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Parallel Regimes: Bankruptcy and Dodd-Frank's Orderly Liquidation Authority

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VI. *Parallel Regimes: Bankruptcy and Dodd-Frank's Orderly Liquidation Authority*

A. Introduction

Following the bankruptcy of Lehman Brothers Holdings Inc. and the government bailout of American International Group (“AIG”), two pivotal events of the 2008 financial crisis,¹ policymakers sought a resolution regime outside of bankruptcy for similarly large, complex financial institutions.² Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-

¹ Scholars differ on the impact that Lehman’s bankruptcy had on the financial crisis. Compare Jeffrey N. Gordon & Christopher Muller, *Confronting Financial Crisis: Dodd-Frank’s Dangers and the Case for a Systemic Emergency Insurance Fund*, 28 YALE J. ON REG. 151, 180 (2011) (“Bankruptcy did not protect the financial system from financial distress; indeed, it heightened it.”), with DAVID SKEEL, *THE NEW FINANCIAL DEAL: UNDERSTANDING THE DODD-FRANK ACT AND ITS (UNINTENDED) CONSEQUENCES* 26 (2011) (refuting “the contention that bankruptcy failed [in the case of Lehman Brothers], and that it is a disorderly and ineffective mechanism for dealing with the financial distress of a financial institution”).

² See *Federal Reserve Perspectives on Financial Regulatory Reform Proposals: Hearing Before the H. Comm. on Fin. Serv.*, 111th Cong. 10 (2009) (statement of Ben S. Bernanke, Chairman, Bd. of Governors of the Fed. Reserve Sys.) (arguing that, following Lehman’s bankruptcy and AIG’s bailout, “there is little doubt that we need a third option between the choices of bankruptcy and bailout for those firms” in the form of a “new resolution regime for non-banks, analogous to the regime currently used by the FDIC for banks”); CHRISTOPHER DODD, *THE RESTORING AMERICAN FINANCIAL STABILITY ACT OF 2010*, S. REP. NO. 111-176, at 4 (2010) (describing an early version of Title II as “giv[ing] the U.S. government a viable alternative to the undesirable choice it faced during the financial crisis between bankruptcy of a large, complex financial company that would disrupt markets and damage the economy, and bailout of such financial company that would expose taxpayers to losses and undermine market discipline”); Hollace T. Cohen, *Orderly Liquidation Authority: A New Insolvency Regime to Address Systemic Risk*, 45 U. RICH. L. REV. 1143, 1147-48 & nn.32-35 (2011) (describing FDIC Chairman Sheila C. Bair’s advocacy for a new insolvency regime, based on the view that neither traditional bankruptcy proceedings nor federally funded bailouts of large, complex financial institutions was preferable).

Frank Act”),³ which establishes the Orderly Liquidation Authority (“OLA”) to resolve failed, non-bank financial companies,⁴ represents Congress’ “effort to craft an intermediate option between a bankruptcy and a bailout.”⁵

Title II’s OLA extends to the Federal Deposit Insurance Corporation (“FDIC”) the exclusive authority to take charge of “covered financial companies”—troubled, non-bank financial institutions whose failure and resolution under bankruptcy would pose systemic risk⁶—“in a manner substantially similar to the FDIC’s resolution process for depository institutions.”⁷ The OLA displaces ongoing bankruptcy proceedings and prevents any further

³ Pub. L. No. 111-203, 124 Stat. 1376 (2010) (to be codified in scattered sections of U.S.C.).

⁴ The OLA applies only to “covered financial companies.” *See infra* note 6 and accompanying text.

⁵ John C. Coffee, Jr., *Bail-Ins Versus Bail-Outs: Using Contingent Capital to Mitigate Systemic Risk* 31 (Columbia Law Sch. Ctr. for Law & Econ. Studies, Working Paper No. 380, 2010), available at <http://papers.ssrn.com/abstract=1675015>. Although Title II makes several references to bankruptcy, *see, e.g.*, 12 U.S.C.A. § 5388(a) (West 2012) (dismissing ongoing bankruptcy proceedings for covered financial companies under FDIC receivership); *id.* § 5389 (“To the extent possible, the Corporation shall seek to harmonize applicable rules and regulations promulgated under this section with the insolvency laws that would otherwise apply to a covered financial company.”); Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 216, 124 Stat. 1376, 1519 (2010) (ordering a study on the effectiveness of Chapters 7 and 11 in achieving orderly resolution of financial institutions), the Title’s statutory purpose does not explicitly mention bankruptcy. *See* 12 U.S.C.A. § 5384(a) (“It is the purpose of this subchapter to provide the necessary authority to liquidate failing financial companies that pose a significant risk to the financial stability of the United States in a manner that mitigates such risk and minimizes moral hazard.”)

