominantly engaged in financial activities other than a subsidiary that is an insured depository institution or an insurance company.[86]

The definition expressly covers any bank holding company as well as any nonbank financial company supervised by the Federal Reserve Board pursuant to an FSOC designation under Title I of the Dodd-Frank Act.[87] A nonbank company engaged in financial activities that has not been designated for supervision by the Federal Reserve Board under Title I is also potentially subject to Title II under clause (iii) of the financial company definition if the company is "predominantly engaged" in financial activities and if the necessary systemic risk findings under Title II (discussed below) are made with respect to the company. A company will be deemed to be "predominantly engaged" in financial activities for purposes of Title II if the consolidated revenues of the company from financial activities constitute 85 percent or more of the total consolidated revenues of the company.[88] Clause (iii) of the definition provides the theoretical flexibility to subject a company predominantly engaged in financial activities to Title II resolution even if the company had not previously been designated by the FSOC for supervision as a systemically important financial institution under Title I.

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[86] *Id.*, § 201(a)(11) (codified at 12 U.S.C. § 5381(a)(11)). Only a "financial company" incorporated or organized under federal law or state law can be subject to Title II. The provisions of Title II do not directly extend to foreign subsidiaries or foreign affiliates of a covered financial company with one possible exception. Section 201(c)(16) provides the FDIC with certain enforcement rights with respect to contracts to which a subsidiary or affiliate of a covered financial company is a party. *See infra* text accompanying notes 151–154. The definitions of the terms "affiliate" and "subsidiary" in the Dodd-Frank Act encompass both U.S. and foreign entities. The application of section 210(c)(16) would nonetheless be limited if the contract to which a foreign subsidiary or affiliate is a party is governed by a foreign choice-of-law provision.

[87] *Id.*, § 201(a)(15) (codified at 12 U.S.C. § 5381(a)(15)). Section 113 of the Dodd-Frank Act provides that the FSOC may designate a nonbank financial company as a systemically important financial institution for supervision by the Federal Reserve Board. *Id.*, § 113(a) & (b) (codified at 12 U.S.C. § 5323(a) & (b)).

[88] *Id.*, § 201(b) (codified at 12 U.S.C. § 5381(b)).

Clause (iv) of the definition makes any subsidiary of any company described in clauses (i) through (iii) that is predominantly engaged in financial activities (other than a subsidiary that is an insured depository institution or an insurance company) a "financial company." This clause has the effect of potentially subjecting, for example, a broker-dealer subsidiary of a holding company as well as the holding company to Title II. The exclusion of an insured depository institution and an insurance company from the reach of clause (iv) is explained by the fact that alternative federal or state resolution schemes are applicable to such entities.[89] An insured depository subsidiary of a holding company will remain subject to the resolution provisions in the FDIA. An insurance company subsidiary generally will remain subject to state insolvency laws.[90] The holding company for an insured depository institution or for an insurance company, however, would potentially be subject to resolution under Title II.[91]

Systemic Risk Determination Process

A financial company will become subject to Title II (and thus a "covered financial company" within the meaning of Title II) if the Secretary of the Treasury and the applicable federal regulatory agencies invoke the authority by making a "systemic risk" determination as provided in section 203 of Title II.[92] The process for making a systemic risk determination is a critical element in the operation of the Title II regime. The legislative history indicates that the process includes "several steps intended to make the use of the authority very rare."[93] The legislative history further indicates that there should be "a strong presumption that the Bankruptcy Code will continue to apply to most failing financial institutions (other than insured depository institutions and insurance companies which have their own separate resolution processes), including large

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[89] *See* S. Rep. No. 111-176, at 58 (2010).

[90] 12 U.S.C. § 5383(e).

[91] In addition, in any case in which the FDIC is appointed as a receiver for a financial company under Title II, the FDIC may thereafter appoint itself as the receiver for any subsidiary of that company (other than an insured depository institution subsidiary, insurance company subsidiary, or SIPC-member broker-dealer subsidiary) if the FDIC and the Secretary of the Treasury make the determination that the subsidiary is in default or danger of default, that the action would mitigate serious adverse effects on financial stability, and that the action would facilitate the orderly liquidation of the covered financial company. Such a subsidiary is deemed a "covered subsidiary" for purposes of Title II. 12 U.S.C. § 5390(a)(1)(E). The FDIC would then have all the powers and rights with respect to that covered subsidiary as it would have with respect to the parent covered financial company under Title II.

[92] 12 U.S.C. § 5383.

[93] S. Rep. No. 111-176, at 58 (2010).

financial institutions."[94]

The process for making a systemic risk determination in section 203 of Title II is modeled on the systemic risk provision in section 13(c)(4)(G) of the FDIA.[95] Under section 203 the systemic risk determination process for a bank holding company is initiated by the FDIC and the Board of Governors, either on their own initiative or at the request of the Secretary of the Treasury, by making a written recommendation to the Secretary that the Secretary appoint the FDIC as receiver for the company. This recommendation must be supported by a vote of not fewer than two-thirds of the directors of the FDIC and two-thirds of the members of the Board of Governors.[96]

The written recommendation to the Secretary of the Treasury from the relevant federal agencies must contain an evaluation of a number of specified factors, including most importantly whether the company is in default or danger of default, the effect that the default would have on financial stability in the United States, and why a case under the Bankruptcy Code would not be appropriate for the company.[97] Upon receipt of such a written recommendation from the FDIC and the Board of Governors, the Secretary of the Treasury in consultation with the President must in turn make two basic determinations:

(i) that the financial company is in default or in danger of default;[98] and

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[94] *Id.*

[95] *See* 12 U.S.C. § 1823(c)(4)(G). The systemic risk provision in the FDIA is discussed in Part IV of this article.

[96] The systemic risk determination process is slightly modified if a broker-dealer or insurance company is involved. In the case of a broker-dealer or a holding company in which the largest U.S. subsidiary is a broker-dealer, the SEC (rather than the FDIC) and the Board of Governors would make the recommendation, on a two-thirds vote in the case of each agency, in consultation with the FDIC. In the case of an insurance company or a holding company in which the largest U.S. subsidiary is an insurance company, the Director of the Federal Insurance Office (an office in the Treasury established pursuant to Title V of the Dodd-Frank Act) and the Board of Governors would make the recommendation on the vote of two-thirds of the members of the Board of Governors, in consultation with the FDIC. 12 U.S.C. § 5383(a)(1)(A)–(C).

[97] Other factors that must be evaluated in the recommendation include the likelihood of a private sector alternative to prevent default by the company, the nature of the actions that would be taken with respect to the financial company under Title II, and the effects on creditors, counterparties, and shareholders of the company and other market participants. 12 U.S.C. § 5383(a)(2).

[98] For purposes of Title II, a financial company would be considered to be in default or in danger of default if:

(i) a case has been, or likely will promptly be, commenced with respect to the financial company under the Bankruptcy Code;

(ii) that the failure of the financial company and its resolution under otherwise applicable Federal or State law would have serious adverse effects on financial stability in the United States.[99]

The latter of these two determinations is the linchpin to the use of Title II.

Judicial Review

Upon making a determination under section 203, the Secretary of the Treasury must notify the covered financial company.[100] This notification to the covered financial company theoretically triggers a binary process. If the board of directors of the company acquiesces to the appointment of the FDIC as receiver, the Secretary will thereupon appoint the FDIC as receiver.[101] Title II expressly exculpates the members of a board of directors from liability to shareholders or creditors for acquiescing in good faith to the appointment of the FDIC as a receiver.[102] This provision parallels a provision in the FDIA that protects directors of an insured depository institution from liability for

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(ii) the financial company has incurred, or is likely to incur, losses that will deplete all or substantially all of its capital, and there is no reasonable prospect for the company to avoid such depletion;

(iii) the assets of the financial company are, or are likely to be, less than its obligations to creditors and others; or

(iv) the financial company is, or is likely to be, unable to pay its obligations (other than those subject to a bona fide dispute) in the normal course of business.

12 U.S.C. § 5383(c)(4).

[99] In addition, the Secretary of the Treasury must make the determination that:

(i) no viable private sector alternative is available to prevent the default of the financial company;

(ii) any effect on the claims or interests of creditors, counterparties, and shareholders of the financial company and other market participants as a result of actions to be taken under Title II is appropriate, given the impact that any action taken under Title II would have on financial stability in the United States;

(iii) any action under section 204 (which includes authority to provide federal funding to the receivership) would avoid or mitigate such adverse effects, taking into consideration the effectiveness of the action in mitigating potential adverse effects on the financial system, the cost to the general fund of the Treasury, and the potential to increase excessive risk taking on the part of creditors, counterparties, and shareholders in the financial company;

(iv) a Federal regulatory agency has ordered the financial company to convert all of its convertible debt instruments that are subject to the regulatory order; and

(v) the company satisfies the definition of a financial company under section 201.

12 U.S.C. § 5383(b).

[100] 12 U.S.C. § 5383(c)(1)(C).

[101] 12 U.S.C. § 5382(a)(1)(A)(i).

[102] 12 U.S.C. § 5387.

acquiescing to the appointment of the FDIC as conservator or receiver for the institution.[103] This provision is intended to promote acquiescence by the board of directors to the appointment of the FDIC as receiver, thus avoiding the need for a court review discussed below.

If the board of directors of the company does not acquiesce, the Secretary of the Treasury must petition the U.S. District Court for the District of Columbia (the "District Court") for an order authorizing the Secretary to appoint the FDIC as receiver.[104] This petition is filed under seal and the ensuing judicial process is to be conducted on a strictly confidential basis.[105] The District Court will provide notice and an opportunity for a hearing to the covered financial company, but with significant constraints on both the timing and scope of the judicial review process. The District Court review of the petition is limited to two issues: the Secretary's determination that the company is "in default or in danger of default" and the Secretary's determination that the company satisfies the definition of "financial company."[106] The District Court review does not extend to the fundamental determination that the resolution of the covered financial company under the Bankruptcy Code would have serious adverse effects on financial stability in the U.S. As to the two determinations that are subject to judicial review, the standard of review is an arbitrary and capricious standard.[107]

If the District Court upholds the Secretary's determination on these two issues, the District Court will issue an order immediately authorizing the Secretary to appoint the FDIC as receiver. Under the provisions of Title II, the District Court has 24 hours from the time of receipt of the petition to act upon the petition.[108] If the District Court does not act on the petition within 24 hours, the petition is deemed granted by operation of law and the resolution process under Title II begins automatically without further notice or action.[109] Title II provides for a limited right to appeal from the decision of the District

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[103] 12 U.S.C. § 1821(c)(12).

[104] 12 U.S.C. § 5382(a)(1)(A)(i).

[105] 12 U.S.C. § 5382(a)(1)(A)(ii) & (iii). Criminal sanctions apply to any person who recklessly discloses the determination of the Secretary, the petition filed by the Secretary with the District Court, or the pendency of the court proceedings. 12 U.S.C. § 5382(a)(1)(C).

[106] 12 U.S.C. § 5382(a)(1)(A)(iii).

[107] 12 U.S.C. § 5382(a)(1)(A)(iv).

[108] 12 U.S.C. § 5382(a)(1)(A)(v).

