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The Orderly Liquidation Authority: The Creditor's Perspective

I. INTRODUCTION

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), has been referred to as "the strongest financial reform[] this country has considered since the Great Depression."[1] This legislation, enacted in response to the near collapse of the U.S. economy in 2008, contains multiple aspects of financial reform.[2] One of Dodd-Frank's overarching purposes is to address systemic fragility in the U.S. economy.[3] As a primary means of achieving this goal, Title II of Dodd-Frank established the Orderly Liquidation Authority (OLA), which will be used to resolve certain failing nonbank financial institutions.[4] A majority of the debate over the OLA relates to the general propriety and effectiveness of Title II to decrease systemic risk and protect taxpayers from future bailouts.[5] However, another important consequence of Title II is its effect on creditors' rights and interests.[6]

This Note addresses how creditors will likely be affected by the provisions in Title II. The Note begins by discussing why financial reform was needed to address systemic risk, and why it was designed to deal with failures among significant nonbank

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1. *See* Press Release, U.S. Dept. of Treasury, Treasury Sec'y Timothy Geithner Remarks on Passage of the Wall Street Reform and Consumer Protection Act (July 15, 2010), www.financialstability.gov/latest/pr_07152010.html.

2. *See* BAIRD WEBEL, CONG. RESEARCH SERV., R41350, THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT: ISSUES AND SUMMARY 2 (2010) (discussing areas of reform in Dodd-Frank, including regulation of derivatives and hedge funds, the creation of the Consumer Financial Protection Bureau, and changes in bank regulation, among others).

3. *See infra* Part IV.A; Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 204(a), 124 Stat. 1376, 1454 (2010) (to be codified at 12 U.S.C. § 5384).

4. Dodd-Frank Act § 204(a) (to be codified at 12 U.S.C. § 5384).

5. *See infra* Part II.B.

6. *See infra* Part IV.

financial institutions.[7] The Note goes on to discuss congressional intent in enacting Title II and argues that protecting creditors' rights was a subordinate concern to protecting the government's and taxpayers' interests.[8] Next, the Note examines Lehman Brothers' bankruptcy and maintains that bankruptcy can still be a viable and preferable option to the OLA.[9] Lastly, the Note explores the differences between Title II provisions and the Bankruptcy Code, illustrating that the Code provisions are generally more concerned with the protection of creditors' rights than Title II.[10] The conclusion is that creditors are less protected under Title II, and that alternative mechanisms, namely the bankruptcy system, would provide creditors with more protection and more equitable outcomes, when companies fail.[11]

II. GOVERNMENT DEBATES ON THE RESPONSE TO THE FINANCIAL CRISIS

A. *An Overview of Proposed Legislation*

In response to the financial crisis, the Treasury Department issued proposals for financial reform, including the creation of a resolution authority, fashioned after the FDIC's authority to resolve failing banks.[12] Both houses of Congress began working on their own reform proposals as well.[13] The House passed the Wall Street Reform and Consumer Protection Act, introduced by Congressman Barney Frank, in December 2009.[14] In May 2010, the Senate passed the Restoring American Financial Stability Act,

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7. *See infra* Part II.A.
8. *See infra* Part II.B.
9. *See infra* Part III.
10. *See infra* Part IV.
11. *See infra* Part V.
12. DEPT. OF TREASURY, FINANCIAL REGULATORY REFORM: A NEW FOUNDATION 8 (2009), *available at* http://www.treasury.gov/initiatives/wsr/Documents/FinalReport_web.pdf.
13. MAYER BROWN LLP, UNDERSTANDING THE NEW FINANCIAL REFORM LEGISLATION: THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT 2 (2010), http://www.mayerbrown.com/publications/article.asp?id=9307&nid=6.
14. Wall Street Reform and Consumer Protection Act of 2009, H.R. 4173, 111th Cong. (2009).

introduced by Senator Chris Dodd.[15] A Joint Conference Committee was convened to reconcile the differences between the bills passed by the two houses, resulting in Dodd-Frank, which was approved by the House on June 30, by the Senate on July 15, and signed into law by President Obama on July 21, 2010.[16]

The resolution system for nonbank financial institutions crafted in Title II, the OLA, was not the only proposed means of dealing with failing Systemically Significant Financial Companies (SSFCs).[17] Other proposals in Congress, such as H.R. 3310, the Consumer Protection and Regulatory Enhancement Act, would resolve SSFCs by creating a new chapter within the Bankruptcy Code to specifically deal with SSFCs.[18] Vigorous debate between supporters of the two mechanisms permeates the Congressional Record of Dodd-Frank.[19] This debate highlights some of the significant differences and far-reaching implications of each of the proposed means of dealing with failing financial institutions.[20]

B. *Bankruptcy or Bailout*

1. Congressional Debates

A common theme throughout the congressional debates was whether or not Title II and the OLA will, in practice, be used as a government bailout.[21] Protecting taxpayers from having to pay for more bailouts was a primary concern.[22] Supporters of Title

15. Restoring American Financial Stability Act of 2010, S. 3217, 111th Cong. (2010).

16. MAYER BROWN LLP, *supra* note 13.

17. *See infra* Parts II.A-B.

18. DAVID H. CARPENTER, CONG. RESEARCH SERV., R40928, LEHMAN BROTHERS AND INDYMAC: COMPARING RESOLUTION REGIMES 1 (2009) [hereinafter CARPENTER R40928].

19. *See infra* Part II.B.

20. *See infra* Part II.B.

21. *See, e.g.*, Transcript of Conference Meeting at 55, House-Senate Conference Committee Holds a Meeting on the Wall Street Reform and Consumer Protection Act, 111th Congress (2010) (LEXIS) (referring to the proposed OLA, statement by "Unknown" Congressman that "Where I disagree is that the answer is bailout. The answer should be bankruptcy.").

22. *See, e.g.*, *id.* at 116, ("[T]hese conditions on emergency lending do protect tax payers while preserving a very important tool for dealing with the financial crisis."). In March 2008, the Fed participated in the bailout of the fifth largest U.S. securities

II responded that traditional bankruptcy would still be the primary and preferred means for large financial institutions to unwind, and that the OLA would only be used if the bankruptcy plan was not approved by the institution's regulators.[23] The stated goal was to protect taxpayers, while designating shareholders and management, as "toast."[24] In refuting the bailout accusation, the House Committee on Financial Services countered that there would be no bailouts but rather that the company's management, shareholders, and creditors would pay the price.[25]

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firm, Bear Stearns (Bear), through facilitation of its acquisition by JP Morgan Chase (JP Morgan). The Fed, acting under expanded authority of section 13(3) of the Federal Reserve Act, initially gave a $30 billion discount window loan to JP Morgan to extend a line of credit to Bear. The following weekend, the Fed made a $29 billion ten-year loan to JP Morgan to enable them to acquire Bear. In July 2008, Fannie Mae and Freddie Mac were placed in conservatorship by the Federal Housing Finance Agency. By August 2010, the Treasury bought $145 billion in preferred stock of the two entities, and the Fed and the Treasury bought over $1.6 trillion in debt and mortgage backed securities from them. AIG, the world's largest insurance company, was on the verge of insolvency in September 2008, when the Fed exercised its section 13(3) authority to provide an $85 billion loan in return for preferred stock and warrants convertible to 79.9% ownership in the company. Ben Bernanke, Chairman of the Fed, explained that a reason why AIG was bailed out and Lehman Brothers was not was that "The failure of Lehman Brothers posed risks. But the troubles at Lehman had been well known for some time . . . and investors clearly recognized that the failure of the firm was a significant possibility. Thus, we judged that investors and counterparties had had time to take precautionary measures." FIN. CRISIS INQUIRY COMM'N, GOVERNMENT RESCUES OF "TOO-BIG-TO-FAIL" FINANCIAL INSTITUTIONS 21-26 (2010), *available at* http://c0181567.cdn1.cloudfiles.rackspacecloud.com/2010-08-31%20Preliminary%20Staff%20Report-%20Too%20Big%20To%20Fail%20Institutions.pdf [hereinafter FCIC RESCUES].

23. 156 CONG. REC. S5870 (daily ed. July 15, 2010) (statement of Sen. Mark Warner). *see infra* Part IV.A.

24. 156 CONG. REC. S5870, 5882 (statement of Sen. Mark Warner) ("Our goal was twofold: One, taxpayers should never have to bear the risk; and, two, if an entity goes into liquidation, it will not come out. Liquidation or resolution is not an attempt to stand up an institution. But we wanted to make clear to shareholders, to management, if you go into resolution, you are toast . . . .").