⁶ *See* 12 U.S.C.A. §§ 5381(a)(8), 5383(b) (defining “covered financial company” as a non-bank financial institution in danger of default whose failure and resolution under existing law “would have serious adverse effects on financial stability in the United States”).

⁷ *Systemically Important Institutions and the Issue of “Too Big to Fail” Before the Fin. Crisis Inquiry Comm’n*, 111th Cong. 18 (2010) (statement of Sheila C. Bair, Chairman, Fed. Deposit Ins. Corp.), available at http://fcic-static.law.stanford.edu/cdn_media/fcic-testimony/2010-0902-Bair.pdf.

bankruptcies—or taxpayer-funded bailouts—of the companies throughout the receivership.⁸

Under Title II, if the Secretary of the Treasury determines that a troubled firm is a “covered financial company”⁹ and such determination is supported by a two-thirds vote of the Federal Reserve Board and FDIC,¹⁰ the Secretary must provide the firm a chance to acquiesce to FDIC receivership.¹¹ Absent such consent, the Treasury must petition the U.S. District Court for the District of Columbia to appoint the FDIC as receiver.¹² Title II limits judicial review to whether the Secretary’s determination was “arbitrary and capricious” and establishes FDIC receivership by default if the Court does not respond within 24 hours.¹³ Appeals are limited to the same standard of review.¹⁴

Once appointed as receiver, the FDIC has a mandate to liquidate the covered financial company,¹⁵ though it can also transfer assets to a temporary “bridge financial company” in a process that may mimic certain aspects of reorganization under Chapter 11 of the

⁸ See 12 U.S.C.A. § 5388(a) (West 2012) (ordering the dismissal of ongoing bankruptcy proceedings with respect to covered financial companies upon the appointment of FDIC as receiver of such companies); *id.* § 5394(a) (prohibiting the use of taxpayer funds to prevent their liquidation).

⁹ See 12 U.S.C.A. § 5381(a)(8) (defining “covered financial company”); *id.* § 5383(b) (describing the Secretary’s determination of such a company).

¹⁰ See 12 U.S.C.A. § 5383(a)(1)(A) (requiring a recommendation by the Secretary about FDIC receivership to be made “upon” a two-thirds vote of the Federal Reserve and FDIC).

¹¹ See *id.* § 5382(a)(1)(A)(i) (“If the board of directors . . . of the covered financial company acquiesces or consents to the appointment of the Corporation as receiver, the Secretary shall appoint the Corporation as receiver.”).

¹² See *id.* (describing the petition process to the U.S. District Court for the District of Columbia absent the financial company’s consent).

¹³ See *id.* § 5382(a)(1)(A)(iv)-(v) (limiting the District Court’s scope of review to whether the FDIC determination that the covered financial is “in default or in danger of default and satisfies the definition of a financial company” was arbitrary and capricious, and requiring default approval after 24 hours).

¹⁴ See *id.* § 5382(a)(2) (describing the scope of review for appeals to higher courts).

¹⁵ See *id.* § 5394(a) (West 2012) (“All financial companies put into receivership under this subchapter shall be liquidated.”).

Bankruptcy Code.¹⁶ In theory, much of the work of the OLA will happen preemptively, both by the FDIC in performing due diligence on financial companies, and by financial companies in writing “living wills” that anticipate the possibility of liquidation.¹⁷ Finally, specific Title II provisions address the handling of insurance companies and broker-dealers, which are outside the scope of this article.¹⁸

The differences between bankruptcy and FDIC receivership are stark.¹⁹ Whereas the OLA mandates that the FDIC liquidate covered financial companies,²⁰ the Bankruptcy Code allows for troubled institutions to reorganize and pay off creditors with future earnings.²¹ Furthermore, while the OLA restricts judicial oversight and proceeds under the FDIC’s discretion, bankruptcy “relies on negotiations between the debtor’s managers and its creditors . . . with clear rules and opportunities for judicial review throughout the

¹⁶ See *id.* § 5390(h)(1)(B) (authorizing bridge financial companies, at the FDIC’s discretion, to assume liabilities and purchase assets of covered financial companies, and to “perform any other temporary function which the Corporation may, in its discretion, prescribe in accordance with this section”); SKEEL, *supra* note 1, at 149 (“By picking and choosing which assets and liabilities to transfer to the bridge company, and subsequently merging it with another firm or selling stock to investors, the FDIC could achieve a de facto reorganization.”).