[109] Section 202(b) of the Dodd-Frank Act directs the District Court to establish rules and procedures to govern the review process, including rules and procedures to ensure that the 24-hour deadline is met. 12 U.S.C. § 5382(b). The District Court on January 19, 2011 adopted

Court. The Secretary of the Treasury or the covered financial company may appeal the decision of the District Court to the Court of Appeals for the District of Columbia Circuit not later than 30 days after the decision of the District Court has been rendered (or deemed rendered).[110] The Court of Appeals is to consider the appeal on an expedited basis. The scope of review is limited to the two determinations reviewed by the District Court under an arbitrary and capricious standard.[111] Moreover, there can be no stay of the District Court decision pending any appeal.[112] Because the FDIC as receiver will almost certainly take immediate action under the Orderly Liquidation Authority, including the transfer of certain assets and liabilities to a bridge financial company or possibly to other third parties, the absence of a stay may mean that there would be no effective remedy even if the Court of Appeals were to overturn the decision of the District Court approving a petition to appoint the FDIC as receiver. Title II also provides for the possibility of discretionary review by the Supreme Court under a writ of certiorari. The scope of the Supreme Court discretionary review is subject to the same limitations as the review by the Court of Appeals.[113]

Bankruptcy practitioners and academicians have criticized the pre-seizure judicial hearing in Title II as "an empty formality" and the tightly circumscribed appellate review process as one that "invites constitutional due process challenge."[114] The operative assumption may be that the directors of the failing institution will embrace the exculpatory provision in Title II in the face of the otherwise dire options available to them.

Funding for Title II

Perhaps the most important element of Title II and certainly the element that

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Local Civil Rule 85 to implement the provisions of section 202 of the Dodd-Frank Act. D.D.C.R. L.R. 85 (2011).

[110] 12 U.S.C. § 5382(a)(2)(A)(i).

[111] 12 U.S.C. § 5832(a)(2)(A)(iv).

[112] 12 U.S.C. § 5382(a)(1)(B).

[113] 12 U.S.C. § 5382(a)(2)(b)(iv).

[114] Kenneth E. Scott, *The Context for Bankruptcy Resolutions, in* MAKING FAILURE FEASIBLE: HOW BANKRUPTCY REFORM CAN END "TOO BIG TO FAIL" 1, 9 (Kenneth E. Scott et al. eds., Hoover Institution Press 2015); *see also* Thomas W. Merrill & Margaret L. Merrill, *Dodd-Frank Orderly Liquidation Authority: Too Big for the Constitution?*, 165 U. PA. L. REV. 165 (2014) ("Title II unfortunately raises a number of serious constitutional questions"); DAVID SKEEL, THE NEW FINANCIAL DEAL: UNDERSTANDING THE DODD-FRANK ACT AND ITS (UNINTENDED) CONSEQUENCES 139 (2011) ("the restrictions on challenge to the resolution rules [relating to the appointment of the FDIC as receiver] are so severe as to raise serious Constitutional doubts") (footnote omitted).

most clearly distinguishes Title II from the Bankruptcy Code is the availability of government funding to facilitate the resolution of the covered financial company under Title II. There are several provisions in Title II that provide the authority and mechanics for this funding. Section 204(d) provides that upon appointment as a receiver, the FDIC in its discretion may make available to the receivership, subject to certain restrictions discussed below, funds for the orderly liquidation of the covered financial company.[115] Any funds provided by the FDIC will be entitled to a priority for payment in the receivership.[116] The FDIC may use the funds to make loans to the covered financial company or any covered subsidiary, purchase or guarantee assets of the covered financial company or any covered subsidiary, assume or guarantee liabilities of the covered financial company or any covered subsidiary, take a lien on any or all assets of the covered financial company or any covered subsidiary, sell or transfer assets or liabilities of the covered financial company or any covered subsidiary, or make "additional" payments to certain creditors (as described further below).[117] This broad authority is designed to provide the FDIC with the ability to fund the systemically important functions of a failed institution over an orderly wind-down period, to fund a bridge financial company, to facilitate the transfer of assets or liabilities to a third-party financial company, or to pay out claims in the receivership without the need for a fire-sale of assets in the receivership.

The source of the funds that the FDIC would use to implement this funding authority is provided in Section 210(n)(5).[118] This section authorizes the FDIC upon its appointment as a receiver of a covered financial company to issue obligations to the Secretary of the Treasury. Under Section 210(n)(6) the ability of the FDIC as receiver to borrow from the Treasury is limited to the aggregate of (i) an amount equal to 10 percent of the total consolidated assets of the covered financial company (based on the company's most recent financial statement) during the initial 30-day period following the date of the FDIC's appointment as receiver and (ii) an amount equal to 90 percent of the fair value of the total consolidated assets of the covered financial company after the initial 30-day period following the date of the FDIC's appointment as receiver.[119] The ability of the FDIC to borrow from the Treasury after the initial 30-day borrowing period is subject to another significant limitation. Under Section

[115] 12 U.S.C. 5384(d).

[116] *Id.*

[117] *Id.*

[118] 12 U.S.C. § 5390(n)(5).

[119] 12 U.S.C. § 5390(n)(6).

210(n)(9) no amount may be borrowed after the initial 30-day borrowing period unless the FDIC and the Secretary of the Treasury have an agreement in place that provides a specific plan and schedule to repay the borrowing and demonstrates that "income" to the FDIC from the liquidated assets of the covered financial companies and assessments against financial companies (as discussed further below) will be sufficient to amortize the outstanding balance of the borrowing plus interest within 60 months after the date of the borrowing.[120]

Title II creates a separate fund in the Treasury Department, the Orderly Liquidation Fund, to support and carry out the responsibilities relating to the Orderly Liquidation Authority.[121] The Orderly Liquidation Fund will cover the costs incurred by the FDIC under Title II, including both FDIC administrative expenses and the repayment of all amounts borrowed by the FDIC from the Treasury in connection with the resolution of a covered financial company. The Orderly Liquidation Fund will be funded in the first instance by borrowings from the Treasury, but ultimately by *ex post* assessments on certain creditors who receive "additional" payments in an orderly liquidation proceeding and, if necessary, on certain other large financial companies. The Treasury funding is to be repaid on a priority basis from the proceeds of the receivership and, if necessary, from assessments on private sector entities.

The assessment mechanism in Title II encompasses two basic assessment processes. The first assessment process is on claimants that received 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).[122] If these assessments are insufficient to repay the Treasury, 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.[123] The FDIC is directed to use a risk matrix to impose assessments on a graduated basis with financial companies having greater assets and presenting greater risks being assessed at a higher rate.[124] The purpose of this assessment process is to assure

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[120] 12 U.S.C. § 5390(n)(9)(B). The word "income" should probably be construed to mean "proceeds."

[121] 12 U.S.C. § 5390(n)(1).

[122] 12 U.S.C. § 5390(o)(1)(D)(i).

[123] 12 U.S.C. § 5390(o)(1)(D)(ii).

[124] 12 U.S.C. § 5390(o)(4).

that the private sector and not the taxpayers ultimately pay the costs of resolving any systemically important financial institution. The opponents of Title II object as a matter of principle to the availability of Treasury funding in a Title II proceeding. The opponents also argue that the assessment and repayment processes in Title II are not adequate to ensure that the government will be repaid for all the costs it might incur in resolving a large financial institution.

Special Process and Powers Under Title II

Title II provides for a receivership process for a covered financial company that is based in large part on the receivership provisions in the FDIA for a failed banking institution. Paralleling the receivership provisions of the FDIA, Title II provides the FDIC as receiver for a covered financial company with a range of special powers that are not available under the Bankruptcy Code. These powers were thought by the supporters of Title II to make Title II a better alternative than the Bankruptcy Code for resolving a systemically important financial institution.

In a report issued by the FDIC in April 2011, the FDIC emphasized this point by discussing hypothetically how Lehman could have been resolved more successfully in a Title II process rather than in a Bankruptcy Code process.[125] The FDIC concluded that a Title II proceeding would have been "vastly" superior to the Bankruptcy Code process for Lehman both from the perspective of financial stability and from the perspective of Lehman's unsecured creditors who the FDIC projected would have received much higher recoveries in a Title II proceeding.[126] The FDIC said that there were various features in Title II that would be more advantageous for handling the resolution of a systemically important financial institution like Lehman than the provisions in the Bankruptcy Code. One feature was the speed that Title II would provide because it is an administrative rather than a judicial process. Title II is intended to replicate the expedited process with which the FDIC handles a failed banking institution under the FDIA.[127] The FDIC is appointed as a receiver

[125] *See* The Orderly Liquidation of Lehman Brothers Holdings Inc. Under the Dodd-Frank Act, http:/www.fdic.gov/bank/analytical/quarterly/2011_vol5_2/lehman.pdf [hereinafter Lehman Report].

[126] *See* Press Release, FDIC, FDIC Report Examines How An Orderly Resolution of Lehman Brothers Could Have Been Structured Under the Dodd-Frank Act (Apr. 18, 2011), http://www.fdic.gov/news/news/press/2011/pr11076.html.

[127] As discussed above, Title II does provide for the possibility of judicial review of the administrative decision to appoint the FDIC as receiver for a covered financial company. The judicial review, however, is severely circumscribed in terms of time and scope. By comparison, the FDIA provides only for after-the-fact judicial review of an administrative decision to appoint

under the FDIA by administrative action and typically transfers most of the assets and liabilities of a failed bank to an acquirer in the course of a single day or at worst in the course of a "resolution weekend."[128]

In its Lehman report, the FDIC emphasized the specific powers available to it under Title II that are not available in a bankruptcy case and that would greatly facilitate the resolution of a financial firm like Lehman. These were the same powers that the FDIC had cited in its original testimony in support of enactment of Title II. The FDIC cited one power under Title II that would be particularly important in resolving a systemically important financial company, namely, the power to create a bridge financial company. Title II authorizes the FDIC as receiver to create one or more bridge financial companies to which various assets and liabilities of the failed financial company can be transferred.[129] The immediate transfer of these assets and liabilities to a bridge financial company is designed to preserve the going-concern value of the failed company's assets and business lines. As discussed further below, the use of a bridge financial company coupled with an SPOE strategy has emerged as perhaps the most important development in the post-financial crisis resolution planning process.

The transfer of assets and liabilities to a bridge financial company is facilitated by other provisions in Title II that do not have an analogue in the Bankruptcy Code. Similar to the receivership provisions in the FDIA, Title II provides the FDIC as receiver for a failed financial company with the power to transfer assets and liabilities to a bridge financial company without any court approval and without any other party's consent.[130] Also similar to the provisions in the FDIA, Title II provides that a counterparty on a qualified financial contract ("QFC") is stayed for one business day from exercising any termination or netting rights arising solely from the appointment of the FDIC as receiver for the failed company or otherwise based on the financial condition of the company.[131] This one-business day stay would facilitate the transfer of a

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the FDIC as a receiver for an insured depository institution. 12 U.S.C. § 1821(c)(7).

[128] The procedures used by the FDIC to handle a failed bank are discussed in Part IV of the article.

[129] 12 U.S.C. § 5390(h)(1).

[130] 12 U.S.C. § 5390(h)(2)(E).

[131] 12 U.S.C. § 5390(c)(10)(B). Title II includes a further enhancement upon the QFC temporary stay provision in the FDIA. Title II includes an additional provision dealing with contracts of subsidiaries or affiliates of the covered financial company that are guaranteed or supported by or "linked" to the covered financial company. 12 U.S.C. § 5390(c)(16). *See infra* text accompanying notes 151–154.

QFC book of business over a "resolution" weekend to a bridge financial company or theoretically even to a third-party acquirer if such an acquirer could be found.

Another critical advantage under Title II is the availability of government funding to preserve the continuity of the systemically important operations of the failed company. The availability of government funding is an important difference from the Bankruptcy Code option. Government funding is available immediately upon the appointment of the FDIC as a receiver under Title II.[132] As noted above, the Dodd-Frank Act provides that the FDIC may borrow funds from the Treasury to make loans to, or guarantee obligations of, a bridge financial company, to provide liquidity to the bridge financial company and to facilitate market access for the bridge financial company.[133] In the case of the failure of a large financial company, the FDIC would want to take immediate steps to preserve the value of the assets of the failed company and to minimize the cascading consequences of the failure on the financial system. The availability of funding from a secure source will be critical to the immediate execution of any such plan. The funding may be needed for the receivership proceeding itself, for any bridge financial company created by the FDIC, or for any third-party acquirer that is prepared to assume parts of the operations of the failed financial company.