25. *Wall Street Reform and Consumer Protection Act: Myth vs. Facts*, OFFICE OF SPEAKER NANCY PELOSI (Dec. 9, 2009), http://webcache.googleusercontent.com/custom?q=cache:bxtvGwqZfKcJ:reyes.house.gov/UploadedFiles/Financial_Regulatory_Reform_Myth_QA_1209_new.doc+Myths+v.+Facts+Wall+Street+House&cd=2&hl=en&ct=clnk&gl=us&client=google-csbe ("[T]his is no bailout. . . . These financial institutions will be allowed to fail, but in a way that protects the economy. Under this authority, as a last resort, federal regulators will shut down these institutions that pose a risk to the whole economy. They will fire the managers, fire the executives, wipe out shareholders, sell off the assets, but protect our financial system and taxpayers from collateral damage. For a market to function, those who

Many opponents maintained that the "permanent Wall Street bailout authority" provided for in Dodd-Frank was the wrong course of action.[26] They alleged that Dodd-Frank would allow big businesses to get bigger, posing even greater threats, considering that the safety net of a government bailout would only promote moral hazard.[27] Their solution: reform the Bankruptcy Code to better deal with failing financial institutions.[28] Enhanced bankruptcy procedures would allegedly "create[ ] a level playing field between Wall Street and Main Street and would . . . assure[ ] [that] all parties know the rules of the game ahead of time."[29] Responding to that suggestion, supporters argued that the orderly liquidation was preferable to bankruptcy because it would not allow failing institutions to linger in Chapter 11; rather, failing institutions would fail and be liquidated.[30]

Opponents further argued that the liquidation authority provisions would only create more confusion and uncertainty for market participants.[31] First, they alleged that the government would have discretion to "pick winners and losers" in deciding which firms would be liquidated.[32] Second, the very possibility of two potential options for dealing with SSFCs would result in chaos in the financial markets.[33] They argued that this uncertainty would result in an overall decline in investing and would create confusion for investors, counterparties, and others.[34] Finally, some suggested that the fate of creditors would be subject to discretionary

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invest and lend in that market must know that their money is actually at risk. Institutions and investors must be responsible for their decisions.").

26. *See* 156 CONG. REC. H5223, 5225 (daily ed. June 30, 2010) (statement of Rep. Hensarling).

27. *See id.* at 5226 (statement of Rep. Capito).

28. *Id.* at 5225 (statement of Rep. Hensarling) ("Republicans believe in the Bankruptcy Code. [Although,] [t]here are improvements that need to be made . . . .").

29. *Id.* at 5226 (statement of Rep. Capito).

30. *Id.* at 5225 (statement of Rep. Perlmutter).

31. *See id.* at 5226 (statement of Rep. Garrett) ("[O]ne of the major fundamental flaws of this 2,300-page bill is the section that basically empowers government bureaucrats with so-called resolution authority to basically pick winners and losers again, to continue that failed bailout philosophy.").

32. *See* 156 CONG. REC. H5223, 5226 (Statement of Rep. Garrett).

33. *See id.* at 5225 (Statement of Rep. Garrett).

34. *See id.* (Statement of Rep. Garrett).

government authority, which may be used to unfairly benefit politically favored unsecured creditors.[35]

Opponents also alleged that the bankruptcy system is preferable because it is open, transparent, and has clear rules, precedents, and a judge, which ensure fairness.[36] Additionally, the bankruptcy system does not itself fund the liquidations of debtors.[37] On the other hand, a government resolution may take place "behind closed doors," using discretionary action, and utilizing government funds to pay creditors as it sees fit.[38]

2. Expert Opinion

The May 6, 2009 hearing on regulating and resolving institutions considered "too big to fail" before the Senate Committee on Banking, Housing, and Urban Affairs is also instructive in surmising the purpose and intent of Congress in establishing the OLA.[39] Sheila Bair, Chairman of the FDIC, stated that one of the key solutions to financial reform would be creating a resolution authority to deal with nonbank financial institutions posing systemic risk.[40] However, her proposal had several caveats. She asserted that in order to maintain the credibility of the system, an independent entity, similar to the FDIC, should be created to

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35. *See id.* (statement of Rep. Garrett) ("We've seen the rule of law trampled when the Federal Government bullied into submission secured creditors in the Chrysler situation. In favor of whom? Well, politically favored unsecured creditors."). Although it is outside the scope of this Note, some commentators and parties involved in the bankruptcies of Chrysler and General Motors accused the White House of using political pressure and the media to ultimately subordinate senior priority claims to certain junior claims; Declan McCullough, *Chrysler Bankruptcy Exposes Dirty Politics*, CBSNEWS.COM, May 7, 2009, http://www.cbsnews.com/stories/2009/05/07/politics/otherpeoplesmoney/main4997900.shtml?tag=mncol;lst;4.

36. 156 CONG. REC. H4289, 4289 (daily ed. June 9, 2010) (statement of Rep. Bachus).

37. *Id.* (statement of Rep. Bachus).

38. *Id.* (statement of Rep. Bachus) ("By contrast, the resolution authority proposed by the Democrats would be carried out entirely behind closed doors with no guarantee of adequate stakeholder and protection and without a bankruptcy judge to ensure a fair and equitable outcome.").

39. *See Regulating and Resolving Institutions Considered "Too Big to Fail": Hearing Before the S. Comm. on Banking, Hous., and Urban Affairs*, 111th Cong. (2009) [hereinafter *Regulating*].

40. *See id.* at 3 (statement of Sheila Bair, Chairman, Fed. Deposit Ins. Corp.).

handle resolution of SSFCs in the quickest and cheapest fashion.[41] Additionally, to be effective, a resolution fund paid by assessments on SSFCs needed to be created.[42] Finally, to ensure fairness, provisions needed to be in place for a clear payment priority system."[43] Bair further elaborated that bankruptcy was ineffective to deal with SSFCs because of (1) the inability to set up a bridge financial company (BFC) after filing for bankruptcy;[44] (2) the possibility that firms would discontinue operations during liquidation; and (3) the preferential treatment given to parties with derivatives contracts under the Code.[45]

Gary Stearn, President of the Federal Reserve Bank of Minneapolis, stated that in order to address the too big to fail problem, unsecured creditors would have to be dealt with.[46] He explained that when creditors believe that a financial institution will be bailed out, they are less likely to monitor their investments, and risk-taking will be underpriced.[47] Under-priced risk allows an institution to take on more risk than it can really handle.[48] Rather than let these institutions fail, Congress bailed them out, confirming creditor expectations.[49] Stearn endorsed the policy of explicitly putting the creditors of SSFCs at the risk of loss, to

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41. *See id.* at 4 (statement of Sheila Bair, Chairman, Fed. Deposit Ins. Corp.).

42. *See id.* (statement of Sheila Bair, Chairman, Fed. Deposit Ins. Corp.).

43. *See id.* (statement of Sheila Bair, Chairman, Fed. Deposit Ins. Corp.).

44. Dodd-Frank allows the FDIC to create a bridge financial company, to which it can sell or transfer assets and liabilities of the CFC. MAYER BROWN LLP, *supra* note 13, at 36. A BFC is a beneficial tool for the FDIC because it can be used to hold any part of the CFC worth keeping until it can be sold at a fair price or efficiently liquidated. DAVIS POLK & WARDWELL LLP, SUMMARY OF THE DODD FRANK WALL ST. REFORM AND CONSUMER PROT. ACT 27 (2010), http://www.davispolk.com/files/Publication/7084f9fe-6580-413b-b870-b7c025ed2ecf/Presentation/PublicationAttachment/1d4495c7-0be0-4e9a-ba77-f786fb90464a/070910_Financial_Reform_Summary.pdf.

45. *See Regulating, supra* note 39, at 12 (statement of Sheila Bair, Chairman, Fed. Deposit Ins. Corp.). By contrast, a resolution authority could be empowered to decide whether to accept or reject those derivatives contracts receiving preferential treatment under the Code.

46. *See id.* at 6 (statement of Gary Stearn, Pres., Fed. Reserve Bank of Minneapolis).

47. *See id.* at 4 (statement of Gary Stearn, Pres., Fed. Reserve Bank of Minneapolis).

48. *See id.* (statement of Gary Stearn, Pres., Fed. Reserve Bank of Minneapolis).