¹⁷ These provisions are contained in other sections of Dodd-Frank. See Fed. Deposit Ins. Corp., *The Orderly Liquidation of Lehman Brothers Holdings Inc. under the Dodd-Frank Act*, 5 FDIC Q., no. 2, 2011 at 31, 40, available at http://www.fdic.gov/bank/analytical/quarterly/2011_vol5_2/Article2.pdf (“Title I of the Dodd-Frank Act significantly enhances regulators’ ability to conduct advance resolution planning in respect of systemically important financial institutions through a variety of mechanisms, including heightened supervisory authority and the resolution plans, or living wills, required under section 165(d) . . .”).

¹⁸ See 12 U.S.C.A. § 5383(e) (prescribing rules for treatment of insurance companies); *id.* § 5385 (prescribing rules for orderly liquidation of covered brokers and dealers).

¹⁹ See Cohen, *supra* note 2, at 1144 (“The rights of creditors, equity security holders, and counterparties of the covered financial company [under Title II] vary significantly from those under the Bankruptcy Code.”).

²⁰ See 12 U.S.C.A. § 5394(a) (“All financial companies put into receivership under this subchapter shall be liquidated.”).

²¹ See NATHALIE MARTIN, *THE GLANNON GUIDE TO BANKRUPTCY* 27 (3d ed. 2011) (“The general idea [of Chapter 11] . . . is that the debtor will repay a portion of its debts over time from its future operations”).

process.”²² Deciding which of these two insolvency regimes to apply, in some cases, turns on a bright-line test for whether a company receives eight-five percent of its revenues from financial activities.²³

This article examines the OLA’s position, as an alternative resolution regime, alongside bankruptcy. Critics of the OLA have expressed concerns about the divergent paths of bankruptcy and the OLA, which this article addresses in Part B.²⁴ These concerns are divided roughly into two categories: concerns about (1) mandatory liquidation and (2) judicial oversight and notice.²⁵ The latter category includes a Constitutional dimension.²⁶ Part C allows the FDIC a “response” via its own comparisons of the OLA with bankruptcy.²⁷ Additionally, this section considers a recent FDIC report contemplating what the Lehman bankruptcy would have looked like under the OLA.²⁸ In Part D, the article describes the FDIC’s recent Final Rule clarifying its receivership role, which responds to several bankruptcy-related concerns.²⁹ Finally, in Part E, the article offers a conclusion as to how the two insolvency regimes “harmonize,” as mandated by Title II,³⁰ and whether the Final Rule is a note of harmony or discord.³¹

²² SKEEL, *supra* note 1, at 122; *see also* Cohen, *supra* note 2, at 1149-50 (contrasting the “minimal” judicial oversight under Title II with broader judicial involvement under the Bankruptcy Code).

²³ FDIC receivership extends to bank holding companies, companies the Financial Stability Oversight Committee has deemed “systemically important non-bank financial institutions,” and companies “predominantly engaged” in financial activities. 12 U.S.C. § 5381(a)(11); Stephen J. Lubben, *Financial Institutions in Bankruptcy*, 34 SEATTLE U. L. REV. 1259, 1268-69 (2011). Companies that earn less than 85% of revenue from financial activities are not “predominantly engaged” in financial activities. 12 U.S.C.A. § 5381(b) (“[N]o company shall be deemed to be predominantly engaged in activities . . . financial in nature or incidental thereto. . . if the consolidated revenues of such company from such activities constitute less than 85 percent of . . . total consolidated revenues . . .”).

²⁴ *See infra* Part B.

²⁵ *See infra* Part B.

²⁶ *See, e.g., infra* notes 50-51 and accompanying text.

²⁷ *See infra* Part C.

²⁸ *See infra* notes 56-66 and accompanying text.

²⁹ *See infra* Part D.

³⁰ *See* 12 U.S.C.A. § 5389 (“To the extent possible, the Corporation shall seek to harmonize applicable rules and regulations promulgated under this

B. Bankruptcy-Based Critiques of OLA

1. Liquidation Versus Reorganization

A principal bankruptcy-based critique of the OLA is that, unlike bankruptcy's dual options of liquidation and reorganization, the latter option allowing the corporation to survive,³² the OLA exclusively contemplates liquidation.³³ Other provisions in the Dodd-Frank Act further narrow Title II's focus on liquidation by limiting the ability of the FDIC and the Federal Reserve Board to extend assistance to financial institutions outside of liquidation.³⁴ David Skeel, a prominent bankruptcy scholar and OLA critic, argues that this "bias toward liquidation marks a radical change in American insolvency regulation," which historically has sought to preserve value for both debtors and creditors by providing troubled firms a path toward continued, profitable existence.³⁵ The upshot of the OLA's preference for liquidation, Skeel argues, is an "increase[] [in] the potential for value to be squandered."³⁶

Corporate law scholar John Coffee, Jr. argues that the OLA subverts the long accepted role of the central bank, articulated by Walter Bagehot in 1873, by categorically choosing liquidation over

section with the insolvency laws that would otherwise apply to a covered financial company.")