The third significant advantage of the Title II regime is that it lends itself more readily to advance planning than a bankruptcy process. In the Lehman case, the lack of advance planning is thought to have contributed significantly to the diminution in value of the bankruptcy estate.[134] As noted above, Title I of the Dodd-Frank Act requires advance resolution planning under the Bankruptcy Code by bank holding companies with consolidated assets of $50 billion or more and by nonbank companies designated as systemically important by the FSOC under Title I.[135] Planning under Title I will now occur in advance of events that might theoretically precipitate a bankruptcy filing and

[132] 12 U.S.C. § 5384(d).

[133] *See* Lehman Report, *supra* note 125, at 8–9. As discussed above, funding available to the FDIC under section 204(d) is subject to certain conditions and limitations provided in section 210(n)(6) and (9) of the Dodd-Frank Act.

[134] *See, e.g.,* Jeffrey McCracken, *Lehman's Chaotic Bankruptcy Filing Destroyed Billions in Value,* WALL ST. J., Dec. 29, 2008, at A10 (discussing how the lack of bankruptcy planning affected the Lehman bankruptcy). *See also* Trustee's Preliminary Investigation Report and Recommendations, In re Lehman Brothers Inc., (U.S. Bankr. S.D.N.Y. Aug. 25, 2010) (recommending as a general regulatory matter that broker-dealers be required to maintain up-to-date liquidation plans).

[135] 12 U.S.C. § 5365(d).

without the specific market consequences that would otherwise attach to a company engaging in bankruptcy planning.[136] The Title I resolution plan requirement provides the cover for systemically important financial companies and the relevant regulators to engage in detailed analyses of recovery and resolution plans for individual institutions as part of the regular supervisory process. While the advance planning requirement under Title I is specifically directed to achieving an orderly resolution under the Bankruptcy Code, the details of the Title I resolution plan would provide the FDIC with critical information and insights into the challenges of achieving an orderly resolution under Title II as well as under the Bankruptcy Code. As will be discussed in Part VI of this article, the resolution planning requirement in Title I has fundamentally changed the internal planning and business management processes at the largest bank holding companies and significantly improved the prospects for a more orderly resolution of such companies under the Bankruptcy Code or Title II.

The FDIC's hypothetical rendering of how it would have resolved Lehman under Title II nonetheless met with substantial skepticism from private observers.[137] These observers questioned various assumptions underlying the FDIC analysis, including the assumption that the FDIC could "conduct due diligence, identify potential acquirers and troubled assets, determine a transaction structure and conduct sealed bidding—all before Lehman ever failed and was put into receivership under Title II."[138] This extrapolation from the FDIC

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[136] *See, e.g., Examining the Causes of the Current Financial and Economic Crisis of the United States and of the Collapse of Lehman Brothers: Hearing Before the Financial Crisis Inquiry Commission,* 12 (Sept. 1, 2010) (statement of Harvey R. Miller, lead bankruptcy counsel for Lehman):

> The Lehman bankruptcy was unplanned. As a financial institution, Lehman's viability depended to a large extent on the confidence of the financial markets and the public. Accordingly, the disclosure of bankruptcy consideration and planning would have been disastrous to the continued operations of such a financial institution.

[137] *See, e.g.,* Joshua Mitts, *Systemic Risk and Managerial Incentives in the Dodd-Frank Orderly Liquidation Authority,* J. FIN. REG. 51, 81 (2015) (noting that there were a "host of problems with the FDIC analysis"); Stephen J. Lubben, *Resolution, Orderly and Otherwise: B of A in OLA,* 81 U. CIN. L. REV, 485, 485 (2013) (noting that the FDIC hypothetical "amused many by its naiveté"); Thomas H. Jackson & David A. Skeel, Jr., *Dynamic Resolution of Large Financial Institutions,* 2 HARV. BUS. L. REV. 435, 436 (2012) (noting that critics "scoffed" at the claim in the FDIC hypothetical that a Title II process could have provided a recovery to Lehman creditors of 97 cents on the dollar); William F. Kroener, *Comment on Orderly Liquidation under Title II of Dodd-Frank and Chapter 14, in* BANKRUPTCY, NOT BAILOUT: A SPECIAL CHAPTER 14 78–83 (Kenneth E. Scott & John B. Taylor eds., Hoover Institution Press 2012).

[138] Press Release, *supra* note 126, at 3.

historical experience resolving small and medium sized banks seemed misplaced when dealing with an institution as large and complex as Lehman. The FDIC's discussion of the sales options for Lehman's operations, cast in the traditional FDIC terminology of a "whole company purchase and assumption with partial loss share" or a "modified purchase and assumption without loss share," likewise appeared firmly rooted in past FDIC experience and failed to acknowledge the complexity of the situation that the FDIC would invariably face in a future Title II proceeding. Many observers concluded that in implementing the Title II authority, the FDIC would have to expand its thinking in fundamental ways to address the challenges that would be presented by the failure of a large complex financial institution.[139]

RULEMAKING UNDER TITLE II

At the same time that the FDIC was analyzing how Title II might hypothetically have been used to resolve a large financial company like Lehman, the FDIC was also engaged in a rulemaking process to provide greater clarity around certain of the key aspects of a Title II resolution process. In an initial rulemaking, the FDIC addressed several threshold issues under Title II, including one that had been the source of much controversy during the legislative process.[140] This issue related to the authority contained in Title II for the FDIC as receiver to make "additional payments" to certain creditors of a covered financial company.[141] Under this authority, the FDIC is authorized to pay certain creditors more than other "similarly situated" creditors (*i.e.*, creditors otherwise entitled to the same priority under the priority provision in Title II), if the FDIC decides such payments are necessary to maximize the value of the assets of the company, to minimize the amount of the loss on the sale of assets of the company, or to continue operations essential to the implementation of the receivership or any bridge financial company.[142] This authority under Title II is in contrast to the absolute priority rule under the Bankruptcy Code. Critics of Title II cited the authority to make such additional payments as a significant flaw in Title II.[143] The authority appeared to permit

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[139] *See, e.g.,* Kroener, *supra* note 137.

[140] *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. 64,173 (Oct. 19, 2010).

[141] The provisions relating to "additional payments" are codified at 12 U.S.C. § 5390(b)(4), (d)(4)&(h)(5)(E).

[142] 12 U.S.C. § 5390(b)(4).

[143] *See, e.g.*, Statement of Republican Policy, *supra* note 8.

the "bailout" of certain creditors. The source of funding for these additional payments would be the FDIC's authority under Title II to borrow from the Treasury, enhancing in the mind of the critics the perception that these additional payments would amount to a government bailout of certain creditors.

The FDIC sought to defuse this criticism by circumscribing in its new rule some of the authority otherwise potentially available to it under the statutory provisions relating to "additional payments." In the preamble to the proposed rule, the FDIC explained its intent:

> To emphasize that all unsecured creditors should expect to absorb losses along with other creditors, the Proposed Rule clarifies the narrow circumstances under which creditors could receive any additional payments or credit amounts under Sections 210(b)(4), (d)(4), or (h)(5)(E).[144]

The proposed rule provided that holders of unsecured senior debt with a term of more than 360 days would not be eligible to receive "additional payments."[145] In response to comments filed on the proposed rule, the FDIC said at the time that it finalized the rule that there appeared to be a misapprehension among the commenters that the language in the proposed rule made it more likely that short-term debt holders would receive "additional payments."[146] In response to those commenters, the FDIC said that short-term debt holders (including holders of commercial paper and derivatives) are "highly unlikely to meet the criteria set forth in the statute for permitting payment of additional amounts" and that "additional payments" to any creditor would be "very rare."[147] It further stated that "[i]n virtually all cases, creditors with shorter-term claims on the covered financial company will receive the same pro rata share of their claim that is being provided to the long-term debt holders."[148] The FDIC then provided a few examples of the types of creditors who might be afforded "additional payments." These included the providers of utility contract and

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[144] 75 Fed. Reg. at 64,175.

[145] 75 Fed. Reg. at 64,181 (proposed § 380.2). In explaining the approach in the proposed rule, the FDIC said that the proposed rule focused on unsecured senior debt with a term of more than 360 days "to distinguish bondholders from commercial lenders or other providers of financing who have made lines of credit available to the covered financial company that are essential for its continued operation and orderly liquidation." *Id*. at 64,177.

[146] Interim Final Rule, Orderly Liquidation Authority Provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act, 76 Fed. Reg. 4,207, 4,212 (Jan. 25, 2011).

[147] *Id.*

[148] *Id.*

other service contracts, such as payment processing services, that would be essential to the operation of a bridge financial company.[149] The provision in the rule intended by the FDIC to circumscribe the authority otherwise available to it to make "additional payments" has not satisfied critics of Title II. These critics continue to assert that the "additional payments" provision lends itself to favoritism for certain creditors and to a government bailout of those creditors.[150]

In its rulemakings under Title II, the FDIC addressed other important aspects of the Orderly Liquidation Authority, such as the special provision in section 210(c)(16) that authorizes the FDIC as receiver to enforce contracts of subsidiaries or affiliates of a covered financial company. Section 210(c)(16) provides that the FDIC as receiver has the power to enforce contracts of subsidiaries or affiliates of the covered financial company, the obligations of which are guaranteed, supported by or "linked" to the covered financial company, notwithstanding any contractual right to terminate, liquidate or accelerate such contracts based on the insolvency or financial condition of the covered financial company, (i) if the guaranty or other support and related assets and liabilities are transferred to and assumed by a bridge financial company or other third party within the same period of time covered by the stay on the close-out rights on the QFCs of the covered financial company, or (ii) if the FDIC as receiver otherwise provides adequate protection with respect to the obligations.[151] This provision is designed to address the concern with cross-default and acceleration rights that would otherwise permit the close-out and liquidation of these contracts. The exercise of such cross-default rights against subsidiaries and affiliates of the covered financial company is perceived to be disruptive to an orderly resolution process of the covered financial company and to present potential systemic risk through a fire sale of collateral by counterparties of the subsidiaries and affiliates. This additional provision in Title II is an important expansion of the temporary QFC stay provision in the FDIA. It is significantly broader than the temporary QFC stay provision in the FDIA because it extends generally to contracts of subsidiaries and affiliates of the covered financial company and not just the QFCs of the covered financial company itself.

In fashioning its rule, the FDIC adopted a broad reading of section 210(c)(16).[152] The FDIC noted that significant subsidiaries of a covered

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[149] *Id.* at 4,211.

[150] *See, e.g.,* 2014 HOUSE REPORT, *supra* note 8, at 77–78.

[151] 12 U.S.C. § 5390(c)(16).

[152] *See* Enforcement of Subsidiary and Affiliate Contracts by the FDIC as Receiver of a Covered Financial Company, 77 Fed. Reg. 63,205 (Oct. 16, 2012).

financial company might be essential to core business lines or to the conduct of critical operations of the covered financial company.[153] It further observed that an orderly liquidation of the covered financial company might best be accomplished "by establishing a single receivership of the parent holding company and transferring valuable operations and assets to a solvent bridge financial company, including the stock or other equity interests of some or all of the company's various subsidiaries."[154] This provision in Title II in effect anticipated an SPOE strategy.

Other provisions in the rules adopted by the FDIC under Title II paralleled the practices developed by the FDIC in its resolution of insured banks under the FDIA. These practices have generally proved adequate for handling the failure of small or medium sized banks. Many observers, however, questioned whether FDIC practices would be adequate to address the significantly greater challenges presented by the failure of a very large complex financial institution.[155] Another criticism made of Title II by several prominent commentators was that it mandated a liquidation of the failed entity in contrast to the Bankruptcy Code, which provides the option for preserving the going-concern value of the company through a reorganization.[156] These commentators characterized a pure liquidation approach as punitive and misguided.[157] The FDIC was quietly at work on a strategy that would respond to the criticism that Title II requires a pure liquidation approach.