49. *See id.* (statement of Gary Stearn, Pres., Fed. Reserve Bank of Minneapolis).

influence their risk-taking behavior from the outset.[50] Both Bair and Stearn advocated a resolution authority as opposed to the bankruptcy process for dealing with SSFCs.[51]

Treasury officials have stated that a resolution authority provides the government with a "stick" by means of the threat of involuntary takeover and liquidation, as opposed to the "carrot" of a bailout.[52] It also provides statutory authority for the government to intervene and commence an orderly wind-up.[53] In response to this assertion, bankruptcy experts, David Skeel and Kenneth Ayotte, noted that while a resolution authority might theoretically have an advantage by allowing for earlier intervention, in the case of failed or failing banks, the FDIC has generally not exercised its authority in that manner.[54] Rather, failing banks have been routinely bailed out to avoid creditor losses and a "contagion effect" among other banks.[55] This predictable FDIC behavior has incentivized investors to lend more to systemically significant institutions rather than those that are not systemically significant, and thus would not be bailed out.[56] Skeel and Ayotte concluded that the effect of an "expanded resolution regime" would be to "institutionaliz[e] the recent bailout policy, . . . [and] spur the continued creation of institutions that are too big and interconnected to fail."[57]

Some suggest that the Bankruptcy Code would not be effective at addressing systemic risk.[58] A resolution authority may

50. *See id.* at 5 (statement of Gary Stearn, Pres., Fed. Reserve Bank of Minneapolis).

51. *See Regulating, supra* note 39, at 6 (statement of Gary Stearn, Pres., Fed. Reserve Bank of Minneapolis and Sheila Bair, Chairman, Fed. Deposit Ins. Corp.).

52. Kenneth Ayotte & David A. Skeel Jr., *Bankruptcy or Bailouts?*, 35 J. CORP. L. 469, 497 (2010).

53. *Id.*

54. *Id.*

55. *Id.*

56. *Id.* at 498.

57. *Id.*

58. *See, e.g.*, FIN. CRISIS INQUIRY COMM'N, STATEMENT OF SHEILA C. BAIR, CHAIRMAN, FEDERAL DEPOSIT INSURANCE CORPORATION, ON SYSTEMICALLY IMPORTANT INSTITUTIONS AND THE ISSUE OF "TOO BIG TO FAIL" BEFORE THE FINANCIAL CRISIS INQUIRY COMMISSION 12-13 (2010), *available at* http://www.fcic.gov/hearings/pdfs/2010-0902-Bair.pdf [hereinafter FCIC BAIR] (explaining that bankruptcy is insufficient for financial institutions because the bankruptcy court has little experience with the resolution of a financial firm, it cannot

effectively address systemic risk, but it may be inadequate to handle complex insolvencies and may not be protective enough of creditors.[59] A third alternative, suggested by Ayotte and Skeel, is a hybrid approach to allow SSFCs to file for bankruptcy, while also providing either rescue loans or a government guarantee for particularly vulnerable assets.[60]

III. LEHMAN BROTHERS: CAN CREDITORS ACTUALLY BENEFIT WHEN A FAILED FINANCIAL INSTITUTION USES THE BANKRUPTCY SYSTEM?

A. *What Happened to Lehman Brothers?*

Lehman Brothers Holdings Inc. (Lehman) was a global financial institution involved in numerous financial activities in forty different countries with multiple subsidiaries and affiliates.[61] Lehman was not bailed out during the financial crisis, but was instead allowed to fail.[62] On September 15, 2008, Lehman filed for bankruptcy.[63] That day, the Dow Jones Industrial Average dropped 504 points, the greatest drop since September 11, 2001.[64]

A closer look at aspects of the Lehman bankruptcy demonstrates some of the real world benefits and detractions of bankruptcy for the creditors involved in the collapse of an SSFC.[65] At least nineteen of Lehman's subsidiaries filed for Chapter 11

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work with the financial regulators prior to the failure, it is unable to provide comparable extensive pre-planning to provide for continuous critical operations, and it cannot ensure timely acquisition of the failed entity with minimal economic impact); *infra* Part IV.B 1.

59. *See* DAVID H. CARPENTER, CONG. RESEARCH SERV., R40530, INSOLVENCY OF SYSTEMICALLY SIGNIFICANT FINANCIAL COMPANIES: BANKRUPTCY VS. CONSERVATORSHIP/RECEIVERSHIP 4, 8 (2009) [hereinafter CARPENTER R40530].

60. *See* Ayotte & Skeel Jr., *supra* note 52, at 496. An in depth analysis of this hybrid alternative is outside the scope of this paper. However, considering that both bankruptcy and a resolution authority appear to have inadequacies when it comes to resolving SSFCs, a mechanism that blends the best attributes of each system in the case of SSFCs may ultimately be the best option. *See infra* Part IV (discussing various pros and cons of bankruptcy and the OLA for dealing with SSFCs with regards to creditors' interests).

61. CARPENTER R40928, *supra* note 18, at 7.

62. *Id.*

63. FCIC RESCUES, *supra* note 22, at 24.

64. *Id.*

65. *See* CARPENTER R40928, *supra* note 18, at 7.

bankruptcy, and over 60,000 claims were filed against Lehman and its subsidiaries (collectively "Debtors").[66] Some debtors were subject to other nation's insolvency laws, some avoided insolvency and have reemerged under new names, and some were acquired by other entities.[67] Lehman's North American businesses were largely acquired by Barclays,[68] and its entities in Asia, the Middle East, and Europe were purchased by a Japanese investment bank, Nomura.[69]

B. Lehman's Bankruptcy Proceeding

The handling of such a complex bankruptcy was facilitated by certain features unique to the Bankruptcy Code.[70] First, 11 U.S.C. § 364's Debtor-in-Possession (DIP) provision allows the debtor to continue operations, so that those Lehman entities with going concern value[71] or those that were not insolvent could successfully recover from the parent company's collapse.[72] By contrast, there are no DIP provisions under the OLA, and furthermore, there is no option to reorganize.[73]

Second, 11 U.S.C. § 363 allowed Barclays to provide Lehman with DIP financing,[74] free and clear of almost all liens and

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66. *Id.* at 7.

67. *Id.* at 8.

68. *Id.* at 16-17. Barclays also provided Lehman $500 million DIP loan so that Lehman could continue operations during the sale. *Id.*

69. Ayotte & Skeel Jr., *supra* note 52, at 481-82.

70. *See infra* Part III.B.

71. A DIP is a debtor who remains in control of the assets and of the reorganization of an entity in a Chapter 11 reorganization. The "ordinary course" of business continues, controlled by the DIP. 11 U.S.C. § 363(c) (2006). "Going concern value" means that a company will be worth more to creditors and shareholders if it reorganizes in Chapter 11 and continues to operate, rather than if it were to liquidate. *See id.* § 1101.

72. CARPENTER R40928, *supra* note 18, at 16-17.

73. *See infra* Part IV.B.8.

74. DIP financing allows the debtor to borrow money from new creditors, giving the new creditors priority over pre-bankruptcy creditors, in order to continue business operations and to attempt to successfully emerge from a Chapter 11 reorganization. Robert R. Bliss & George G. Kaufman, *U.S. Corporate and Bank Insolvency Regimes: A Comparison and Evaluation*, 2 VA. L. & BUS. REV. 143, 162 (2007). Additionally, the DIP can sell assets free and clear of all liens, with distribution proceeds from the sale of the bankruptcy estate's assets going to pay the other creditors. Ayotte & Skeel Jr., *supra* note 52, at 476.

liabilities, and according Barclays priority over pre-petition debts.[75] Such financing is typically not possible outside of bankruptcy.[76]

Third, the automatic stay, often viewed as a debtor protection, also helps to ensure fair treatment of similarly situated creditors by prohibiting a race to the courthouse or an attempt to grab the debtor's assets before other creditors.[77] Particularly where there are a large number of creditors and extensive assets and liabilities at stake, as was the case with Lehman, the automatic stay affords the bankruptcy court and interested parties time to "collect and validate claims, to determine the best way to dispose of assets in an orderly, non-fire sale manner, and to treat all like priority creditors equally. Stays prevent creditor runs and keep contracts in force. . . . This facilitates the coordination of creditor claims."[78] The automatic stay thus ensures better treatment for all creditors.[79]

Many qualified financial contracts (QFCs) are excepted from the automatic stay through the Bankruptcy Code's "safe-harbor protections."[80] Parties to these QFCs are able to

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75. CARPENTER R40928, *supra* note 18, at 16-17. Pre-petition debts are those debts incurred prior to a debtor's bankruptcy filing *See* 11 U.S.C. § 301 (2006).

76. CARPENTER R40928, *supra* note 18, at 16-17.

77. The automatic stay goes into effect at the time of a bankruptcy filing and stops all collection actions against the debtor, the debtor-in-possession, and the property of the estate. 11 U.S.C. § 362. Additionally, secured creditors can file to have the automatic stay lifted, and the burden will be on the DIP to show that the creditor has "adequate protection." *Id.* § 362(g).