³¹ See *infra* Part E.

³² See WALTER W. MILLER, JR., *BANKRUPTCY* 7 (2003) ("The Code provides creditors with two basic remedies: payment from assets (liquidation), or payment from future income (reorganization).").

³³ See 12 U.S.C.A. § 5394(a) ("All financial companies put into receivership under this subchapter shall be liquidated.").

³⁴ See *id.* § 343 (limiting the ability of the Federal Reserve Board to provide emergency assistance to specific companies presently in, or seeking to avoid, bankruptcy or FDIC receivership under the OLA); *id.* § 5392(a) ("Funds for the orderly liquidation of any covered financial company under this subchapter shall only be provided as specified under this subchapter."); Coffee, *supra* note 5, at 31 & n.59 ("Although the FDIC can advance funds to keep [a failing non-bank] afloat until the liquidation is completed, neither the FDIC nor the [Federal Reserve Board] can advance funds to a specific company to enable it to avoid insolvency. Thus, the Dodd-Frank Act makes FDIC receivership the exclusive route by which such a firm can receive funds from these agencies.").

³⁵ See SKEEL, *supra* note 1, at 150.

³⁶ See *id.*

reorganization.³⁷ Rather than separating firms that are insolvent (and letting them fail) from those that are merely illiquid (and allowing them access to funds in order to prevent a panic), the OLA effectively ensures that the only firms receiving assistance are those that are “under the death sentence of liquidation.”³⁸ Thus, Coffee argues, the Dodd-Frank Act has converted the Federal Reserve Board, the central bank of the United States, from a “lender of last resort” to a “financial undertaker.”³⁹ The upshot, Coffee suggests, is “unnecessary liquidations” that could have been prevented by extending credit to illiquid firms before they became insolvent.⁴⁰

In order to avoid the “death sentence” of FDIC receivership, bankruptcy scholar Stephen J. Lubben argues that firms that do not automatically qualify as “covered financial companies” have an incentive to “fragment” their financial activities so that less than eighty-five percent of their revenues are financial in nature.⁴¹ Lubben argues that the bright-line eighty-five percent test may lead to some companies being subject to FDIC receivership on the basis of one quarter’s report,⁴² while others engage in regulatory arbitrage knowing that they are below the eighty-five percent threshold.⁴³ The resulting uncertainty, Lubben argues, will lead to “systemic risk” and represents a missed opportunity to craft a “single forum,” whether in bankruptcy or in the OLA, “for resolving financial distress.”⁴⁴

³⁷ See Coffee, *supra* note 5, at 30 (“The Dodd-Frank Act appears to turn Bagehot’s advice on its head.”)

³⁸ *Id.*

³⁹ See *id.*

⁴⁰ See *id.* at 31-32.

⁴¹ See 12 U.S.C.A. § 5381(b) (West 2012) (“[N]o company shall be deemed to be predominantly engaged in activities . . . financial in nature or incidental thereto. . . if the consolidated revenues of such company from such activities constitute less than 85 percent of . . . total consolidated revenues”); Lubben, *supra* note 23, at 1272 (arguing there will be “some temptations to fragment the financial activities of a firm” in order to avoid FDIC receivership).

⁴² See Lubben, *supra* note 23, at 1272 (arguing that firms “near the margin” will fall “above or below the 85% mark . . . from quarter to quarter”).

⁴³ See *id.* at 1275 (“What if Apple decided to run what amounted to a technology-focused hedge fund out of an unincorporated division of the parent company?”).

⁴⁴ See *id.* at 1278. Lubben does not advocate for either regime but argues Congress should have “the courage to pick one.” For a proposal to address the needs of large financial institutions under the Bankruptcy Code, see

Skeel echoes Lubben's concern over what Skeel deems an "ad hoc, unpredictable insolvency process" where "no one knows for sure who is subject to it."⁴⁵ Whereas Chapter 11 typically allows directors, as debtors in possession, to be their own masters of the resolution process and offers shareholders a chance to retain assets or ownership, FDIC receivership "dispenses with these carrots" and thus provides no incentive for a quick resolution.⁴⁶ By contrast, Skeel argues, Title II may encourage companies to make "a potential resolution look as messy as possible in the hope of securing a bailout or persuading regulators to delay intervention"—outcomes Title II seeks to avoid.⁴⁷