THE DEVELOPMENT OF THE SPOE STRATEGY

Recapitalization as an Option

The FDIC received many comment letters as part of its rulemaking processes under Title II. Most of these comment letters were directed to the technical requirements of Title II and its liquidation and claims procedures. One comment letter, however, stood out for the strategic importance of the approach that it proposed. The letter from the Securities Industry and Financial Markets Association ("SIFMA") and The Clearing House Association ("TCH"), trade groups representing the financial services industry, proposed a recapitalization

[153] *Id.* at 63,206.

[154] *Id.*

[155] *See, e.g.,* Skeel, *supra* note 80, at 118–127.

[156] *See id.* at 148–152 and Wallison, *supra* note 81, at 8–9. As the basis for their criticism, these critics cited section 214(a) of Title II, which provides that "[a]ll financial companies put into receivership under this title shall be liquidated." 12 U.S.C. § 5394(a).

[157] *See* Skeel, *supra* note 80, at 148–149, and Wallison, *supra* note 81, at 8–9.

approach as an alternative to a pure liquidation approach that many observers assumed Title II required.[158] The comment letter suggested that a recapitalization approach would be more effective during a financial crisis than a liquidation of assets or the sale of a failed firm to a third-party pursuant to a traditional purchase and assumption agreement.[159] The comment letter also sought to dispel the "misperception" that "Title II requires the value-destroying liquidation of financial assets at the bottom of the market during a financial crisis."[160] As a corollary, the comment letter suggested that a recapitalization approach would reduce concern that during a financial crisis there might not be any institution confident enough to acquire a large failed institution through a traditional purchase and assumption agreement.[161] As the comment letter further noted, a recapitalization approach would also address the concern that the "going-concern surplus" of the failed institution—the difference between the going-concern value and the liquidation value of the institution—might be transferred at a discount to a third party rather than being preserved for the benefit of the creditors of the failed institution.[162]

At the most basic level, a recapitalization approach would have the FDIC as receiver create a bridge financial company, transfer the systemically important and viable parts of the closed institution's business to the bridge financial company, exchange the debt claims of creditors against the closed institution for equity in the bridge entity, and liquidate the remaining assets and liabilities of the closed institution left behind in the receivership. The FDIC would as quickly as feasible turn the bridge financial company itself over to the closed institution's creditors by using equity in the bridge company in satisfaction of the creditors' claims against the closed institution. As the comment letter noted,

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[158] *See* Letter from the Securities Industry and Financial Markets Association and The Clearing House Association to the Federal Deposit Insurance Corporation, May 23, 2011, *available at* http://www.fdic.gov/regulations/laws/federal/2011/ 11c16Ad73.pdf. [hereinafter the SIFMA Letter]; *see also* Randall D. Guynn, *Are Bailouts Inevitable?*, 29 YALE J. REG. 121 (2012) (similarly proposing a recapitalization approach for use in Title II).

[159] SIFMA Letter, *supra* note 158, at 2.

[160] *Id.* at 3.

[161] *Id.* A recapitalization approach would also reduce the concern that even if there were a large enough institution willing to acquire a large failed institution, the acquiring institution would necessarily become larger and perhaps more complex, thereby itself contributing to greater systemic risk. *Id.* The alternative prospect of decomposing the failed institution via separate sales of its various business units or lines would present significant timing and execution issues.

[162] *Id.* Some of the risks in the fire sale of assets in a bankruptcy or liquidation proceeding are suggested in the "hurried, at times harried" sale of assets of the Lehman bankruptcy estate to Barclays Capital Inc. in 2008. *See In re* Lehman Brothers Holdings Inc., 445 B.R. 143, 148 & 156 (Bankr. S.D.N.Y. 2011), *aff'd in part, rev'd in part*, 478 B.R. 570 (S.D.N.Y. 2012).

the transfer of assets and liabilities to the bridge financial company would likely have to occur within a very compressed timeframe (such as over a "resolution weekend"), but the conversion of the claims against the failed institution into equity interests in the bridge financial company could take place over a more extended period necessary for claims processing and valuation.

The comment letter was notable for promoting the concept of recapitalization not simply as an alternative to, but more importantly as a better alternative than the pure liquidation of a large financial company. Nonetheless, it was clear from the comment letter that the recapitalization proposal would require further refinement in several important respects. As the comment letter itself noted, the recapitalization proposal did not address all of the potential issues that might arise out of a cross-border resolution of a global systemically important financial institution.[163] For example, the comment letter did not resolve the knotty issue of which categories of general creditor claims would be transferred to the bridge financial company (with the prospect of being paid in full) and which categories of general creditor claims would be left in the receivership (with the prospect of no recovery or a substantially reduced recovery).[164] Thus, important aspects of the recapitalization approach would still have to be determined.

Refining the Recapitalization Approach

As the FDIC staff finalized their initial rulemakings under Title II, they continued to analyze the recapitalization approach recommended in the SIFMA comment letter. In a briefing provided to the FDIC's Systemic Resolution Advisory Committee in January 2012, the FDIC staff provided the first public indication of its thinking on two strategies that might be used under Title II: (i) a single receivership-parent company entry; and (ii) multiple receiverships-

[163] *Id.* at 4.

[164] The comment letter discussed the process of determining which claims would be transferred to the bridge financial company in general terms:

> We would anticipate that only certain classes of debt would be exchanged for equity and that shareholder claims would remain behind in the receivership. We can envision circumstances where all subordinated debt and even a portion of the general creditor claims would be exchanged for equity in the bridge, with the rest of the general creditor claims, and secured claims, being transferred to the bridge, depending upon an assessment of the value of the assets transferred to the bridge bank and the assets left behind in the receivership. We believe that litigation claims should be left behind in the failed bank or non-bank SIFI, and not transferred to a bridge, but this issue should probably be studied further in light of the goals of minimizing moral hazard and avoiding or mitigating severe financial instability during a financial crisis.

Id. at A-7 n.7.

parent and subsidiaries entry.[165] These two strategies have subsequently come to be styled as a single-point-of-entry (SPOE) strategy and a multiple-point-of-entry (MPOE) strategy. The single receivership-parent company entry strategy relied on a recapitalization approach largely as proposed in the SIFMA comment letter. The SPOE strategy has come to be recognized by many observers as a significant conceptual breakthrough in resolution planning.

The SPOE strategy in its most "stylized" version envisions that a legal resolution would occur only at the top-tier holding company, avoiding to the greatest extent possible the need for the initiation of resolution proceedings at the level of the operating subsidiaries. This approach minimizes the complexities and conflicts that would invariably arise if multiple resolution proceedings in home and host jurisdictions had to be commenced at the level of the operating subsidiaries. It also mitigates the risk of "runs" by depositors and other short-term creditors of the operating companies.[166] This approach envisions that losses that have been incurred at the level of the operating subsidiaries would in effect be "pushed up" to the top-tier holding company (as discussed below).

In this resolution process, the first step would be for the FDIC after its appointment as receiver for the top-tier company to transfer virtually all the assets of the top-tier company, principally the shares of its operating subsidiaries (and loans previously made to its operating subsidiaries), to a new bridge financial company. As noted above, under Title II, this transfer can be effected by the FDIC as receiver without any court approval or any customer or counterparty consent, facilitating a resolution over a "resolution weekend." Virtually all liabilities of the top-tier company, consisting principally of subordinated debt and long-term senior debt specifically intended to be "loss absorbing," would be left behind in the receivership proceeding under Title II. Critical vendor claims and guarantees related to the operating subsidiaries would also be transferred to the bridge company. The direct effect of these actions would be to create on paper a strongly capitalized bridge company because it is envisioned that many more assets than liabilities would be

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[165] *See* FDIC, Office of Complex Financial Institutions, *Dodd-Frank Act Title II: Resolution Strategy Overview* (Jan. 25, 2012), *available at* http://www.fdic.gov/about/srac/2012/2012-01-25_resolution-strategy.pdf.

[166] For a discussion of some of the benefits and challenges of an SPOE approach, see Thomas C. Baxter, Jr., Executive Vice President and General Counsel of the Federal Reserve Bank of New York, Resolving the Unresolvable: The Alternative Pathways to Ending Too Big to Fail, Remarks at the International Insolvency Institute 13th Annual Conference, Columbia University Law School (June 17, 2013), *available at* http://www.newyorkfed.org/newsevents/speeches/2013/bax130618.html.

transferred to the bridge company. The indirect effect of these actions would be to position the bridge company to recapitalize the operating subsidiaries transferred to it (as discussed below). The holders of claims left behind in the receivership would receive interests in the equity of the bridge company.

The second step would be for the bridge financial company to recapitalize the operating subsidiaries by contributing assets to the operating subsidiaries or by converting existing debt obligations due from the operating subsidiaries to the successor bridge company into equity in the operating subsidiaries. As a result of this action, the losses at the level of the operating subsidiaries would in effect be absorbed by the subordinated and long-term senior debt at the top-tier holding company level. Under the SPOE model, the top-tier holding company would generally not have other business operations and would have only minimum liabilities (*e.g.*, for taxes) other than its "loss absorbing" senior long-term debt and subordinated debt. The presence of short-term debt or other operating liabilities at the top-tier holding company would complicate the resolution process because these liabilities would rank *pari passu* with the senior long-term debt and would have to be treated the same as the senior long-term debt unless FDIC used its special power to make "additional payments" with respect to the short-term debt and operating claims.

The SPOE strategy is particularly well-suited to the topography of the U.S. financial system where the largest banking institutions are organized in a holding company form and issue large amounts of long-term debt at the holding company level. The SPOE strategy is not so well suited to the topography of certain other financial systems, such as those that generally do not rely on the use of a holding company structure or those in which long-term debt is generally raised at the operating subsidiary level and not at the top-tier holding company level. These financial systems will require a different resolution approach, such as the MPOE approach.[167] An MPOE strategy envisions that there would be insolvency proceedings at the top-tier company level and at various intermediate holding company or operating company levels, initiated by multiple resolution authorities. The FDIC staff has acknowledged that an MPOE strategy might have to be used in some cases. It was clear, however, from FDIC staff's presentation to the Advisory Committee in January 2012 that the FDIC staff itself saw the SPOE strategy as the more promising approach, particularly from the perspective of minimizing the potential for

[167] For a discussion of the considerations relevant to the choice between an SPOE strategy and an MPOE strategy, see FSB, *Consultative Document*, *Recovery and Resolution Planning: Making the Key Attributes Requirements Operational* 14–15 (Nov. 2012), *available at* http://www.financialstabilityboard.org/publications/r_121102.pdf.

adverse consequences of a resolution of a large U.S. financial institution in a cross-border context and for disruption in critical financial functions even in a domestic context.[168] If the SPOE strategy can be made operational, it would represent an "elegant" solution to many of the most vexing problems presented by the failure of a large interconnected financial company.

In a speech in May 2012, Chairman Gruenberg of the FDIC confirmed that from the FDIC's point of view, an SPOE strategy represented a "much more promising approach" than the prospect of initiating multiple resolution proceedings at the level of the operating subsidiaries.[169] He specifically observed that the SPOE strategy "offers the promise of overcoming many of the cross-border issues that have been identified in both theory and practice."[170] In December 2012, the FDIC and the Bank of England issued a joint paper discussing how an SPOE strategy could be used for a U.S. or a U.K. financial group to facilitate an orderly resolution.[171] In August 2013, the Swiss Financial Market Supervisory Authority ("FINMA") issued a position paper on the resolution of Swiss systemically important banks.[172] The position paper confirmed that based on consultation with the FDIC and the Bank of England, FINMA's preferred resolution approach for the two Swiss systemically important banks would be an SPOE bail-in approach. Although both the Bank of England paper and the FINMA paper noted that there were significant preconditions to the successful use of an SPOE strategy, the issuance of the papers gave increased international prominence to the SPOE approach. Industry and private sector groups also raised their voices in support of the

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[168] *See Resolution Strategy Overview*, *supra* note 165.