78. CARPENTER R40928, *supra* note 18, at 18 (quoting Robert R. Bliss and George G. Kaufman, *U.S. Corporate and Bank Insolvency: An Economic Comparison and Evaluation*, FED. RESERVE BANK OF CHICAGO (2006), *available at* http://www.chicagofed.org/publications/workingpapers/wp2006_01.pdf). The Bankruptcy Code includes explicit rules of priority whereby administrative expenses of the trustee will receive priority payment, followed by secured claims, then general unsecured creditors, with limited exceptions. 11 U.S.C. § 507.

79. *See supra* Part III.B.

80. CARPENTER R40928, *supra* note 18, at 18. The Bankruptcy Code provides for an exception to the automatic stay to liquidate, terminate, or accelerate a securities contract in 11 U.S.C. § 555 and for a commodities contract or forward contract in 11 U.S.C. § 556, for swap agreements in 11 U.S.C. § 560, for repurchase agreements in 11 U.S.C. § 559, and for master netting agreements in 11 U.S.C. § 561. *See infra* Part IV.B.4. QFC exemption from the automatic stay is generally believed to reduce systemic risk. In a fast-paced market, a party to one of these QFCs may need the proceeds from the transaction at issue to pay off other transactions. Thus, prohibiting closing out the contract with the party in bankruptcy could have a ripple effect on the financial market. Norman Carleton, *Bankruptcy and Close-Out Netting of Financial Products,* WASHINGTON OUTSIDE (Apr. 25, 2010, 4:12 PM),

circumvent the stay by affording a unique right to automatically terminate the contract or liquidate the collateral on their claim, once a party has defaulted or filed for bankruptcy – acts generally prohibited by the automatic stay.[81] While utilizing these provisions added to the complexity of the Lehman case and was likely harmful to DIP operations and possibly to other creditors not holding QFCs, the safe-harbors proved advantageous to many holders of QFCs.[82] Additionally, the special treatment of QFCs helped avoid disruption of the financial markets, an unlikely result had certain counterparties not been able to terminate their contracts.[83]

C. *Outcomes for Lehman's Creditors*

The outcome and implications of the Lehman failure and bankruptcy are debatable. Ben Bernanke stated in a *60 Minutes* interview, "[people said] 'Let 'em fail.' You know, 'It's not a problem. The markets will take care of it.' And I think I knew better than that. And Lehman proved that you cannot let a large internationally active firm fail in the middle of a financial crisis."[84] Treasury Secretary Timothy Geithner described the Lehman insolvency as causing "catastrophic damage" to the financial system.[85] Many pointed to the government's failure to intervene and bail out Lehman as the tipping point of the financial crisis.[86]

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http://washingtonoutside.blogspot.com/2010/04/bankruptcy-and-close-out-netting-of.html.

81. CARPENTER R40928, *supra* note 18, at 18-19.

82. *See* CARPENTER R40928, *supra* note 18, at 19-20.

83. *See* Ayotte & Skeel, Jr., *supra* note 52, at 494-95. Lehman used its own modified system for dealing with QFCs, with holders of QFCs that were fully collateralized having the best prospect for recovery. While it was beneficial to give certain holders of QFCs the ability to close-out their contracts, the simultaneous closing out of all QFCs to which Lehman was a party could have also caused chaos in the derivatives market. Either way, the special treatment of QFCs in Lehman's case appears to have been linked to avoiding systemic disruption of the markets. *Id.* at 494-96.

84. *60 Minutes: Ben Bernanke's Greatest Challenge* (CBS television broadcast Mar. 15, 2009), *available at* http://www.cbsnews.com/stories/2009/03/12/60minutes/main4862191.shtml.

85. *This Week with George Stephanopoulos* (ABC television broadcast Mar. 29, 2009), *available at* http://abcnews.go.com/ThisWeek/story?id=7200273&page=4.

86. Ayotte & Skeel, Jr., *supra* note 52, at 470.

Others have argued that the mere prospect that Lehman's failure could have devastating effects on the economy was a self-fulfilling prophecy, noting that the combination of this fear, along with other bank and SSFC failures, were actually all factors to blame, rather than the bankruptcy system itself.[87]

One downside of using bankruptcy in Lehman's case resulted from the complexity of Lehman's operations combined with the adversarial nature of a court proceeding.[88] Numerous claimants and parties of interest disputed and fought over the allocation of Lehman's assets, resulting in delays in the payment of creditors.[89] The impact of the Lehman bankruptcy on its creditors depended in part on the type of investment held by each creditor. For example, holders of commercial paper issued by Lehman (which is usually a safer investment because of its short maturity) became unsecured creditors in the bankruptcy case, with low prospects for substantial returns on their investments, while certain holders of QFCs fared well.[90] Some Lehman entities were able to avoid insolvency or were bought out by other entities, and were presumably able to continue to pay their creditors.[91] Many of the unsecured creditors of liquidated Lehman entities likely received a smaller, pro rata portion of their claims.[92] The payment of many claims was delayed.[93] An assessment of the treatment of creditors in the Lehman bankruptcy appears to result in mixed conclusions as to whether creditors received favorable outcomes.

The use of bankruptcy had two other negative impacts on Lehman's resolution: extensive costs and attorney's fees as well as prolonged litigation.[94] The litigation has been ongoing for over two years, and as of October, 2010, Lehman's bankruptcy has cost around $2 billion, with over 1,300 people having worked on the

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87. Ayotte & Skeel, Jr., *supra* note 52, at 472.
88. CARPENTER R40928, *supra* note 18, at 20.
89. *See id.*
90. Ayotte & Skeel, Jr., *supra* note 52, at 489; *See infra* Part III.B.
91. *See* CARPENTER R40928, *supra* note 18, at 8.
92. *See* 11 U.S.C. § 726 (2006); Ayotte & Skeel, Jr., *supra* note 52, at 495..
93. *See infra* Part III.C.
94. Telis Demos, *Lehman's US Bankruptcy Costs Top $1b,* FIN. TIMES, November 23, 2010, *available at* http://www.ft.com/cms/s/0/39d642a0-f699-11df-b434-00144feab49a.html#axzz1DliOvBcC.

case.[95] However, Bryan Marsal, a member of the restructuring firm working for Lehman, and the chief executive of Lehman's estate responded that, "[t]he strategy of managing and maximi[z]ing the value of assets rather than liquidating quickly at fire sale values takes time and requires fees . . . but it will yield far greater returns for the creditors than all the costs of personnel and legal and professional services combined."[96]

The Bankruptcy Code provisions discussed above clearly worked to the advantage of creditors.[97] However, for creditors, negative aspects of the bankruptcy process include the potential for only partial payment on claims and possible delays in claim payment.[98] The successes and failures of the Lehman bankruptcy indicate that the bankruptcy system is advantageous to creditors in many ways in resolving SSFCs.[99] However, the over-arching question of whether the bankruptcy court is the best forum to resolve issues of such complex financial nature remains. Instead of creating a new resolution mechanism, the better option is perhaps to preserve the aspects of bankruptcy that work, and then make changes to improve the bankruptcy process for failed or failing SSFCs.

IV. TITLE II OF THE DODD FRANK ACT AS IT RELATES TO CREDITORS

A. *Brief Summary of Title II*

The OLA provides in part for the forced liquidation of certain SSFCs, deemed to be failing or on the verge of failing.[100] The Financial Stability Oversight Council (FSOC), established by Dodd-Frank, will identify as SSFCs those nonbank financial companies which it deems to pose a significant threat to the U.S.

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95. *Id.*
96. *Id.*
97. *See supra* Part III.B.
98. *See supra* Part III.C.
99. *See supra* Part III.B.
100. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 203(a)(2), 124 Stat. 1376, 1450-51 (2010) (to be codified at 12 U.S.C. 5383).

economy.[101] These financial companies must be predominantly engaged in activities that are financial in nature, as defined in section 4(k) of the Bank Holding Company Act.[102] Excluded from this provision are Fannie Mae, Freddie Mac, any Federal Home Loan Bank, any Farm Credit System, and any other government entity.[103] SSFCs are required to submit "living wills" or plans for their own rapid and orderly resolution under the Bankruptcy Code.[104] The plan must detail how the resolution will be accomplished without posing systemic risk.[105] If these SSFCs do not submit a credible plan, then the FDIC and the Federal Reserve Board may impose requirements that ultimately lead to the divestiture of assets and operations.[106]

Firms subject to the OLA and thus eligible to be placed in receivership are designated Covered Financial Companies (CFCs).[107] CFCs are those financial companies which are found to meet certain requirements.[108] The FDIC and the Board of Governors must first recommend to the Treasury Secretary that the financial company poses a systemic risk.[109] Two-thirds of the members of the Board of Directors of the FDIC and two-thirds of the members of the Federal Reserve Board of Governors are required to vote to recommend that the Treasury Secretary

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101. *Id.* § 113 (to be codified at 12 U.S.C. § 5323).

