

The Dodd-Frank Act and Insolvency 2.0

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A new tool lets regulators order troubled financial companies into receivership to avoid systemic risk

The financial crisis of 2008, particularly the bailout of the investment firm Bear Stearns and the bankruptcy of Lehman Brothers Holdings, led many policymakers to reach two conclusions: first, that the bankruptcy process lacks the expertise and agility needed to handle the failure of systemically important financial institutions, or SIFIs, such as Bear Stearns and Lehman; and second, that bailouts of financial institutions are unacceptable to voters and are themselves a source of excessive risk-taking.

In the wide-ranging Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, better known as the Dodd-Frank Act, Congress sought to address these issues by creating a new regime for handling the failure or expected failure of a SIFI. This regime, known as Orderly Liquidation Authority, has significant implications for the largest, most interconnected financial companies — both in death and in life.

How It Works

Orderly Liquidation Authority covers a subset of nonbank financial companies: bank holding companies, brokers and dealers registered with the Securities and Exchange Commission, and nonbanks designated for supervision by the Fed on the basis that they are systemically important. (On the latter category, see “Sifting for SIFIs,” *Region Focus*, Second Quarter 2011.) In addition, Orderly Liquidation Authority covers financial subsidiaries of bank holding companies and designated nonbanks, other than insured depository institutions and insurance companies.

Companies in these categories are eligible to be placed into orderly liquidation if certain conditions are met. The Treasury Department must determine that the company is “in default

or in danger of default,” that its resolution under otherwise-applicable law (normally bankruptcy law) “would have serious adverse effects on the financial stability of the United States,” and that “no viable private sector alternative” is available to prevent the company’s default, among other requirements. (See box.) The process for reaching this determination is a complex one: It begins with a recommendation by both the Fed’s Board of Governors and the board of the Federal Deposit Insurance Corp. (FDIC) — unless the company is a broker-dealer or an insurance company, in which case the FDIC’s role in the process is taken instead by the Securities and Exchange Commission or the newly created Federal Insurance Office of the Treasury Department, respectively. Once the designated agencies have made a recommendation (supported by a detailed analysis), the Secretary of the Treasury is required to consult with the President and decide whether the company meets the statute’s requirements for orderly liquidation.

When the Treasury makes such a determination, the company’s board has a limited opportunity to challenge it in federal district court. The only findings of the Treasury Secretary that it can challenge are that it is indeed “in default or in danger of default” and that the company is a financial company as defined by the Act. The court can reject the Treasury Secretary’s decisions on these issues only if it finds them to have been “arbitrary and capricious.” Moreover, if the district court does not act within 24 hours, then the law deems the Treasury Secretary’s determination to have been upheld. (The U.S. District Court for the District of Columbia, the court that will hear companies’ objections, has issued a rule requiring Treasury to give 48 hours’ advance

notice to allow time to prepare; Treasury and the FDIC have objected to this requirement.)

At that point, the company involved is placed into a receivership, with the FDIC as receiver. In the FDIC's words, it is required to use its best efforts "to liquidate the covered financial company in a manner that maximizes the value of the company's assets, minimizes losses, mitigates risk, and minimizes moral hazard." The FDIC's powers over the company as receiver are analogous to its powers over a failing FDIC-insured depository institution. Among other things, it may sell the company or any of its assets; it may create a company to receive the failing company's assets; and it may repudiate contracts and leases to which the financial company is a party.

An Expansion of Discretion

The Orderly Liquidation Authority provisions of the Act attempt to place numerous limits on regulators' discretion, both at the stage of designating a company for orderly liquidation and during the receivership process. The two agencies that recommend designation must agree with one another and must follow criteria set out in the law; the Secretary of the Treasury must also agree that designation is warranted on the basis of the law's criteria for him or her to apply. In carrying out its receivership, the FDIC must ensure that its actions conform to the criteria of maximizing the value of the company's assets, minimizing losses, mitigating risk, and minimizing moral hazard

Still, in comparison with the bankruptcy process, orderly liquidation gives regulators more discretion in the triggering of the process and in its administration. At least in the short term, and perhaps in the longer term, this difference may create a higher level of uncertainty in orderly liquidation than in bankruptcy.

For example, the incentives facing regulators with political accountability are likely to differ from those facing creditors, who have a distinct kind of accountability — their own money is at stake. Creditors have an incentive to provide more funding if they believe the company is a viable going concern and if they believe doing so will be profitable. But the motivations affecting regulators in deciding whether to pursue orderly liquidation are not so clear. In the post-financial-crisis era, will regulators consider it anathema to designate financial companies for orderly liquidation, knowing that an arranged acquisition of a company will almost certainly lead to a more concentrated industry in the hands of the companies left standing? Or, alternatively, will skittish regulators perceive dangers of default and systemic risk everywhere they look?

When the bankruptcy process is underway, it is overseen by trustees and bankruptcy judges with the involvement of the company and its creditors. In orderly liquidation, in contrast, the FDIC is not required to allow any party to be represented in the process. When the FDIC sells a financial company to another entity, for example, it is not required to consult or even give notice to the company's shareholders or

Ordering Orderly Liquidation

If the Secretary of the Treasury receives recommendations from the Fed and another designated regulatory agency that a nonbank financial company should be placed in receivership, the Dodd-Frank Act requires him or her to determine whether certain criteria are met. If so, he or she must pursue receivership for the company (with the consent of the company's directors, if they agree, or by court order, if not).