[169] *See* Martin J. Gruenberg, Acting Chairman, FDIC, Remarks to the Federal Reserve Bank of Chicago Bank Structure Conference (May 10, 2012), *available at* https://www.fdic.gov/news/news/speeches/archives/2012/spmay1012.html. In his comments, Gruenberg indicated that the FDIC would look to "subordinated debt or even senior unsecured debt claims" of the parent company to provide the cushion for the recapitalization of the new bridge company, thus anticipating the concept of TLAC.

[170] *Id.*

[171] *See* FDIC & THE BANK OF ENGLAND, *Resolving Globally Active, Systemically Important, Financial Institutions* (Dec. 10, 2012), *available at* http://www.fdic.gov/about/srac/2012/gsifi.pdf. *See also* Martin Gruenberg & Paul Tucker, *Global Banks Need Global Solutions When They Fail*, FIN. TIMES, Dec. 10, 2012, *available at* http://www.fdic.gov/news/letters/srac.html.

[172] *See* FINMA, *Resolution of global systemically important banks* (Aug. 7, 2013), *available at* https://www.finma.ch/en/~/media/finma/dokumente/dokumentencenter/myfinma/finma-publikationen/diskussionspapiere/diskussionspapier-20130807-sanierung-abwicklung-global-systemrelevante-banken.pdf?la=en.

SPOE concept.[173] The SPOE concept appeared to be achieving wide recognition.

In December 2013 the FDIC issued a request for public comment on the SPOE strategy, apparently at the urging of two members of the FDIC board who actually questioned the wisdom of an SPOE strategy.[174] The request for comment provided a relatively detailed discussion of how an SPOE strategy might be implemented in a Title II case and highlighted certain issues that the FDIC staff had identified during the development of the SPOE strategy. The request for public comment came exactly a year to the day after the FDIC and the Bank of England had publicly endorsed the SPOE strategy in their joint paper and in an editorial in the *Financial Times*.[175] The FDIC rang in the anniversary of the joint paper by issuing a request for public comment that raised questions—at least nominally—about the SPOE strategy. Two members of the FDIC board of directors released individual statements on the issues that they saw in the proposed SPOE strategy.[176] Among the issues raised by the two board members were the competitive and moral hazard effects of protecting all the creditors of the operating subsidiaries of a systemically important firm.[177]

The request for public comment elicited substantial comment. Comments filed by banking groups were generally supportive of the SPOE strategy, though requesting more detail on various elements of the strategy.[178] Comments filed

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[173] *See, e.g.*, The Clearing House, Ending "Too-Big-to-Fail": Title II of the Dodd-Frank Act and the Approach of "Single Point of Entry" Private Sector Recapitalization of a Failed Financial Company (Jan. 2013), *available at* https://www.cov.com/-/media/files/corporate/publications/2013/01/white_paper_ending_too-big-to-fail.pdf; Bipartisan Policy Center, Too Big to Fail: The Path to a Solution (May 2013), *available at* https://bipartisanpolicy.org/sites/default/files/TooBigToFail.pdf; Institute of International Finance, Making Resolution Robust—Completing the Legal and Institutional Frameworks for Effective Cross-Border Resolution of Financial Institutions (June 2012), *available at* https://www.iif.com/system/files/Making_Resolution_Robust_20120607.pdf.

[174] Press Release, FDIC Board Releases Resolution Strategy for Public Comment (Dec. 10, 2013), *available at* https://www.fdic.gov/news/news/press/2013/pr13112.html; Notice and Request for Comments, Resolution of Systemically Important Financial Institutions: The Single Point of Entry Strategy, 78 Fed. Reg. 76,614 (Dec. 18, 2013).

[175] *See supra* note 171 and accompanying text.

[176] *See* Statement of FDIC Vice Chairman Thomas M. Hoenig on the Single Point of Entry Strategy (Dec. 10, 2013), *available at* https://www.fdic.gov/about/learn/board/hoenig/statement20131210b.html; Statement of FDIC Director Jeremiah Norton on the Single Point of Entry Strategy (Dec. 10, 2013), *available at* https://www.fdic.gov/about/learn/board/norton/statement12-10-2013.pdf.

[177] *Id.*; *see also* Joe Adler, *Likely Battle Ahead for FDIC's 'Single Point' Resolution Plan*, Am. Bank., Dec. 10, 2013.

[178] *See, e.g.*, Letter from The Clearing House, SIFMA, American Bankers Assn., Financial

by groups not affiliated with the banking industry were generally more quizzical of the tenets and operations of an SPOE model.[179] Several commentators went further and actually mounted a frontal assault on the SPOE concept.[180] These commentators challenged both the legal and policy legitimacy of the SPOE approach. As a legal matter, these commentators asserted that Title II explicitly requires a liquidation of the covered financial company and that there is no language in Title II to suggest that it can be used to recapitalize a bank subsidiary of the holding company.[181] As a policy matter, they asserted that an SPOE strategy would institutionalize "too big to fail" by providing assurances that all the creditors of a bank subsidiary would be protected from loss.[182]

Notwithstanding these criticisms, the SPOE concept has come to dominate the planning process for the resolution of large financial institutions in the United States. Seven of the eight largest U.S. bank holding companies have expressly adopted an SPOE approach in their most recent Title I resolution plans.[183] This adoption relies on the extension of the SPOE concept as developed originally for use in a resolution under Title II to a resolution under the Bankruptcy Code. An SPOE approach is also the preferred approach for many of the largest foreign banking organizations as referenced in their Title I resolution plans filed in the United States.[184]

Services Roundtable and Global Financial Markets Assn. to the FDIC (Feb. 18, 2014), *available at* http://www.aba.com/Advocacy/commentletters/Documents/Joint-Trades-Single-Pt-Entry-CL-21814.pdf.

[179] *See, e.g.*, Letter from The Systemic Risk Council to the FDIC (Feb. 18, 2014), *available at* http://www.systemicriskcouncil.org/wp-content/uploads/2014/02/SRC-Comment-Ltr-to-FDIC-re-SPOE-2-18-14.pdf.

[180] *See* Paul H. Kupiec & Peter J. Wallison, *Can the "single point of entry" strategy be used to recapitalize a failing bank?* (America Enterprise Institute Economic Working Paper 2014-08, Nov. 4, 2014). For other criticisms of the SPOE concept, see Stephen Lubben, *OLA After Single Point of Entry—Has Anything Changed?*, *in* AN UNFINISHED MISSION: MAKING WALL STREET WORK FOR US 13, 16 (Roosevelt Inst. 2013), http://rooseveltinstitute.org/sites/all/files/Unfinished_Mission_2013.pdf; John Crawford, *"Single Point of Entry": The Promise and Limits of the Latest Cure for Bailouts*, 109 Nw. U.L. REV. 103 (2014).

[181] *See* Kupiec & Wallison, *supra* note 180, at 4.

[182] *Id.* at 5.

[183] *See* PwC, Regulatory brief, 2017 Public sections: The resolution evolution (July 2017), *available at* http://www.pwc.com/us/en/financial-services/regulatory-services/publications/assets/resolution-plans-2017.pdf.

[184] In their Title I resolution plans, the four foreign banks with the largest U.S. operations have indicated that their global resolution plans use an SPOE strategy as the preferred strategy. *See* 2015 UBS US Resolution Plan Public Section (June 2015) at 6–7; Credit Suisse Global Recovery and Resolution Plan Chapter 1—Public Section (July 2015) at 1–20. Barclays

PREDICATES FOR AN SPOE APPROACH

With the general acceptance of SPOE as a strategy, the focus has shifted to establishing the financial and operational predicates for the use of an SPOE strategy under Title II and under the Bankruptcy Code. The most important predicate for the use of an SPOE strategy is a sufficient amount of loss-absorbing debt and equity at the top-tier holding company (*i.e.*, TLAC) to cover the losses both at the holding company and at the material operating subsidiaries (where most of the losses are likely to be incurred).

The TLAC predicate encompasses at least four sub-predicates. The first sub-predicate is that the parent company will, after the depletion of its equity, have the sufficient "loss-absorbing" debt on the parent-only balance sheet to permit the conversion of such loss-absorbing debt into equity to recapitalize the group on a consolidated basis. The second sub-predicate is that the parent company will have sufficient assets on the parent-only balance sheet to permit the intra-group recapitalization of the principal operating subsidiaries. The intra-group recapitalization would be accomplished through the contribution of assets by the parent company to the individual operating subsidiaries, or through conversion into equity of debt (internal TLAC) owed by the operating subsidiaries to the parent company or through a combination of these techniques. The intra-group recapitalization of the operating subsidiaries must be sufficient to restore the capital of those subsidiaries to levels that the marketplace and the applicable supervisory authorities find adequate (after accounting for all the losses at the operating subsidiaries). Local supervisory authorities for the operating subsidiaries may want the additional assurance that the benefit of the recapitalization of the top-tier holding company will readily be extended to the operating subsidiaries through a so-called "prepositioning" of internal loss-absorbing capacity at the operating subsidiaries. The internal prepositioning could take the form of debt issued by the operating subsidiary to the holding company that can be converted into equity at the direction of the local supervisory authority. The third sub-predicate is that the holding company structure will be relatively "clean," meaning that the top-tier holding company will be relatively free of short-term liabilities and other operating liabilities, the existence of which at the holding company level would complicate the restructuring and recapitalization of the bridge company.

The fourth sub-predicate is that the bridge company will be in a position to provide liquidity support to its operating subsidiaries. The holders of "run-

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Resolution Plan Public Section (July 2015) at 39; Deutsche Bank U.S. Resolution Plan Section 1: Public Section (July 2015) at 39.

nable" liabilities at operating subsidiaries (and the supervisory authorities of those subsidiaries) will require strong assurances on day one (after the failure of the top-tier holding company) that the bridge company will support the ongoing operations of the operating subsidiaries. The intra-group recapitalization envisioned above, even if effected through a prepositioning of internal loss-absorbing capacity, does not directly provide liquidity to the operating subsidiaries. Funding from, or guarantees by, the bridge company of certain short-term liabilities of the operating subsidiaries may be required by the marketplace and the relevant supervisory authorities, particularly if the operating subsidiaries have significantly depleted their liquidity reserves in the run-up to the initiation of a resolution proceeding for the top-tier holding company. In a Title II resolution, such funding would be available from the Treasury through the Orderly Liquidation Fund.

REGULATORY ACTION ON THE PREDICATES FOR SPOE

TLAC

Because of the potential advantages of an SPOE (and, indeed, even an MPOE) strategy for mitigating the problems of cross-border resolution, the FSB took an early interest in establishing a common international standard for TLAC applicable to entities that are designated as global systemically important banking institutions ("G-SIBs") by the FSB.[185] In 2014, the FSB began a consultation process on a proposal for an international standard on TLAC and commissioned a comprehensive quantitative impact study on the proposal for TLAC.[186] Upon completion of the quantitative impact study in 2015, the FSB issued an international TLAC standard for G-SIBs.[187] The guiding principle behind the FSB TLAC standard is that there must be sufficient loss-absorbing and recapitalization capacity available to a G-SIB to implement an orderly resolution that (i) minimizes any impact on financial stability, (ii) ensures continuity of critical services, and (iii) avoids exposing taxpayers to loss. Under the standard adopted by the FSB, a G-SIB and each of its resolution entities

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[185] The FSB has designated 30 institutions, including eight U.S. institutions, as G-SIBs. *See* Press Release, FSB publishes 2016 G-SIB list (Nov. 21, 2016), *available* at http://www.fsb.org/2016/11/fsb-publishes-2016-g-sib-list/.