102. *Id.* § 102(a)(4), (6) (to be codified at 12 U.S.C. § 5311)..

103. *See id.* §201(a)(11)(C) (to be codified at 12 U.S.C. § 5381).

104. *Id.* §165(d)(1), (4) (to be codified at 12 U.S.C. § 5365).; MAYER BROWN, *supra* note 13, at 23 (referring to these resolution plans as "living wills").

105. Dodd-Frank Act §§ 112(a)(2)(I), 165(d) (to be codified at 12 U.S.C. §§ 5322, 5365).

106. *Id.* §165(d)(5)(A) (to be codified 12 U.S.C. § 5365).

107. *Id.* § 201(a)(8) (to be codified 12 U.S.C. § 5381). Non-financial subsidiaries of CFCs are excluded from Dodd-Frank Title II as well as subsidiaries that are insured depository institutions or insurance companies. *Id.* § 201(a)(9); *see also id.* § 201(11) (defining financial company to exclude non-financial in nature subsidiaries by omission). Stockbrokers who are not members of SIPC as well as commodity brokers will be liquidated by the FDIC in accordance with the Bankruptcy Code. DAVIS POLK LLP, *supra* note 44, at 31. Subsidiaries of a CFC are also subject to Title II receivership provisions if they are financial in nature, are in default or danger of default, if their liquidation would mitigate serious harm to the U.S. economy, and their liquidation would facilitate the liquidation of the CFC. Dodd-Frank Act, § 210(a)(1)(E)(i) (to be codified at 12 U.S.C. 5390).

108. *Id.* § 203(b)(1)-(7) (to be codified 12 U.S.C. § 5383).

109. *Id.* § 203(a)(1)(A).

appoint the FDIC as receiver.[110] This recommendation is to be based on several factors: (1) whether the entity is in default or danger of default;[111] (2) the effect that a default would have on United States financial stability; (3) a finding that bankruptcy is inappropriate, the likelihood of a private sector alternative to avoid default; and (4) an evaluation of the effect on creditors, shareholders, and counterparties if the FDIC were appointed as receiver.[112]

Upon receiving such a recommendation, the Treasury Secretary is empowered, in consultation with the President, and after the Secretary makes the necessary determinations, to appoint the FDIC as a receiver, in order to liquidate failing nonbank financial companies.[113] After receiving the recommendation, the Secretary is to determine: (1) whether the financial company is in default or danger of default; (2) whether the failure of the financial company would have serious adverse effects on the U.S. economy; (3) that there is no viable private sector alternative; (4) the effect on the financial company's creditors, counterparties and shareholders is appropriate given the benefit to the U.S. economy; and (5) the orderly liquidation will avoid the harmful consequences of the financial company to proceeding under applicable insolvency laws.[114] If the Secretary finds that the entity meets these requirements, then the Secretary may appoint the FDIC as the receiver.[115]

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110. *Id.* In the case of a broker or a dealer, the Federal regulators who make the recommendation to the Secretary are the Federal Reserve Board and the Securities and Exchange Commission. For an insurance company, the recommendation is made by the Federal Reserve Board and the Director of the Federal Insurance Office. *Id.* § 203(a)(1)(B), (C).

111. An SSFC will be in default or in danger of default if it has or is likely to file for bankruptcy, it has or is likely to deplete substantially all of its capital, it is balance sheet insolvent, or it is unable to pay its obligations as they come due. *Id.* § 203(c)(4)(A)-(D). An SSFC will be in default or in danger of default if it has or is likely to file for bankruptcy, it has or is likely to deplete substantially all of its capital, it is balance sheet insolvent, or it is unable to pay its obligations as they come due. *Id.*

112. Dodd-Frank Act § 203(a)(2)(A)-(H), (to be codified at 12 U.S.C. 5383).

113. *Id.* § 203(b).

114. *Id.* § 203(b)(1)-(7).

115. *Id.* § 202(a)(1)(A)(i) (to be codified 12 U.S.C. § 5382). However, if the board of directors of the company does not agree to the receivership, then they have a right of review in the District Court for the District of Columbia, who will employ an arbitrary and capricious standard to review the decision. *Id.* § 202(a)(2)(A)(i)-(iv).

The OLA is to first be funded by the disposition of the CFC's assets.[116] All funding acquired by the FDIC to facilitate the liquidation of the CFC will receive priority in payment.[117] The FDIC may borrow limited amounts from the Treasury to intermittently fund the liquidation.[118] These Treasury funds are to be repaid through the disposition of the CFC's assets or through assessments.[119] If the disposition of assets provides insufficient funding for repayment, then assessments may be made on certain entities and financial companies.[120] Assessments are to be made first on claimants who received additional payment from the FDIC during the liquidation, beyond what other similarly situated parties received.[121] The recoupment from these claimants will be the difference in the amount the claimant received and the amount they would have been entitled to receive from the proceeds of the CFC liquidation.[122] If these assessments are insufficient to repay Treasury funds, then BHCs with assets in excess of $50 billion as well as nonbank financial companies supervised by the Board of Governors may be subject to risk-based assessments.[123]

The OLA is modeled after the resolution authority given to the FDIC to resolve failing banks under FDIA, with several key differences.[124] Bankruptcy or other insolvency laws are intended to still be the primary means of resolving financial companies, with the OLA used as a last resort.[125]

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116. *See id.* § 210(n)(1)-(2) (to be codified 12 U.S.C. § 5390).

117. Dodd-Frank Act § 204(d) (to be codified at 12 U.S.C. § 5384).

118. *Id.* § 210(n)(1), (6).

119. *Id.* § 210(n)(9)(B)(i)(I)-(II). There is a concern that the Treasury's provision of funds to the FDIC as receiver may still be viewed as a bailout, although it is intended to be temporary, limited in amount and repaid. SKADDEN, ARPS, SLATE, MEAGHER & FLOM LLP & AFFILIATES, ANALYSIS OF THE ORDERLY LIQUIDATION AUTHORITY, TITLE II OF THE DODD-FRANK WALL ST. REFORM AND CONSUMER PROT. ACT 14 (2010) http://www.skadden.com/newsletters/FSR_A_Analysis_Orderly_Liquidation_Authority.pdf [hereinafter SKADDEN].

120. Dodd-Frank Act § 210(o)(1)(D)(i) (to be codified at 12 U.S.C. § 5390).

121. *Id.*

122. *Id.*

123. *Id.* § 210(o)(1)(D)(i)(I), (II).

124. DAVIS POLK & WARDWELL LLP, *supra* note 44, at 23.

125. The intended use of the OLA as a last resort is apparent because of the requirement that an assessment has been made that the Bankruptcy Code is inappropriate and that there is no viable private sector alternative. *See* SKADDEN,

B. *Title II Provisions Relating to Creditors and a Comparison to the Bankruptcy Code*

1. Goals of the Resolution Regime

The underlying purpose of Title II is to put the loss and responsibility for failing institutions on creditors, shareholders, and the institutions themselves, so as to mitigate serious harm to the U.S. economy and avoid taxpayer and FDIC loss.[126]

An overall objective of the OLA in asset disposition is to protect the FDIC's own interest in recovering disbursements made by it on behalf of the CFC during the liquidation.[127] This in turn will reduce the threat that taxpayers will ultimately foot the bill.[128] As such, the guiding principle will be the "least-cost resolution."[129] A second objective is to minimize the impact of the failure or liquidation on the U.S. economy.[130]

By contrast, the underlying purpose of the bankruptcy system is to maximize value available to creditors and to equitably distribute assets (in a Chapter 7), or to restructure and restore a debtor to financial solvency through a reorganization (in a Chapter 11).[131] Bankruptcy law is not concerned with systemic risk, but rather focuses on the relationships and outcomes for the debtors and creditors involved.[132]

2. Initiation of Proceedings

Under the OLA, the FDIC will be appointed as receiver and will commence liquidation proceedings, possibly even before

supra note 119, at 5-6.

126. Dodd-Frank Act § 204(a) (to be codified at 12 U.S.C. § 5384).

127. *See id.* § 204(d).

128. *See* CARPENTER R40530, *supra* note 59, at 4.