The statute sets out this list of determinations that the Secretary of the Treasury must make for the process to go forward:

- 1 the financial company is in default or in danger of default;
- 2 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;
- 3 no viable private sector alternative is available to prevent the default of the financial company;
- 4 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 this title is appropriate, given the impact that any action taken under this title would have on financial stability in the United States;
- 5 any [orderly liquidation] 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;
- 6 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
- 7 the company satisfies the definition of a financial company under section 201.

SOURCE: Dodd-Frank Wall Street Reform and Consumer Protection Act, sec. 203(b)

creditors. The same has long been true in the receivership of an insured depository institution.

"Nobody has any standing except for the administrator who makes all the decisions," says Robert Bliss, a business professor at Wake Forest University. "They're going to be making massive decisions by themselves. The Act will have them doing it in a way that is not transparent and not subject to any substantial right of appeal. So it's an enormous amount of power and conflicting objectives."

Paying for Liquidation

Resolving a failing company typically requires an infusion of capital. In the case of failing banks, this may mean the government taking liabilities or bad assets off the institution's balance sheet, or promising sweeteners to an acquirer (such as loss-sharing agreements). When the FDIC resolves a nonbank in the orderly liquidation process, where will this money come from, if needed?

The statute emphatically states that it will not come from taxpayers. ("Taxpayers shall bear no losses from the exercise of any authority under this title," it directs at one point.) This mandate upholds one of the primary purposes of Orderly Liquidation Authority: to put companies and

markets on notice that there will be no government bailouts of “too big to fail” institutions.

Instead, the first source of the funds needed to liquidate a company will be the disposition of the company’s assets. If those funds are not enough, the FDIC is to recover the rest through assessments on other companies — initially on creditors that received preferential treatment during orderly liquidation, and then on other companies in the financial sector (specifically, large bank holding companies and Fed-supervised nonbanks).

During Congress’ consideration of the Act, FDIC Chairman Sheila Bair argued for the creation of a reserve funded by the industry in advance rather than after-the-fact assessments on the industry. She contended that an advance reserve would avoid the pro-cyclical effects of assessments that would tend to hit other financial companies — and perhaps weaken them — during a downturn. Congress opted for the assessment approach, however.

Government money may flow into the process on an interim basis, however. The Act allows the FDIC to borrow from the Treasury Department in connection with a liquidation — for example, to make loans to the company (or a bridge company formed from the company), to guarantee its obligations, or to pay other costs of liquidation. Some observers have questioned whether the use of taxpayer funds to support the financial company, even if it is formally required to be repaid, may signal to markets that the government is likely to back the company further if necessary to get its money back and to avoid potential systemic consequences.

“In a bankruptcy process, there is no presumption that the court is going to put money into the insolvent company; the court doesn’t have any money,” says Bliss. “In the administrative process, the FDIC does have access to funds. There is, therefore, a presumption that the government is going to back anything that they put into a bridge bank. You have a potential for a much bigger commitment in the administrative process.”

Treatment of Derivatives and Repos

One area where Orderly Liquidation Authority does draw upon existing bankruptcy law is in its treatment of so-called “qualified financial contracts” — primarily derivatives and repos. Federal bankruptcy law gives counterparties to these contracts special treatment; most notably, they are free to close out the contracts with the bankrupt company,

overriding the automatic stay in bankruptcy and normal bankruptcy preference rules. This special treatment has been viewed as a means of averting the systemic risk that could be created by the default of derivatives counterparties.

A counterparty in the context of an orderly liquidation enjoys the same special treatment, but with an exception: It cannot exercise those rights if the FDIC transfers the qualified financial contract to a private acquirer or a newly created bridge company within one day from the start of the receivership. This one-day automatic stay gives the FDIC the opportunity to avoid close-outs of qualified financial contracts if they would be problematic to the institution.

As a policy matter, the desirability of special treatment for counterparties to qualified financial contracts — in both bankruptcy and orderly liquidation — has been criticized by some scholars. At a workshop on financial firm bankruptcy in July, co-sponsored by the Richmond Fed and the Philadelphia Fed, several business and law professors argued against the special treatment. David Skeel of the University of Pennsylvania Law School, Franklin Edwards of the Columbia University Graduate School of Business, and Douglas Diamond of the University of Chicago Booth School of Business contended that it reduces counterparties’ incentives to investigate risks (since they have, in effect, a priority claim on the company’s assets), that it leads to excessive use of derivatives (by making them cheaper relative to debt), and that it contributes to runs on the troubled financial company.

Waiting For A Stress Test

The Treasury Secretary has not yet placed any nonbank financial companies in orderly liquidation, so there is still much to be learned about how it will operate in practice and how effective it will be. Indeed, some of the regulations relevant to orderly liquidation are still being written. The ideal, though perhaps unlikely, outcome is that it will never need to be used. Some of its more severe provisions — from the perspective of directors, management, creditors, and equity investors — may have the beneficial effect of encouraging systemically-important companies to seek additional capital (even at highly dilutive terms) when they are facing trouble, rather than risk entering the orderly liquidation process. Almost certainly, sooner or later, a crisis in the finances of a major nonbank will shed light on how the existence of Orderly Liquidation Authority shapes the behavior of private parties and regulators alike. **RF**

READINGS

Bliss, Robert R., and George K. Kaufman, “Resolving Large Complex Financial Institutions: The Case for Reorganization.” Paper presented at the Federal Reserve Bank of Cleveland’s “Conference on Resolving Insolvent Large and Complex Financial Institutions,” April 14-15, 2011.

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