[186] FSB, *Consultative Document*, *Adequacy of loss-absorbing capacity of global systemically important banks in resolution* (Nov. 10, 2014), *available at* http://www.financialstabilityboard.org/wp-content/uploads/TLAC-Condoc-6-Nov-2014-FINAL.pdf.

[187] FSB, *Principles on Loss-Absorbing and Recapitalization Capacity of G-SIBs in Resolution: Total Loss-Absorbing Capacity (TLAC) Term Sheet* (Nov. 9, 2015), *available at* http://www.fsb.org/wp-content/uploads/TLAC-Principles-and-Term-Sheet-for-publication-final.pdf.

(*i.e.*, the entities to which resolution tools will be applied) are required to meet a minimum total loss-absorbing capacity requirement ("Minimum TLAC") alongside the minimum regulatory capital requirements already set out in the Basel III capital framework.[188] The instruments that are eligible to be counted toward Minimum TLAC are generally tier 1 and tier 2 regulatory capital instruments and unsecured long-term debt instruments (*i.e.*, with a minimum remaining maturity of at least one year).[189] TLAC-eligible instruments must absorb losses prior to liabilities excluded from TLAC in the insolvency or resolution of the G-SIB and its resolution entities.[190] The Minimum TLAC requirement set by the FSB is in an amount equal to at least 16% of the G-SIB's risk-weighted assets from January 1, 2019 and 18% from January 1, 2022. In addition, the Minimum TLAC must be equal to at least 6% of the Basel III leverage ratio denominator from January 1, 2019 and 6.75% from January 1, 2022. There is an expectation that TLAC-eligible debt instruments will constitute at least 33% of the Minimum TLAC requirement.[191]

The FSB has also included a requirement for internal TLAC to ensure appropriate distribution of loss-absorbing capacity within resolution groups outside of the resolution entity's home jurisdiction. Each material sub-group of a resolution entity must maintain internal TLAC of 75% to 90% of the external Minimum TLAC requirement that would apply to the material sub-group if it were a resolution group.[192] As noted above, internal TLAC would be used to transfer losses from the operating subsidiaries to intermediate holding companies and the parent holding company. The prepositioning of internal TLAC is intended to diminish the incentives on the part of host jurisdictions to ring-fence assets in their jurisdictions.[193]

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[188] *Id.* at 9. Depending upon the resolution strategy, a resolution entity may be the parent company, an intermediate holding company, or one or more operating companies. The FSB TLAC requirement thus envisions the possibility of the use of either an SPOE strategy or an MPOE strategy.

[189] *Id.* at 7 & 11–12.

[190] According to the FSB, TLAC-eligible instruments may absorb losses ahead of liabilities that are excluded from TLAC by being (1) contractually subordinated to the excluded liabilities on the balance sheet of the resolution entity ("contractual subordination"); (2) junior in the statutory creditor hierarchy to the excluded liabilities on the balance sheet of the resolution entity ("statutory subordination"); or (3) issued by a resolution entity that does not have excluded liabilities on the balance sheet that rank *pari passu* or junior to TLAC-eligible instruments ("structural subordination"). *Id.* at 15–16.

[191] *Id.* at 12.

[192] *Id.* at 19.

[193] For a detailed discussion of the issues implicated in internal TLAC, *see* FSB, *Guiding*

The Federal Reserve Board commenced its own rulemaking process on TLAC in October 2015 shortly before the FSB issued its final TLAC standard.[194] The Federal Reserve Board TLAC rule follows the general approach in the FSB TLAC standard but is more stringent in several important respects than the FSB standard.[195] The Federal Reserve Board rule generally requires a U.S. top-tier bank holding company identified under the Federal Reserve Board's rules as a global systemically important bank holding company (a covered BHC) to maintain a minimum amount of loss-absorbing capacity, consisting of tier 1 capital and a minimum amount of eligible long-term debt ("LTD").[196] In addition, the rule prescribes two additional equity buffers that sit on top of the risk-weighted asset and leverage exposure components of TLAC (described below). The breach of either of these buffers would result in limitations on capital distributions and discretionary bonus payments by a covered BHC. The rule applies analogous requirements to the top-tier U.S. intermediate holding company of a global systemically important foreign banking organization with $50 billion or more in U.S. non-branch assets (a covered IHC).[197] The rule also imposes restrictions on other liabilities that a

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Principles on the Internal Total-Loss-Absorbing Capacity of G-SIBs ('Internal TLAC') (July 6, 2017), *available at* http://www.fsb.org/2017/07/guiding-principles-on-the-internal-total-loss-absorbing-capacity-of-g-sibs.

[194] *See* Total Loss-Absorbing Capacity, Long-Term Debt, and Clean Holding Company Requirements for Systemically Important U.S. Bank Holding Companies and Intermediate Holding Companies of Systemically Important Foreign Banking Organizations, 80 Fed. Reg. 74,926 (Nov. 30, 2015) (proposed rule).

[195] *See* Total Loss-Absorbing Capacity, Long-Term Debt, and Clean Holding Company Requirements for Systemically Important U.S. Bank Holding Companies and Intermediate Holding Companies of Systemically Important Foreign Banking Organizations, 82 Fed. Reg. 8,266 (Jan. 24, 2017) (final rule).

[196] The Federal Reserve Board has identified eight U.S. bank holding companies as global systemically important banking institutions for purposes of additional capital provisions as well as the TLAC requirement. *See* 82 Fed. Reg. at 8,272 n. 35. The FSB has designated the same eight U.S. institutions as global systemically important banking institutions for purposes of its supervisory standards such as TLAC. *See also* Press Release, FSB publishes 2016 G-SIB list (Nov. 21, 2016), *available at* http://www.fsb.org/2016/11/fsb-publishes-2016-g-sib-list/.

[197] The TLAC rules for covered IHCs differ from the TLAC rules for covered BHCs in several respects in recognition of the different circumstances of the U.S. operations of foreign banking organizations. The TLAC rule for IHCs distinguishes between a resolution Covered IHC, meaning an IHC expected to enter into resolution proceedings in the United States under its parent foreign banking organization's MPOE strategy, and a non-resolution Covered IHC, meaning an IHC expected to remain a going concern under its parent foreign banking organization's SPOE strategy. 12 C.F.R. § 252.61. A non-resolution Covered IHC must maintain TLAC that is not less than the greater of 16% of its risk-weighted assets, 6% of its total

covered BHC or covered IHC may have outstanding in order to improve their resolvability and resiliency; these restrictions are referred to as "clean holding company requirements."

A covered BHC is required to maintain eligible external TLAC in an amount not less than the greater of (i) 18% of its risk-weighted assets and (ii) 7.5% of its total leverage exposure (the denominator of the supplementary leverage ratio in the Federal Reserve Board capital rules).[198] These percentages are higher than the comparable minimum requirements in the FSB TLAC standards. A covered BHC is also subject to a buffer (to be met only with common equity) equal to 2.5% of its risk-weighted assets, plus the surcharge applicable to the firm under the GSIB risk-based capital surcharge rule. A covered BHC is also subject to a buffer (to be met only with common equity) equal to 2% of its total leverage exposure.[199] The buffer provisions are not included in the FSB TLAC standards.

As a component of its overall TLAC requirement, a covered BHC is required to maintain external LTD in an amount not less than the greater of (i) 6% of risk-weighted assets plus the firm's surcharge under the GSIB surcharge rule and (ii) 4.5% of the total leverage exposure.[200] A number of commenters urged the Federal Reserve Board to eliminate the separate LTD requirement and allow institutions to meet their TLAC requirement with additional equity rather than any required level of LTD. The Federal Reserve Board chose to retain a separate LTD component as part of its TLAC requirement. The Federal Reserve Board noted that unlike equity, LTD can be "bailed in" to create additional equity subsequent to a firm's failure. Also unlike equity, the loss-absorbing capacity of

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leverage exposure and 8% of its total consolidated assets, compared to the corresponding percentages of 18, 6.75 and 9 for a resolution Covered IHC. 12 C.F.R. § 252.165(a) and (b). A Covered IHC is also subject to a buffer equal to 2.5% of risk-weighted assets. A non-resolution Covered IHC can satisfy its LTD and TLAC requirements only with internal LTD and TLAC. A resolution Covered IHC may issue LTD to third parties. In adopting the TLAC rule, the Federal Reserve Board observed that an MPOE resolution strategy involving a Covered IHC may be the equivalent in effect of an SPOE resolution strategy for the U.S. operations of the parent foreign banking organization. 82 Fed. Reg. at 8,270 n.29.

[198] 12 C.F.R. § 252.63(a).

[199] 12 C.F.R. § 252.63(c).

[200] 12 C.F.R. § 252.62. To be eligible as LTD, debt issued after December 31, 2016 must be unsecured and not have any credit enhancement from an affiliate, have a remaining maturity of at least 365 days, be governed by U.S. law and be "plain vanilla," meaning *inter alia* that the debt does not have a credit-sensitive feature and does not provide the holder a contractual right to accelerate payment other than on dates specified in the instrument or in the event of the insolvency or receivership of the covered BHC or a payment default by the covered BHC. 12 C.F.R. § 252.61.

LTD would not be at substantial risk of volatility or depletion before the firm fails or enters a resolution proceeding. The separate LTD requirement thus helps to ensure that a covered BHC would have a "known and observable quantity of loss-absorbing capacity" at the point of failure to provide a fresh source of capital.[201]

The clean holding company requirements in the rule also impose significant restrictions on the operations of a covered BHC. The clean holding requirements generally prohibit a covered BHC from entering into any (i) short-term debt instrument (*i.e.*, with an original maturity of less than 365 days) with a third party, (ii) QFC with a third party, (iii) agreement in which the covered BHC guarantees a subsidiary's obligations if the beneficiary of the guarantee would have a default right arising from the covered BHC's insolvency or entry into resolution proceedings, or (iv) agreement that provides for the covered BHC's liabilities to be guaranteed by any of its subsidiaries.[202] The Federal Reserve Board concluded that these particular restrictions served several purposes.[203] First, they work to ensure that the risk of losses to and the imposition of losses on a covered BHC's creditors do not pose an undue risk to U.S. financial stability. Prohibiting a covered BHC from having third-party short-term creditors or QFC counterparties mitigates the risk that destabilizing funding runs or asset fire sales could result from the covered BHC's failure. Second, the proposed restrictions seek to ensure that a covered BHC's subsidiaries do not take losses in an SPOE resolution of the covered BHC and are instead able to continue operating normally, for instance by preventing guarantees of the covered BHC's debt by its subsidiaries along with offset rights that could have similar effects. Third, the proposed restrictions seek to limit the complexity of a covered BHC's liability structure so as to facilitate a rapid and orderly resolution of the covered BHC over a "resolution weekend" if necessary.

In addition, the rule imposes a cap equal to 5% of the covered BHC's eligible external TLAC on the amount of its liabilities that do not qualify as eligible external TLAC and that are not senior to the covered BHC's eligible external debt or secured.[204] The liabilities of a covered BHC that would be subject to the cap include, for example, debt instruments with derivative-linked features and other debt instruments that are not eligible debt for TLAC purposes as well as litigation liabilities, employee liabilities and vendor liabilities such as for

[201] 82 Fed. Reg. at 8,273–8,274.

[202] 12 C.F.R. § 252.64(a).

[203] 80 Fed. Reg. at 74,944.