129. Least-cost resolution means that because the federal government's money is at stake, through its role as receiver, it will try to liquidate the CFC as quickly and cheaply as possible. This may result in an intentional effort to pay creditors as little as is permissible under the law. *See id.*

130. Dodd-Frank Act § 204(a) (to be codified at 12 U.S.C. § 5384).

131. Bliss & Kaufman, *supra* note 74, at 153-54.

132. CARPENTER R40530, *supra* note 59, at 4.

the CFC is actually insolvent.[133] Creditors have no right to initiate liquidation under Title II.[134] The ability for the FDIC to preemptively take control of a CFC may be beneficial in that it may act as a stop-loss, preventing losses to the company and its creditors.[135] Quick takeover of a CFC will prevent management from taking risks to salvage the company, which could result in further losses to the creditors.[136]

Bankruptcy may be initiated voluntarily by a debtor, or involuntarily, by a debtor's creditors.[137] However, bankruptcy cannot be preemptively initiated; instead, creditors must typically wait for the company to be in default.[138] A creditor's option to initiate the bankruptcy may give them a strategic advantage by providing leverage in pre-bankruptcy negotiations, and may allow them to better prepare for their claims in bankruptcy.

Debtors who wish to avoid involuntary bankruptcy proceedings may be more apt to pay their creditors.[139] Additionally, the creditor can file an involuntary bankruptcy petition in order to take advantage of certain Bankruptcy Code provisions.[140]

3. Timeliness

The duration of an orderly liquidation versus a bankruptcy will also affect creditors.[141] Title II provides for a three-year limit on the appointment of the FDIC as receiver, subject to two one-

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133. *See* Dodd-Frank Act § 203(b) (to be codified at 12 U.S.C. § 5383); *supra* Part IV.A (discussing the requirements for the FDIC to be appointed as receiver of a CFC).

134. *See* Dodd-Frank Act § 203(b) (to be codified at 12 U.S.C. § 5383); *supra* Part IV.A.

135. Bliss & Kaufman, *supra* note 74, at 166.

136. *Id.*

137. 11 U.S.C. §§ 301(a), 303(b) (2006).

138. Bliss & Kaufman, *supra* note 74, at 166.

139. *See id.*

140. For example, the automatic stay provision could prevent a judgment creditor from foreclosing on a debtor's otherwise unencumbered assets. *See* 11 U.S.C. § 362. Creditors could also seek to have a trustee appointed to oversee and manage a debtor's property and business, in the case of suspected misconduct. *See id.* §§ 1104(a), 1106.

141. *See supra* Part IV.B.3.

year extensions.[142] A goal of the OLA is, however, to achieve a speedy resolution.[143] An expedited resolution mechanism may allow claims to be paid in a manner that minimizes loss of value.

The duration of bankruptcy proceedings varies.[144] Resolutions in bankruptcy court are never immediate.[145] The adversarial process in the bankruptcy court, the participation of various parties in interest, the ability to appeal, and the possibility of reorganization, will likely result in a slower process.[146] For creditors whose interests are based on short-term investments, or who are themselves facing immediate financial difficulties, this can be a devastating prospect.[147] The OLA may therefore be advantageous by providing a consistently fast resolution process and thus more timely payout to creditors.[148]

4. The Automatic Stay

The OLA does not provide for an automatic stay and is not focused on affording creditors the opportunity to negotiate and organize their claims.[149] Rather the focus is simply on the orderly wind-up of the company so as to effectuate the least-cost resolution policy.[150] Although there is no automatic stay, QFCs

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142. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 202(d), 124 Stat. 1376, 1447-48 (2010) (to be codified at 12 U.S.C. § 5382).

143. SKADDEN, *supra* note 119, at 10 (reasoning that the purpose of a broad grant of authority to the FDIC is necessary to facilitate fast resolutions and to preserve value of a company in receivership).

144. Bliss & Kaufman, *supra* note 74, at 169.

145. *Id.*

146. *See* CARPENTER R40530, *supra* note 59, at 12.

147. *See* FCIC BAIR, *supra* note 58. For example, Lehman was the primary broker for around one hundred hedge funds. When Lehman entered bankruptcy, those hedge funds were frozen. This caused Lehman (and its creditors) to be unable to complete transactions and access sources of liquidity, demonstrating the particular dependence of financial firms on short-term investments and the devastating market effects of a freeze on those investments. *Id.*

148. This assertion is debatable and is likely case specific. For example, the sale of certain Lehman assets to Barclays was arranged three days after Lehman filed for bankruptcy, and then was approved by a court hearing. Ayotte & Skeel, Jr., *supra* note 52, at 481. However, the adversarial nature of bankruptcy and the "vast judicial wrangling" over some of Lehman's other assets led to delays in paying out some claims. CARPENTER R40928, *supra* note 18, at 20.

149. *See* CARPENTER R40530, *supra* note 59, at 10.

150. *See* CARPENTER R40530, *supra* note 59, at 4, 10.

still receive special treatment under the OLA and can be closed out or accelerated by the counterparty.[151] However, the right to close out QFCs is limited in Title II by a one business day stay provision, during which the FDIC can transfer all of a counterparty's QFCs to a third party or to a BFC, ending all termination or acceleration rights of the counterparty.[152] Damages arising from such action will be based on the later date of repudiation of the QFC as opposed to the date of the FDIC takeover.[153] The OLA also recognizes setoff rights but allows the FDIC to transfer liabilities to BFCs or third parties, even to the detriment of mutually offsetting claims.[154] To make up for this loss, a claimant harmed by these actions receives priority over other general creditors.[155]

In bankruptcy, the automatic stay for QFCs is not subject to a one-day stay.[156] Rather, the Bankruptcy Code applies the automatic stay to all contractual agreements, with the exception of QFCs.[157] The Bankruptcy Code generally recognizes setoff rights.[158] The lack of an automatic stay under the OLA is harmful to creditors because it eliminates the window of time during which creditors can organize their claims without fear of assets being disposed of in the meantime.[159] Additionally, the one business day stay on QFCs under the OLA is detrimental to those creditors that are parties to those contracts.[160] The potential for setoff rights to be destroyed is an additional negative consequence for creditors under the OLA.[161] The lack of a similar automatic stay provision in Title II may, however, allow for a quicker resolution.

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151. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 204(c)(8), 124 Stat. 1376, 1481 (2010) (to be codified at 12 U.S.C. § 5384).
152. *Id.* § 210(c)(10)(B)(i).
153. DAVIS POLK & WARDWELL LLP, *supra* note 44, at 30.
154. *Id.*
155. *Id.* at 30-31.
156. *Id.* at 30.
157. *Id.* at 29.
158. 11 U.S.C. § 553(a) (2006).
159. *See supra* Part IV.B.4.
160. *Supra* Part IV.B.4.
161. *Supra* Part IV.B.4.

5. Claim Assessment

Upon appointment as receiver, the FDIC will succeed to all rights of the company, including management and shareholder rights.[162] The receiver is empowered to determine all claims in accordance with Title II.[163] The receiver will allow any claim timely received, which is "prove[n] to the satisfaction of the receiver."[164] This provision basically gives the FDIC unilateral authority to review and allow or disallow claims.[165] Creditors disputing the FDIC's claim determination can file suit on a claim in U.S. District Court.[166]

In the FDIC's resolution of banks, they typically will replace all senior management and officers, and creditors will have no input on how claim distribution and asset disposition decisions

162. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 210(a)(1)(A), 124 Stat. 1376, 1461 (2010) (to be codified at 12 U.S.C. § 5390). The FDIC has issued a proposed rule on the treatment of creditor claims. This proposed rule includes, among other things, a ban on "additional payments to holders of long-term senior debt, subordinated debt, or equity interests" that causes them to receive better treatment than similarly situated creditors. Also, all additional payments must first be voted on by the FDIC Board of Directors. Press Release, Fed. Dep. Ins. Corp., PR-224-2010, FDIC Board Issues Proposed Rule on Claims Process Under New Resolution Authority (October 12, 2010), *available at* http://www.fdic.gov/news/news/press/2010/pr10224.html. It has been argued that this portion of the proposed rule creates a similar but less effective version of the "first day" motions in Chapter 11. "First-day" motions allow the DIP to get court approval to make payments to certain creditors and employees so as to maximize the going concern value of the debtor. Requiring the FDIC to vote to accomplish this same objective may simply be a less effective version of "first-day" motions. Letter from Stephen J. Lubben, Daniel J. Moore Professor of Law, Seton Hall University School of Law, to Robert E. Feldman, Exec. Sec., Fed. Dep. Ins. Corp., Re: 12 CFR 380, Proposed Rules Implementing Dodd-Frank Orderly Liquidation Authority (October 18, 2010) http://www.fdic.gov/regulations/laws/federal/2010/10c04Orderliq.PDF. The proposed rule also states that secured creditors will only have secured claims to the extent they are collateralized, but that transactions secured by United States government securities are going to be valued at par. The proposed rule clarifies that all creditors should expect to suffer losses in a liquidation, and that no taxpayer money may be used in these resolutions. Press Release, Fed. Dep. Ins. Corp., PR-224-2010, FDIC Board Issues Proposed Rule on Claims Process Under New Resolution Authority (October 12, 2010) http://www.fdic.gov/news/news/press/2010/pr10224.html.