2. Judicial Review and Notice

Another principal critique of the OLA, as it relates to bankruptcy, is that the OLA has comparably insufficient judicial review and notice—in other words, that it lacks due process.⁴⁸ As noted in Part A, the OLA prescribes limited judicial review and notice (e.g. requiring a court to approve or deny FDIC receivership within 24 hours of the Secretary's request) and little or no involvement by creditors.⁴⁹

Skeel notes that if regulators decide to take over a financial company, an administrative decision over which the Treasury, FDIC, and Federal Reserve have significant discretion, "it will be essentially impossible for the company to resist, since the company is given almost no time and no basis for resisting—in violation of the

Thomas H. Jackson, *Bankruptcy Code Chapter 14: A Proposal*, in THOMAS H. JACKSON, KENNETH E. SCOTT, KIMBERLY ANNE SUMME & JOHN B. TAYLOR, *RESOLUTION OF FAILED FINANCIAL INSTITUTIONS: ORDERLY LIQUIDATION AUTHORITY AND A NEW CHAPTER 14*, at 2-1, 2-3 to -5 (2011), available at <http://media.hoover.org/documents/Resolution-Project-Booklet-4-11.pdf> (proposing "Chapter 14," which would "provide a new bankruptcy process . . . for the liquidation or reorganization" of financial institutions with at least \$100 billion in assets).

⁴⁵ SKEEL, *supra* note 1, at 152.

⁴⁶ *See id.* at 140-41.

⁴⁷ *See id.* at 141. For the proposition that Title II seeks to avoid these outcomes, see *supra* notes 1-5 and accompanying text.

⁴⁸ *See, e.g.*, SKEEL, *supra* note 1, at 152 (arguing that Title II violates due process).

⁴⁹ *See supra* notes 9-14 and accompanying text.

ordinary right to due process.”⁵⁰ Other commentators have raised similar concerns over due process.⁵¹

C. FDIC Response

The FDIC has not remained silent on the question of bankruptcy versus FDIC receivership.⁵² Prior to the passage of Title II, then-FDIC Chairman Sheila C. Bair argued bankruptcy’s deficiencies warranted an alternative resolution regime.⁵³ FDIC officers have made public comments on the OLA’s interaction with, and distinctions from, bankruptcy.⁵⁴ In its July 15, 2011, Final Rule, discussed in Section IV, the Corporation responds to several bankruptcy-based critiques.⁵⁵ In *The Orderly Liquidation of Lehman*

⁵⁰ SKEEL, *supra* note 1, at 152.

⁵¹ See, e.g., Kenneth E. Scott, *Dodd-Frank: Resolution or Expropriation?*, in RESOLUTION OF FAILED FINANCIAL INSTITUTIONS: ORDERLY LIQUIDATION AUTHORITY AND A NEW CHAPTER 14, *supra* note 44, at 4-1, 4-2 to -3 (arguing Title II “squeezes due process down to the vanishing point,” in part because pre-receivership judicial review is “designedly just about meaningless” and post-receivership review is “limited to the same one-sided record”).

⁵² See *infra* notes 53-57 and accompanying text.

⁵³ See *Regulation and Resolving Institutions Considered “Too Big to Fail” Before the S. Comm. on Banking, Hous. & Urban Affairs*, 111th Cong. 51-52 (2009) [hereinafter *Bair 2009 Statement*] (statement of Sheila C. Bair, Chairman, Fed. Deposit Ins. Corp.) (describing bankruptcy as a “very messy process for financial organizations” due in part to the Code’s automatic stay on most creditor claims except for financial contracts, and calling for an alternative resolution authority “similar to that which exists for FDIC insured banks”).

⁵⁴ See, e.g., R. Christian Bruce, *Krimminger’s List: A Little More Chapter 11, a Little Less Title II*, 97 *Banking Rep.* (BNA) 1030 (Dec. 13, 2011) (quoting FDIC General Counsel Michael Krimminger as saying the FDIC “would certainly support having improvements to the Bankruptcy Code to make it much more likely we would never have to use the last option of a Title II resolution”); Thecla Fabian, *FDIC Uses Lehman Failure as Case Study in Orderly Liquidation Versus Bankruptcy*, 96 *Banking Rep.* (BNA) 763 (Apr. 26, 2011) (quoting then FDIC Chairman Sheila Bair as saying bankruptcy, unlike the OLA process, “is not specifically designed to deal with the failure of a financial entity”).