[204] 12 C.F.R. § 252.64(b)–(c).

utilities, rent and services.[205] Capping these liabilities at 5% is intended to limit the amount of complex liabilities (such as structured notes) that would have to be valued quickly as part of a weekend resolution and the amount of essential vendor liabilities that might have to be transferred to the bridge company.

With the adoption of its TLAC and clean holding company rule, the Federal Reserve Board addressed one of the most important predicates for the successful use of an SPOE strategy in either a bankruptcy case or a Title II proceeding. Because the TLAC and clean holding company rule is as applicable only to the eight bank holding companies currently identified as GSIBs, the TLAC and clean holding company predicates for an SPOE strategy may not be met for other large bank holding companies. These companies will more likely have to rely on an MPOE strategy, involving a resolution proceeding at the level of the holding company and at the level of various operating subsidiaries.

Treatment of Derivatives

As part of their review of the living wills filed by the large bank holding companies, the Federal Reserve Board and the FDIC identified a number of other possible impediments to a proposed use of an SPOE strategy. One impediment was a common term in derivative and other financial contracts that permits a counterparty to terminate the contract and sell the collateral underlying the contract in the event of the insolvency or resolution of the other counterparty or its affiliates. As discussed above, this outcome was widely perceived as a significant problem in the Lehman bankruptcy. The FDIC and several other foreign supervisors in November 2013 called upon the International Swaps and Derivatives Association ("ISDA") to add uniform language in its model contracts to provide a temporary stay of such early termination rights.[206]

From a U.S. perspective, the contractual solution to the temporary stay issue has to solve for two problems. The first problem is that unlike the FDIA and Title II, the Bankruptcy Code contains no temporary stay provision and thus permits the immediate exercise of acceleration, close-out, and netting rights under financial contracts to which a banking institution or its subsidiaries and affiliates may be party in the event of insolvency or bankruptcy. The second is that even for an institution in an FDIA or Title II proceeding, foreign

[205] 82 Fed. Reg. at 8,301.

[206] *See* Press Release, FDIC, Federal Deposit Insurance Corporation, Bank of England, German Federal Financial Supervisory Authority and Swiss Financial Market Supervisory Authority Call for Uniform Derivatives Contracts Language (Nov. 5, 2013), *available* at http://www.fdic.govfnews/news/press/2013/pr13099.html.

choice-of-law provisions in financial contracts raise significant issues as to whether the temporary stay provision in the FDIA or the temporary stay and cross-default provisions in Title II would be recognized and enforced. Although various commentators have called for amendments to the Bankruptcy Code to deal with the safe harbor provisions for financial contracts, no amendments to the Bankruptcy Code have yet been made to address this issue. In any event, amending the Bankruptcy Code would not solve the foreign choice-of-law problem. A contractual solution appeared to be the most expedient and practical means of addressing these problems in the near term. As part of their living will review process, the FDIC and the Federal Reserve Board in 2014 called upon the largest U.S. institutions to implement a contractual solution on an industry-wide basis, putting additional pressure on ISDA through some of its largest numbers to achieve a prompt solution to the early termination issue.[207]

The pressure from U.S. and foreign regulators worked. In October 2014, ISDA announced that 18 of its major global bank members had agreed to enter into the ISDA 2014 Resolution Stay Protocol (the "2014 Stay Protocol") developed in coordination with the FSB to support cross-border resolution.[208] In November 2015, ISDA announced the expansion of the 2014 Stay Protocol to cover securities financing transactions, now called the ISDA 2015 Universal Resolution Stay Protocol (the "Universal Stay Protocol").[209] Section 1 of the Universal Stay Protocol provides for the adhering parties to "opt in" to the statutory stay provisions in the special resolution regimes in six initial jurisdictions. The special resolution regimes covered by Section 1 are those of the United States (including the FDIA and Title II), the United Kingdom, Germany, Switzerland, Japan, and France. The Universal Stay Protocol has since been expanded via "Country Annexes" to include the special resolution regimes of Spain, Italy, the Netherlands and Sweden. The length of the stay and

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[207] *See* Joint Press Release, Board of Governors of the Federal Reserve System and Federal Deposit Insurance Corporation, Agencies Provide Feedback in Second Round Resolution Plans of "First-Wave" Filers (Aug. 5, 2014), *available* at https://www.fdic.gov/news/news/press/2014/pr14067.html.

[208] Press Release, ISDA, Major Banks Agree to Sign ISDA Resolution Stay Protocol (Oct. 11, 2014), *available* at http://www2.isda.org/news/major-bacns-agree-to-sign-isda-resolution-stay-protocol. On November 12, 2014, ISDA published the 2014 Stay Protocol. *See* Press Release, ISDA, ISDA Publishes 2014 Resolution Stay Protocol (Nov. 12, 2014), *available* at http://www2.isda.org/news/isda-publishes-2014-resolution-stay-protocol.

[209] Press Release, ISDA, Major Banks Sign Relaunched ISDA Resolution Stay Protocol (Nov. 12, 2015), *available at* http://www2.isda.org/attachment/ODAwNQ==/Resolution%20Stay%20Protocol%20relaunch%20FINAL.pdf.

applicable creditor protections are in each case as specified in the individual special resolution regime, but the stay generally does not exceed two business days. Section 2 of the Universal Stay Protocol is designed to provide a temporary stay of termination rights for cross-defaults resulting from affiliate insolvency proceedings under U.S. resolution regimes, including the Bankruptcy Code and the FDIA. Under Section 2, parties adhering to the Universal Stay Protocol agree to a temporary stay on cross-default rights, provided that certain creditor protection provisions are satisfied. Section 2 has the effect of extending by contract the stay of cross-default rights contained in Title II to companies in proceedings under the FDIA or the Bankruptcy Code. Section 1 took effect for the initial 18 banks on January 1, 2015.[210] Section 2 will take effect on the effective date of national regulations requiring counterparties of global systemically important banks to give up certain cross-default and direct-default rights arising when an affiliate (including a parent) becomes subject to a proceeding under the FDIA or the Bankruptcy Code.

In May 2016, the Federal Reserve Board published a proposal for such national regulations, which it subsequently finalized in September 2017.[211] Under the final rule, U.S. top-tier bank holding companies identified by the Federal Reserve as GSIBs, subsidiaries of any such GSIBs (other than depository subsidiaries) and the U.S. operations of any foreign GSIB are subject to restrictions regarding the terms of their non-cleared QFCs. First, a covered entity would generally be required to ensure that QFCs to which it is party, including QFCs entered into outside the United States, provide that any default rights and restrictions on the transfer of the QFCs are limited to the same extent as they would be under Title II and the FDIA. Second, a covered entity would generally be prohibited from being party to QFCs that would allow a QFC counterparty to exercise default rights against the covered entity based on the entry into a resolution proceeding under Title II, the FDIA, the Bankruptcy Code or other regime by an affiliate of the covered entity. The FDIC and OCC have published complementary proposals to cover the GSIB subsidiaries that they regulate.[212] Implementation of these rules represents another milestone in

[210] As of August 18, 2017, a total of 265 ISDA members (including individual affiliates) had adhered to the Universal Stay Protocol. *See* ISDA, Adhering Parties, https://www2.isda.org/functional-areas/protocol-management/protocol-adherence/22.

[211] *See* Federal Reserve Board, Restrictions on Qualified Financial Contracts of Systemically Important U.S. Banking Organizations and the U.S. Operations of Systemically Important Foreign Banking Organizations; Revisions to the Definition of Qualifying Master Netting Agreement and Related Definitions, 82 Fed. Reg. 42,882 (Sept. 12, 2017) (final rule).

[212] *See* FDIC, Restrictions on Qualified Financial Contracts of Certain FDIC-Supervised Institutions; Revisions to the Definition of Qualifying Master Netting Agreement and Related

establishing the predicates for the successful use of an SPOE strategy.

THE RETREAT FROM TITLE II

Disagreement Within the Regulatory Community

At the time of the enactment of the Dodd-Frank Act, the proponents of Title II, including most prominently the Treasury Department and the federal banking agencies, asserted that Title II was essential to addressing the "too big to fail" problem. Consistent with this position, the FDIC made implementation of Title II one of its top priorities. Yet even as the FDIC staff was working to make Title II operational, principally through the conceptualization of the SPOE strategy, discordant notes were being sounded within the FDIC. When the FDIC issued its request for public comment on the proposed SPOE strategy, Vice Chairman Thomas Hoenig and board member Jeremiah Norton raised questions about the strategy and more significantly about the use of Title II itself.[213] In his own comments accompanying the issuance of the request for public comment on the SPOE strategy, Vice Chairman Hoenig emphasized that under the Dodd-Frank Act, bankruptcy, not Title II, was the preferred means for resolving systemically important financial institutions as reflected in the Title I resolution plan requirement. He expressed a specific concern with an SPOE approach under Title II because significant government support might be needed to provide liquidity to the operating subsidiaries of a covered financial company. Vice Chairman Hoenig subsequently expressed the view that in providing funding in a Title II resolution, the Treasury would be incurring the same consequences as were incurred in the bailout process during the financial crisis.[214] He further observed that the "[financial] industry prefers the Title II solution because it requires nothing fundamentally transformational to its operations."[215] He urged instead rigorous application of the Title I resolution plan requirement to force systemically important financial institutions to reduce their size, complexity and funding profile.

At the same time that Vice Chairman Hoenig was voicing concerns with

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Definitions, 81 Fed. Reg. 74,326 (Oct. 26, 2016); OCC, Mandatory Contractual Stay Requirements for Qualified Financial Contracts, 81 Fed. Reg. 55,381 (Aug. 19, 2016).

[213] *See* note 176 *supra*. *See also* Jeremiah O. Norton, Remarks to the American Bankers Association, Discussion on the Current State of Resolution Planning 2 (Oct. 21, 2013), *available at* https://www.fdic.gov/news/news/speeches/archives/2013/spoct2113.html (stating that the SPOE strategy being formulated by the FDIC staff is "not contemplated in Dodd-Frank").

[214] *See* Thomas M. Hoenig, Can We End Financial Bailouts? (May 7, 2014), *available at* https://www.fdic.gov/news/news/speeches/spmay0714.html.

[215] *Id.* at 3.

Title II and a strong preference for the use of bankruptcy, other members of the federal regulatory community were expressing similar concerns and a similar preference for the use of bankruptcy. The President of the Federal Reserve Bank of Richmond, Jeffrey Lacker, argued that Title II would encourage creditors to believe that they would be protected or bailed out at the cost of taxpayers.[216] He said that robust enforcement of the living will process under the Bankruptcy Code was a more promising alternative than the use of Title II. He subsequently said that "living wills offer the only realistic path to dismantling expectations [for bailouts] and ending "too big to fail."[217] The President of the Federal Reserve Bank of Philadelphia, Charles Plosser, expressed the view that "Title II is likely to be biased toward bailouts" and that "a more standard bankruptcy mechanism, specialized for financial institutions, would be more effective in addressing the too-big-to-fail problem" than Title II.[218] The President of the Federal Reserve Bank of Dallas, Richard Fisher, was even more direct. He characterized the process under Title II as a "quasi nationalization" of the failing institution.[219] There were estimable critics of Title II even within the federal regulatory community.

Criticism from Capitol Hill

When the Republicans assumed control of the House in 2011, the House Committee on Financial Services began a multi-year process of hearings to critique the Dodd-Frank Act with a prominent focus on Title II.[220] A

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[216] Jeffrey M. Lacker, "Ending 'Too Big to Fail' is Going to be Hard Work," Global Society of Fellows Conference, University of Richmond, April 9, 2013.

[217] Jeffrey M. Lacker, "Rethinking the Unthinkable: Bankruptcy for Large Financial Institutions," National Conference of Bankruptcy Judges Annual Meeting, Oct. 10, 2014.