163. Dodd-Frank Act § 210(a)(2) (to be codified at 12 U.S.C. § 5390).

164. *Id.* § 210(a)(3)(B). Once a claim has been accepted by the FDIC, the FDIC may go ahead and make interim payments to that creditor. *Id.* § 210(a)(7).

165. *See id.* § 210(a)(2).

166. *Id.* § 210(a)(4).

are made.[167] Similarly, Title II provides that any responsible management or members of the board of directors will be removed and all claims will be received and assessed by the FDIC.[168] Additionally, any portion of a secured claim that exceeds the fair market value of the asset can be treated as an unsecured claim.[169]

Under the Bankruptcy Code, claims are allowed in a liquidation unless the Chapter 7 trustee objects in court and allows the claimant to be heard on that objection.[170] Claims will only be disallowed if the claimant fails to appear in court or if the court determines that the claim should be disallowed.[171] Shareholders' interests will be eliminated in bankruptcy, if the company is insolvent.[172] However, a solvent company's shareholders are entitled to a distribution based on their equity, a protection not necessarily afforded under the OLA.[173] Creditors can object to a plan in bankruptcy proceedings and creditors in the same class can vote down a proposed plan.[174] However, the court may "cram down" the plan, against creditor objections, if certain statutory standards are met.[175]

6. Claim Priorities

Title II creates a new system for the prioritization of claims.[176] While this system shares some commonality with the Bankruptcy Code, it also leaves much uncertainty as to how creditors' claims will be prioritized. The OLA is intended to be exercised so that "creditors and shareholders will bear the losses of

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167. CARPENTER R40530, *supra* note 59, at 8.

168. Dodd-Frank Act §§ 206, 210(a) (to be codified at 12 U.S.C. §§ 5386, 5390). Claims decisions are reviewable in U.S. District Court, where the receiver's decision is not accorded any deference. *Id.* § 210(a)(4) (to be codified at 12 U.S.C. § 5390).

169. *Id.* § 210(a)(3)(D).

170. 11 U.S.C. § 502(a) (2006).

171. 11 U.S.C. § 502.

172. Ayotte & Skeel, Jr., *supra* note 52, at 487-488.

173. *Id.*

174. 11 U.S.C. § 1126.

175. *See id.* § 1129(b).

176. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 210(b), 124 Stat. 1376, 1475 (2010) (to be codified at 12 U.S.C. § 5390).

the financial company," and "the [FDIC] and other appropriate agencies will take all steps . . . to assure that all parties, including . . . . third parties, having responsibility for the condition of the financial company bear losses consistent with their responsibility. . . ."[177] Furthermore, Title II provides that "shareholders of a [CFC] do not receive payment until after all other claims and the Fund are fully paid."[178]

Claim priority is listed in Title II, with the administrative expenses of the FDIC being first on the list.[179] Similarly situated creditors are to be treated similarly, unless the FDIC determines that it is in the best interest of the CFC to act otherwise.[180] The FDIC can treat similarly situated creditors dissimilarly if it is necessary to maximize the CFC's assets, to continue essential operations, to maximize the return from the disposition of the CFC's assets, or to minimize the loss resulting from the disposition of the CFC's assets.[181]

In addition, Title II includes supplemental priorities, which provide in part that creditors whose setoffs were destroyed by an FDIC transfer of relevant assets and/or liabilities will be treated as senior to general unsecured claims.[182] Furthermore, post-receivership financing incurred by the FDIC on behalf of the CFC is senior to administrative expenses.[183] Under the OLA, proven unsecured claims are only entitled to the recovery that would be available in a hypothetically equivalent Chapter 7 bankruptcy.[184]

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177. *Id.* § 204(a)(1), (3) (to be codified at 12 U.S.C. § 5384).

178. *Id.* § 206(2) (to be codified at 12 U.S.C. § 5386).

179. *Id.* § 210(b)(1) (to be codified at 12 U.S.C. § 5390). Unsecured claims will be paid in the following order: (1) The FDIC's administrative expenses; (2) Debts owed to the United States; (3) Wages earned by employees of the CFC; (4) Contributions to employee benefit plans; (5) Any other "general or senior liability"; (6) Any debt subordinated to general creditors; (7) Wages owed to senior executives and directors of the CFC; and (8) Obligations to shareholders and other parties having equity in the CFC. *Id.*

180. *Id.* § 210(b)(3)-(4).

181. Dodd-Frank Act § 210(b)(4) (to be codified at 12 U.S.C. 5390).

182. *Id.* § 210(a)(12)(F).

183. *Id.* § 210(b)(2).

184. DAVIS POLK & WARDWELL LLP, *supra* note 44. Payment of unsecured claims in a Chapter 7 bankruptcy is done on a pro rata basis determined by the value received from the liquidation of the assets. 11 U.S.C. § 726(b) (2006).

Under the Bankruptcy Code, "[l]egal priority, security interests, and right of offset, where protected, jointly determine what a creditor is entitled to under the law."[185] The administrative costs of the bankruptcy are generally paid first.[186] The Bankruptcy Code lists several unsecured creditor classes that receive priority status.[187] However, most unsecured creditors are grouped together as general creditors.[188] Secured creditors will typically have greater recoveries than unsecured creditors because they will be paid the full value of their secured claim, up to the value of their collateral, and will be paid as an unsecured creditor on the portion of their claim that is not secured.[189] Creditors who provide DIP financing will generally have priority over the pre-bankruptcy creditors.[190] In Chapter 11 bankruptcies, creditors are often paid in securities of the reorganized entity.[191]

The treatment of unsecured creditors and unsecured portions of claims, the priority given to administrative expenses and to DIP financing, as well as the priority given to financing provided by the FDIC seem to provide comparable creditor treatment under both Title II and the Bankruptcy Code.[192] However, the ability of the FDIC to deviate, in certain situations, from the principle of treating similar creditors similarly, may harm creditors' interests, and also inserts an element of uncertainty in the OLA system of prioritization.[193]

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185. Bliss & Kaufman, *supra* note 74, at 160.

186. 11 U.S.C. § 507(a)(1)(C).

187. *Id.* § 507. These groups of preferred unsecured creditors include many types of claims such as those for domestic support obligations, claims for contributions to an employee benefit plan, and taxes owed. *Id.*

188. Bliss & Kaufman, *supra* note 74, at 161.

189. *See id.* at 162.

190. *See* 11 U.S.C. § 363.

191. Bliss & Kaufman, *supra* note 74, at 161. The prioritization of claims (and their corresponding payout) is explicitly spelled out in the Bankruptcy Code for Chapter 7 proceedings. 11 U.S.C. § 726. However, in a Chapter 11 reorganization, there is typically much more room for negotiation and modification of claims, leaving more uncertainty and unpredictability as to what a particular creditor will recover. Bliss & Kaufman, *supra* note 74, at 164.

192. *See supra* Part IV.B.6.

193. *See* SKADDEN, *supra* note 119, at 8; *supra* Part IV.B.6.

7. Asset Disposition

The FDIC is directed to effectuate the liquidation so as to maximize the value of the sale of assets while also mitigating possible damage to the U.S. financial system.[194] As receiver, the FDIC is empowered to sell off any assets to a third party for a fair value.[195] However, if such a purchaser cannot be found, the FDIC may create a BFC to which it can transfer any parts of the business worth preserving, without needing creditor approval, subject to a creditor's minimal right of recovery.[196] The FDIC is to treat similarly situated creditors similarly in transferring assets to a BFC.[197] However, it can deviate from this principle if it is necessary to maximize value or to minimize losses from the transfer.[198] Creditors' recoveries are limited to what they would have likely received in a Chapter 7 bankruptcy.[199] BFCs are meant to be temporary entities that hold CFC assets until a private acquisition is arranged.[200] Thus, a BFC can last for two years, subject to three one-year extensions.[201]

Title II allows the receiver to disaffirm contracts or leases that detract from the interest of the receiver in any CFC assets because the contract is burdensome or disaffirmance would otherwise promote "orderly administration."[202] This power applies regardless of whether the contract or lease is executory.[203] Damages for such repudiation are generally limited to actual, compensatory damages.[204]

The OLA will not accept oral contracts, but will allow claims for any written agreement that was executed and confirmed during the CFC's ordinary course of business and satisfactorily

194. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 210(a), 124 Stat. 1376, 1460 (2010) (to be codified at 12 U.S.C. § 5390).