⁵⁵ See Certain Orderly Liquidation Authority Provisions under Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act, 76 *Fed. Reg.* 41,626, 41,627-38 (July 15, 2011) (codified at 12 C.F.R. pt. 380)

Brothers Holdings Inc. under the Dodd-Frank Act, the FDIC claims that, had Lehman Brothers been liquidated under the OLA rather than under Chapter 7 of the Bankruptcy Code, unsecured creditors would have received 97 cents on the dollar, rather than an estimated 21 cents on the dollar.⁵⁶

The FDIC attributes this hypothetical success to differences between the OLA and bankruptcy.⁵⁷ Unlike the Bankruptcy Code, the OLA requires that companies and the FDIC plan for liquidation *ex ante*, via a “living will” and the FDIC’s due diligence.⁵⁸ Upon liquidation, the OLA allows the FDIC to set up a structured bidding process that benefits from this advance planning.⁵⁹ Further, the OLA provides for the transfer of “qualified financial contracts,” such as derivatives, to an acquirer or bridge financial company.⁶⁰ Upon such a transfer, the OLA prohibits counterparties from terminating these contracts, thus preserving the value of the new entity.⁶¹ This is in contrast to the Bankruptcy Code’s exemption of qualified financial contracts from its automatic stay provisions, which generally prevent counterparties’ termination of contracts.⁶² The OLA also allows the FDIC to borrow money from the Department of the Treasury in order to facilitate quick payment to creditors upon resolution.⁶³ By

(responding to several bankruptcy-based criticisms of the OLA, and comparing and contrasting the two insolvency regimes).

⁵⁶ See Federal Deposit Insurance Corporation, *supra* note 17, at 34, 48. The FDIC argues that, had it taken over Lehman Brothers as receiver, it would have been able to sell Lehman’s assets at a \$40 billion loss, or \$5 billion more than the total value of equity and subordinated debt, leaving the remaining unsecured creditors with 97 cents on the dollar.

⁵⁷ See *id.* at 35-48 (contrasting bankruptcy with the OLA and ultimately concluding that creditors would have received greater value under the OLA than under bankruptcy, in the case of Lehman Brothers).

⁵⁸ See *id.* at 40 (describing Dodd-Frank’s provisions for advance planning).

⁵⁹ See *id.* at 41 (describing Dodd-Frank’s provisions for structured bidding).

⁶⁰ See *id.* at 38 (describing the transfer of financial contracts to an acquiring investor or bridge financial company).

⁶¹ See *id.* (explaining that, upon the FDIC’s transfer of qualified financial contracts to an acquirer or bridge financial company, Title I prohibits counterparties from terminating or netting out such contracts).

⁶² See 11 U.S.C. §§ 555, 556, 559, 560 (2006) (exempting securities contracts, commodities contracts, repurchase agreements, and swap agreements from the automatic stay provisions).

⁶³ See Federal Deposit Insurance Corporation, *supra* note 17, at 38-40 (comparing bankruptcy’s debtor-in-possession financing to the FDIC’s ability to borrow funds from the Treasury to, *inter alia*, pay creditors).

contrast, a company reorganizing under Chapter 11 must first receive court approval before securing financing.⁶⁴ More broadly, the FDIC argues that the mere presence of the OLA will instill confidence in investors and thus prevent the type of “run on the bank” that occurred following Lehman’s collapse.⁶⁵ Several critics have described this assessment as overly optimistic, and the FDIC’s general counsel has responded with a defense of its findings.⁶⁶

D. New Rules: Clarifications on FDIC’s Receivership Role

On July 15, 2011, the FDIC released a Final Rule clarifying its receivership role under the OLA.⁶⁷ In it, the FDIC responds to comments urging “the greatest possible harmony with bankruptcy” by either explaining why the FDIC has not changed a rule to conform to bankruptcy or how a rule change has actually conformed to bankruptcy.⁶⁸ Perhaps the most significant rule announced addresses section 210(s), the provision of Title II authorizing the FDIC to recoup up to two years’ compensation from directors who are “substantially responsible” for the failure of a covered financial company.⁶⁹

⁶⁴ See *id.* at 38 (“Although the Bankruptcy Code provides for a debtor company to obtain [debtor-in-possession] financing with court approval, there are no assurances that the court will approve the DIP financing or that a debtor company will be able to obtain sufficient—or any—funding.”).

⁶⁵ See *id.* at 48 (arguing “the very availability” of the OLA would prevent a bank run).