[218] Charles I. Plosser, "Can We End Too Big to Fail?," 4th Annual Simon New York City Conference, Reform at the Crossroads: Economic Transformation in the Year Ahead, May 9, 2013.

[219] Richard W. Fisher, "Ending 'Too Big to Fail': A Proposal for Reform Before It's Too Late (With Reference to Patrick Henry, Complexity and Reality)" Before the Committee for the Republic, January 16, 2013.

[220] *See*, *e.g.*, *Does the Dodd-Frank Act End "Too Big To Fail?": Hearing Before the Subcomm. on Financial Institutions and Consumer Credit of the House Comm. on Financial Services*, 112th Cong. (2011) [hereinafter *Too Big to Fail Hearing*]; *The Impact of the Dodd-Frank Act: What It Means To Be A Systemically Important Financial Institution: Hearing Before the Subcomm. on Financial Institutions and Consumer Credit of the House Comm. on Financial Services*, 112th Cong. (2012); *Who is Too Big to Fail: Does Title II of the Dodd-Frank Act Enshrine Taxpayer-Funded Bailouts?*: *Hearing Before the Subcomm. on Oversight and Investigations of the House Comm. on Financial Services*, 113th Cong. (2013) [hereinafter *Who Is Too Big to Fail Hearing*]; *Examining How the Dodd-Frank Act Could Result in More Taxpayer-Funded Bailouts: Hearing Before the House Comm. on Financial Services*, 113th Cong. (2013); *Assessing the Impact of the Dodd-Frank*

succession of academic and industry witnesses catalogued their concerns with Title II. Not surprisingly, the Republican staff on the Financial Services Committee arranged for several federal regulators who had previously expressed criticisms of Title II, such as Thomas Hoenig, Richard Fisher and Jeffrey Lacker, to testify as well.[221]

Basic concerns expressed by many witnesses were the lack of transparency in the Title II process, the broad discretion given to the FDIC in the Title II process, the authority of the FDIC to treat certain creditors more advantageously than others, and the liberality of Treasury funding available under Title II.[222] Related concerns went to the competitive advantages that a bridge company would enjoy as a result of its tax-exempt status and the potentially low-cost funding provided to it by the Treasury.[223] Witnesses also specifically challenged the merits of the proposed SPOE strategy. One concern was that the SPOE strategy would in effect extend government guarantees to all the creditors of the subsidiaries of the parent company in a Title II proceeding.[224] Another concern was about how Title II and SPOE would work if multiple financial firms were in distress at the same time. Indeed, there was concern even about the FDIC's ability to staff resolution proceedings if multiple firms were to encounter distress in quick succession as happened in 2008.[225] Concerns were also raised about potential Constitutional challenges to Title II.[226]

The Republican staff for the Financial Services Committee issued a report in

Act Four Years Later: Hearing Before the House Comm. on Financial Services, 113th Cong. (2014) [hereinafter *Assessing the Impact Hearing*]; *Ending "Too Big To Fail": What is the Proper Role of Capital and Liquidity?, Hearing Before the House Comm. on Financial Services*, 114th Cong. (2015); *The Dodd-Frank Act Five Years Later: Are We More Stable?: Hearing before the House Comm. on Financial Services*, 114th Cong. (2015).

[221] *See Examining How the Dodd-Frank Act Could Result in More Taxpayer-Funded Bailouts: Hearing Before the House Comm. on Financial Services*, 113th Cong. (2013) (statement of Richard W. Fisher), (statement of Thomas M. Hoenig) & (statement of Jeffrey M. Lacker).

[222] *See, e.g.*, *Who Is Too Big to Fail Hearing*, *supra* note 220, at 70 (statement of John B. Taylor), at 57 (statement of Joshua Rosner) & at 66 (statement of David A. Skeel, Jr.).

[223] *See, e.g.*, *Who Is Too Big to Fail Hearing*, *supra* note 220, at 67 (statement of David A. Skeel, Jr.).

[224] *See, e.g.*, *Assessing the Impact Hearing*, *supra* note 220, at 134 (statement of Paul H. Kupiec).

[225] *See, e.g.*, *Too Big to Fail Hearing*, *supra* note 220, at 85 (statement of Stephen J. Lubben).

[226] *See, e.g.*, *Examining Constitutional Deficiencies and Legal Uncertainties in the Dodd-Frank Act, Hearing Before the Subcomm. On Oversight and Investigations of the House Comm. On Financial Services*, 113th Cong. 66 (2013) (statement of Thomas W. Merrill).

2014 based on its oversight hearings.[227] The basic conclusion of the report was that "not only did the Dodd-Frank Act not end 'too big to fail,' it had the opposite effect of further entrenching it as official government policy."[228] The report recited various criticisms of Title II that witnesses raised in the hearings. Most of the criticisms were the same as the criticisms raised during the Congressional consideration of Title II in 2009 and 2010. One new source of criticism, however, was the FDIC's proposed SPOE strategy. The report was particularly critical of the SPOE strategy. It concluded that "inflicting losses at the parent company level does nothing to minimize moral hazard on the part of creditors and counterparties at the subsidiary level."[229] It found striking parallels between the SPOE strategy under Title II and the Federal Reserve Board's decision during the financial crisis to pay the creditors and counterparties of AIG's subsidiaries in full.[230] It quoted a witness who suggested that Treasury funding for an SPOE strategy under Title II "could become a stealth bailout of subsidiary creditors."[231] It quoted another academician for the proposition that the ex post assessment process on the members of the financial industry to repay Treasury funding "would essentially require that prudent financial companies pay for the sins of the others."[232]

The Effects of the Living Will Process

When Title II was enacted in July 2010, there was a relatively wide consensus among the federal regulators and other government officials that an orderly resolution of a large complex U.S. financial institution was not possible using the Bankruptcy Code. Title II even in its relatively inchoate state at enactment was thought to be the only possible option. Although the resolution plan requirement in Title I reflected the legislative judgment that bankruptcy should be the first choice, the practicality of a bankruptcy approach for a large complex financial institution was heavily discounted at the time. At the time of enactment of Title II, it is unlikely that many of its supporters thought of it merely as a "backstop" to a bankruptcy approach, at least with respect to the largest, most complex U.S. financial institutions.[233]

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[227] *See* 2014 HOUSE REPORT, *supra* note 8.

[228] *Id.* at 1.

[229] *Id.* at 68.

[230] *Id.* at 69–70.

[231] *Id.* at 72.

[232] *Id.* at 75.

[233] As calls have recently mounted for a repeal of Title II, supporters of Title II are now arguing that Title II should be retained at least as a backstop to bankruptcy. *See, e.g.*, Financial

Developments subsequent to the enactment of Title II, however, have provided some encouragement that an orderly bankruptcy process might be possible even for some of the largest financial institutions. One of these developments comes from the Dodd-Frank Act itself, the resolution plan or living will requirement. After a slow start on this new exercise, the FDIC and the Federal Reserve Board have in the last few years implemented an increasingly robust review process for the living wills, particularly those developed by the eight U.S. GSIBs. The FDIC and the Federal Reserve Board have provided specific guidance on what these institutions should do to make their living wills credible, particularly with respect to an SPOE strategy, and criticisms on where individual institutions stand overall in their efforts. The banking institutions have made correspondingly robust efforts to respond to the guidance and criticism of the FDIC and the Federal Reserve Board. These efforts have resulted in substantial improvements in the resolution plans of the eight GSIBs.

For example, in April 2016, the FDIC and the Federal Reserve Board provided specific guidance to the eight GSIBs on their 2015 resolution plans and determined that the 2015 resolution plans of five of the eight GSIBs were not credible or would not facilitate an orderly resolution under the Bankruptcy Code.[234] The specific guidance provided to the GSIBs by the FDIC and the Federal Reserve Board called for significant enhancements in the structure of the institutions and in the pre-positioning of capital and liquidity resources within a group. The resolution plans filed by the eight GSIBs in July 2017 reflect significant improvement in response to the regulatory comments, particularly with respect to steps to enhance the feasibility of an SPOE approach that has now been adapted by seven of the eight GSIBs.[235] Part VI of this article will discuss the improvements made by the GSIBs in their 2017 resolution plans and the prospects for an orderly resolution of a GSIB under the Bankruptcy Code.

Scholars Oppose Eliminating "Orderly Liquidation Authority" as Crisis-Avoidance Restructuring Backstop (May 26, 2017), https://corpgov.law.harvard.edu/2017/05/26/financial-scholars-oppose-eliminating-orderly-liquidation-authority; Ben Bernanke, Why Dodd-Frank's orderly liquidation authority should be preserved (Feb. 28, 2017), https://www.brookings.edu/blog/ben-bernanke/2017/02/28/why-dodd-franks-orderly-liquidation-authority-should-be-preserved.

[234] Joint Press Release, Federal Reserve Board and FDIC, *Agencies Announce Determinations and Provide Feedback on Resolution Plans of Eight Systematically Important, Domestic Banking Institutions* (April 13, 2016), *available at* https://www.federalreserve.gov/newsevents/press/bereg/20160413a.htm.

[235] *See* PWC, Regulatory Brief, 2017 Public sections: The resolution evolution (July 2017), *supra* note 183.

Proposals for Bankruptcy Reform

As the FDIC and the Federal Reserve Board were initiating the living will process, bankruptcy practitioners and academics were considering the introduction of a new chapter or subchapter to the Bankruptcy Code designed specifically for financial institutions. A working group at the Hoover Institution in 2009 began the thought process in the hope that a specially designed Bankruptcy Code chapter for financial institutions would head off the prospect of a new resolution regime for systemically important financial institutions as proposed by the Treasury in its 2009 financial reform report.[236] After the Dodd-Frank Act was enacted, the Hoover working group in 2012 released a new version of a chapter of the Bankruptcy Code for financial institutions.[237] The stated intent of the drafters of the new chapter was "to minimize the felt necessity to use the alternative government agency resolution process recently enacted as a part of the [Dodd-Frank Act]."[238] Thereafter, the Hoover working group responded to other developments under Title II, such as the proposed SPOE strategy. The Hoover working group produced yet another version of a bankruptcy proposal in 2015. The new version was specifically expanded to provide for the possibility of an SPOE approach in bankruptcy to be effected over a resolution weekend if necessary.[239]

The work of the Hoover group served as a catalyst for Congressional consideration of legislation to add a new Subchapter V to Chapter 11 of the Bankruptcy Code for financial institutions. The House passed such legislative proposals in 2014, 2015 and 2016. These legislative proposals provided for a new Subchapter V to Chapter 11 of the Bankruptcy Code for financial institutions, but did not provide for a repeal of Title II. In 2017 the House passed the Financial CHOICE Act of 2017, which incorporates the proposed Subchapter V, but more significantly also repeals Title II. Part VI of this article will discuss the principal provisions of the proposed Subchapter V and the likely effect of these provisions on the resolution of a systemically important financial institution under the Bankruptcy Code. It will also discuss the arguments in

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[236] *See* The Hoover Institution: The Resolution Project, http://www.hoover.org/research-teams/economic-policy-working-group/resolution-project.

[237] Thomas H. Jackson, *Bankruptcy Code Chapter 14: A Proposal*, in BANKRUPTCY *NOT* BAILOUT: A SPECIAL CHAPTER 14 (Kenneth E. Scott & John B. Taylor eds., Hoover Institution Press 2012).

[238] *Id.* at 26.

[239] Thomas H. Jackson, *Building on Bankruptcy: A Revised Chapter 14 Proposal for the Recapitalization, Reorganization, or Liquidation of Large Financial Institutions*, *in* MAKING FAILURE FEASIBLE: HOW BANKRUPTCY REFORM CAN END "TOO BIG TO FAIL" 15 (Kenneth F. Scott et al. eds., Hoover Institution Press 2015).

favor of retaining Title II as a backstop even if Subchapter V is enacted into law.