195. *Id.*

196. *Id.* § 210(h).

197. *Id.* § 210(h)(5)(E)(i)(III).

198. *Id.* § 210(h)(5)(E).

199. *Id.*

200. SKADDEN, *supra* note 119, at 12.

201. Dodd-Frank Act § 210(h)(12) (to be codified at 12 U.S.C. 5390).

202. *Id.* § 210(c).

203. *Id.* § 210(c)(1).

204. *Id.* § 210(c)(3)(A)(i).

proven to the receiver.[205] The consequence of this provision is that creditors' legitimate oral agreements may be disaffirmed by the FDIC. Additionally, the FDIC has the authority to distribute left-behind assets, including those from the sale of the business, to creditors, in the fashion that it sees fit.[206]

Bankruptcy proceedings are largely guided by the actions of creditors and other interested parties who influence reorganizations, have standing to be represented in the bankruptcy proceeding, and can object to proposed confirmation plans.[207] Furthermore, either a trustee or a DIP is typically overseeing disposition of the assets, which automatically become property of the estate at the time of filing.[208] A DIP will usually be required to get court approval to dispose of any assets out of the ordinary course of business.[209]

In addition to the general provisions for asset disposition, in bankruptcy, the only contracts which may be rejected are executory contracts and unexpired leases.[210] Damages are calculated as breaches of contract under non-bankruptcy law.[211] The Bankruptcy Code will allow claims based on oral agreements if the contract is proven under applicable non-bankruptcy law.[212]

Several provisions of Title II dealing with asset disposition are particularly ominous for creditors.[213] For example, the FDIC's ability to disaffirm certain burdensome contracts obviously poses a threat to affected creditors.[214] Additionally, the FDIC's ability to defeat certain claims against its interests as well as unverified oral agreements is another possible pitfall for creditors.[215] The FDIC's power to transfer assets and liabilities to a BFC, subject to minimal creditor recovery, may treat same-class creditors differently, and

205. DAVIS POLK & WARDWELL LLP, *supra* note 44, at 29.

206. *Id.* at 27.

207. CARPENTER R40530, *supra* note 59, at 8.

208. *See* 11 U.S.C. §§ 363, 541 (2006).

209. *See id.* § 363.

210. *Id.* § 365. Rejection must be accompanied by approval from the Bankruptcy Court. *Id.*

211. DAVIS POLK & WARDWELL LLP, *supra* note 44, at 29.

212. *Id.*

213. *See supra* Part IV.B.7.

214. *See supra* Part IV.B.7.

215. *See supra* Part IV.B.7.

may treat junior creditors as ahead of certain senior creditors.[216] Several of these provisions lack concise guidelines and parameters, leaving room for arbitrary and unfair treatment of creditors. Finally, the FDIC method lacks a judge who often must approve the disposition of assets and in certain cases a trustee who serves as an uninterested third party in effectuating and overseeing the disposition of assets.[217]

8. The Option of Chapter 11 Reorganization

There is no option for reorganization of a CFC under the OLA.[218] However, the FDIC does have broad authority to sell off assets of the CFC to private acquirers.[219] Furthermore, this can be accomplished without any notice or consent from creditors or shareholders, and is not subject to challenge as a fraudulent conveyance.[220] The FDIC can also arrange for the acquisition of the CFC by a private acquirer, and these acquisitions can be accomplished without the consent of creditors and shareholders.[221]

Through Chapter 11, the Bankruptcy Code provides for a means of restructuring failing firms.[222] Firms which may perceive a restructuring to be feasible and thus could have protected the interests of their creditors through a successful debt restructuring and reorganization of the company will not have this option under the OLA.[223] The Bankruptcy Code requires that interested parties receive notice and an opportunity to be heard, as well as court approval, before a company in bankruptcy is sold.[224] Also, a reorganization is generally only possible if creditors approve the

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216. *See supra* Part IV.B.7.

217. *See* 11 U.S.C. §§ 363, 364, 704 (2006).

218. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 214, 124 Stat. 1376, 1518 (2010) (to be codified at 12 U.S.C. § 5394).

219. SKADDEN, *supra* note 119, at 12.

220. Dodd-Frank Act § 210(a), (e) (to be codified at 12 U.S.C. § 5390).

221. *Id.* § 210(h)(2).

222. 11 U.S.C. §§ 1101-1174.

223. *See* Dodd-Frank Act §§ 201, 203 (to be codified at 12 U.S.C. §§ 5381, 5383). However, if an entity has been designated a CFC and placed in FDIC receivership, the decision has already been previously made that a reorganization was not the better option; *supra* Section IV.A.

224. 11 U.S.C. §§ 363(b), (f).

plan and the Bankruptcy Court has found that the plan meets various requirements.[225] On the other hand, a strict liquidation regime may be quicker than reorganization, and that the fact that reorganization is not an option may decrease moral hazard.[226]

9. Oversight Structure

Once an financial company has received CFC designation and been placed in FDIC receivership, the OLA will be carried out in largely administrative fashion, with the FDIC having great discretionary powers in deciding when and if to commence a liquidation, as well as in determining how to liquidate the assets of the CFC, and how to manage the company while it acts as receiver.[227] It is uncertain whether the FDIC will have the proper expertise to efficiently resolve CFCs.[228] Additionally, the FDIC, as administrator, has a financial interest in the resolution and will function in a self-serving manner to some extent, in order to pay itself as a senior creditor.[229] Judicial review of the FDIC's actions and their handling of creditors' claims will be limited, and damages arising therefrom will likely also be limited.[230]

By contrast, bankruptcy proceedings involve judges and courtrooms, creditors and debtors who are usually represented by lawyers, a trustee (who has a fiduciary duty to the creditors) who is often handling the disposition of the assets or the management of the ongoing business, and most decisions are appealable to a higher court.[231] In a Chapter 11 reorganization, creditors and management often remain largely in control of the company and its assets.[232]

225. *Id.* §§ 1123, 1125, 1129.
226. *See supra* Part IV.B.8.
227. CARPENTER R40530, *supra* note 59, at 6-7.
228. *See* Bliss & Kaufman, *supra* note 74, at 143, 174.
229. *See id.*
230. *See supra* Parts IV.B.6-8.
231. CARPENTER R40530, *supra* note 59, at 8.
232. *See* 11 U.S.C. § 363 (2006).

V. CONCLUSION

It is premature to say exactly what the effect and implications of Title II of the Dodd Frank Act will be for creditors. Particularly, it is impossible to know how often and to what extent this provision will be utilized. If the intent really is to have bankruptcy remain the preferred option, then perhaps creditors' rights will remain unaffected by Title II, and we will see more bankruptcies carried out like Lehman, and less government assistance provided to failing firms like Bear Stearns.[233] On the other hand, it is not yet clear how assertive the FDIC will be in effectuating the OLA. It is possible that predictions that Title II merely provides statutory authority for more bailouts will prove true.[234] Without knowing these answers, creditors will not have clear expectations as to when and which institutions will be bailed out or liquidated by the FDIC, or either liquidated or reorganized in Bankruptcy. Much will depend on the actions taken by the Federal Government and the FDIC in the near future. Creditors should pay close attention to government actions including rule proposals and rulemakings, statements by Treasury and FDIC officials, any CFC designations, and ultimately any liquidations, to discern exactly how Title II will be effectuated. Creditors should cautiously evaluate risks and make investments according to those government actions and the resulting expectations for future government action.

Despite this uncertainty, the discussions in Congress prior to the enactment of Dodd-Frank, a closer look at the Lehman bankruptcy, the language of Title II, and a comparison of that language to Bankruptcy Code provisions, lead to the conclusion that the OLA is not, and is not intended to be, protective of creditors' rights and interests.[235] Creditors should be wary of the new OLA. Accordingly, at least a temporary reevaluation of their lending strategies is in order. This includes a careful look at the riskiness of their loans, the type of credit instruments they hold, and the possibility that they are lending to a potential CFC. These

233. *See supra* Part II.B.1.
234. *See supra* Part II.B.1.
235. *See supra* Parts II, III, IV.

evaluations should be made with an eye towards steering clear of holding potential claims against a financial company that may end up under the control of an FDIC receiver. In light of the lack of protection for creditors under the OLA, creditors need to either lend to systemically significant institutions that are more financially sound, or they need to avoid extending credit to systemically significant financial institutions altogether.

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