⁶⁶ Compare Simon Johnson, *The Problem with the F.D.I.C.’s Powers*, *ECONOMIX* (Apr. 28, 2011, 5:00 AM), <http://economix.blogs.nytimes.com/2011/04/28/the-problem-with-the-f-d-i-c-s-powers> (critiquing FDIC report), and Stephen J. Lubben, *The F.D.I.C.’s Lehman Fantasy*, *DEALBOOK* (Apr. 29, 2011, 10:36 AM), <http://dealbook.nytimes.com/2011/04/29/the-f-d-i-c-s-lehman-fantasy> (same), with Michael H. Krimminger, *No Fantasy in F.D.I.C. Lehman Paper*, *DEALBOOK* (May 3, 2011, 9:58 AM), <http://dealbook.nytimes.com/2011/05/03/no-fantasy-in-f-d-i-c-lehman-paper> (responding to criticism).

⁶⁷ Certain Orderly Liquidation Authority Provisions under Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act, 76 Fed. Reg. 41,626 (July 15, 2011) (codified at 12 C.F.R. pt. 380).

⁶⁸ See *id.* at 41,627 (summarizing bankruptcy-based comments).

⁶⁹ See 12 U.S.C.A. § 5390(s) (West 2012) (“The Corporation, as receiver of a covered financial company, may recover from any current or former

Under 12 C.F.R. § 380.7, a director is “substantially responsible” if she “failed to conduct . . . her responsibilities with the degree of skill and care an ordinarily prudent person in a like position would exercise under similar circumstances,” resulting in a loss that “materially contributed” to the company’s failure—in other words, if she was negligent.⁷⁰ The Final Rule clarifies that the burden of proof is on the director to show that she exercised business judgment, regardless of state rules.⁷¹ Additionally, in limited circumstances, a director will be presumed to be substantially responsible.⁷² The FDIC intends to pursue recoupment claims through the court system.⁷³ While there is no direct parallel to the Bankruptcy Code, a bankruptcy trustee can “avoid” (i.e. reclaim for the bankruptcy estate) preferential and fraudulent transfers, including employment contracts to insiders that occurred prior to the bankruptcy petition.⁷⁴ Title II grants the FDIC analogous powers to avoid preferential and fraudulent transfers by covered companies.⁷⁵

senior executive or director substantially responsible for the failed condition of the covered financial company any compensation received during the 2-year period preceding the date on which the Corporation was appointed as the receiver of the covered financial company, except that, in the case of fraud, no time limit shall apply.”)

⁷⁰ See Orderly Liquidation Authority, 12 C.F.R. § 380.7 (2011) (describing standard); Certain Orderly Liquidation Authority Provisions under Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act, 76 Fed. Reg. at 41,631 (clarifying the standard is negligence).

⁷¹ See Certain Orderly Liquidation Authority Provisions under Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act, 76 Fed. Reg. at 41,631 (“State ‘business judgment rules’ . . . will not shift the burden of proof to the FDIC or increase the standard of care under which the FDIC as receiver may recoup compensation.”).

⁷² See 12 C.F.R. § 380.7 (listing circumstances under which a director will be presumed to be substantially responsible for a company’s failure, including serving as chairman of the board of directors, chief executive officer, president, chief financial officer, or “in any other similar role” with certain company-wide responsibilities).

⁷³ See Certain Orderly Liquidation Authority Provisions under Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act, 76 Fed. Reg. at 41,631.

⁷⁴ See 11 U.S.C. § 547 (2006) (allowing trustees to avoid preferential transfers); *id.* § 548 (allowing trustees to avoid fraudulent transfers).

⁷⁵ See 12 U.S.C.A. § 5390(a)(11) (West 2012) (describing FDIC’s ability to avoid preferential and fraudulent transfers).

The Final Rule changes the method for valuation of secured claims to conform to bankruptcy's method of "disposition or use."⁷⁶ Several clarifications to the method of prioritizing claims conform to bankruptcy:⁷⁷ specifically, the FDIC has adopted bankruptcy's method of adjusting for inflation⁷⁸ and respecting enforceable contractual subordination agreements.⁷⁹ In other areas, the FDIC has declined to follow the Bankruptcy Code.⁸⁰

E. Conclusion

Title II's Orderly Liquidation Authority addresses several of the problems of large, complex financial institutions entering bankruptcy—principally, the inconsistent treatment of financial and non-financial contracts,⁸¹ and the potential for a long resolution

⁷⁶ See 12 C.F.R. § 380.50(b) (determining valuation of secured claims "in light of the purpose of the valuation and of the proposed disposition or use of such property and at the time of such proposed disposition or use").

⁷⁷ See Certain Orderly Liquidation Authority Provisions under Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act, 76 Fed. Reg. at 41,632 (describing consistencies between Title II and the Bankruptcy Code with regard to adjusting payments for inflation and respecting enforceable contractual subordination agreements).

⁷⁸ See 12 C.F.R. § 380.21(b) (adjusting for inflation "in the same manner" as under 11 U.S.C. § 507(a)(1)(4)).

⁷⁹ See *id.* § 380.21(c) ("A subordination agreement is enforceable with respect to the priority of payment of allowed claims with any creditor class . . . to the extent that such agreement is enforceable under applicable non-insolvency law.")

⁸⁰ See, e.g., Certain Orderly Liquidation Authority Provisions under Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act, 76 Fed. Reg. at 41,633-36 (declining to follow bankruptcy's "setoff rule," post-insolvency interest rate, or late-filed claims procedure).

⁸¹ See Darrell Duffie & David Skeel, *A Dialogue on the Costs and Benefits of Automatic Stays for Derivatives and Repurchase Agreements* 4-5 (Univ. of Pa. Inst. for Law & Econ., Research Paper No. 12-02, 2012), available at <http://ssrn.com/abstract=1982095> (contrasting the Bankruptcy Code, which exempts qualified financial contracts from its automatic stay provisions, with Title II, which explicitly provides for a 24 hour stay of such contracts, and further explaining that, under Title II, these contracts "may have been transferred to a bridge financial institution or another acquirer of some portion of the debtor's business, without a right by the counterparty to terminate" before the passage of 24 hours). Compare 11 U.S.C. §§ 555, 556, 559, 560 (2006) (exempting securities contracts, commodities contracts, repurchase agreements, and swap agreements from the automatic stay

process.⁸² As an expert in banking and finance, the FDIC may be able to plan for a more efficient resolution than the managers of bankrupt companies who would typically become “debtors in possession” under Chapter 11 of the Bankruptcy Code.⁸³ Despite these aspirations, Congress’s decision to address these problems by creating a parallel regime, abandons bankruptcy’s incentives for debtors and creditors to arrive at mutually beneficial solutions under clear judicial guidelines and introduces uncertainty over which regime will apply.⁸⁴ The Final Rule’s recoupment provision is a promising step, because it gives directors further incentive to avoid liquidation.⁸⁵ There are many convincing arguments as to why we should maintain one regime under bankruptcy.⁸⁶ However, if we are to have two regimes, the FDIC should continue to look to bankruptcy in devising clear guidelines that protect both debtors and creditors.

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provisions), *with* 12 U.S.C.A. § 5390(a)(9) (permitting the FDIC to transfer qualified financial contracts from covered financial institutions to solvent financial institutions, including bridge financial companies), *and id.* § 5390(a)(10)(B)(i) (prohibiting counterparties from terminating, liquidating, or netting qualified financial contracts for 24 hours “solely by reason of or incidental to the appointment . . . of the Corporation as receiver”).

⁸² *See Bair 2009 Statement, supra* note 53, at 51 (arguing FDIC receivership would provide a more efficient resolution than bankruptcy proceedings, which investors view as often “protracted,” at least under Chapter 11).

⁸³ *See* MARTIN, *supra* note 21, at 279 (“In most Chapter 11 cases, the debtor’s management . . . runs the case.”); *Bair 2009 Statement* at 51-52 (arguing FDIC receivership, in contrast to bankruptcy, would present a “credible and efficient means for resolving a distressed large complex non-bank institution”).

⁸⁴ *See supra* notes 45–46 and accompanying text.

⁸⁵ *But see* DAVIS POLK & WARDWELL LLP, FDIC’S SECOND NOTICE OF PROPOSED RULEMAKING UNDER THE ORDERLY LIQUIDATION AUTHORITY 17 (2011), *available at* [http://www.davispolk.com/files/Publication/7b49d031-5cf1-4e65-a066-](http://www.davispolk.com/files/Publication/7b49d031-5cf1-4e65-a066-00bda7e3546f/Presentation/PublicationAttachment/14cff5ec-bf6e-4c26-95be-2d1d15e81542/032411_OLA_prop_rule_sum.pdf)

[00bda7e3546f/Presentation/PublicationAttachment/14cff5ec-bf6e-4c26-95be-2d1d15e81542/032411_OLA_prop_rule_sum.pdf](http://www.davispolk.com/files/Publication/7b49d031-5cf1-4e65-a066-00bda7e3546f/Presentation/PublicationAttachment/14cff5ec-bf6e-4c26-95be-2d1d15e81542/032411_OLA_prop_rule_sum.pdf) (“Such a rule could encourage a revolving door of senior executives and directors seeking to avoid recoupment, which would undermine, rather than promote, stability.”).

⁸⁶ *See supra* Part B.

⁸⁷ Student, Boston University School of Law (J.D. 2013).