

AGAINST REGULATORY DISPLACEMENT: AN INSTITUTIONAL ANALYSIS OF FINANCIAL CRISES

Jonathan C. Lipson*

This Article analyzes institutional choice in preventing and managing financial crises. “Institutional choice” means that different institutions—here, markets, courts and regulators—have different capacities to achieve similar goals. While none is perfect, some may be better than others, so the institutions we choose to prevent or resolve failure will influence the likelihood and severity of future financial crises. I use the analysis of institutional choice to make three claims about current (and foreseeable) approaches to preventing and resolving financial crises.

First, because regulators are vulnerable to capture by large financial services firms, they cannot address the pathologies that create crises: market concentration and complexity. Indeed, regulators may aggravate these conditions through tactics that consolidate firms, and the volume and complexity of regulation, resulting in “regulatory displacement” of markets and courts as institutional choices to prevent or resolve financial distress.

Second, in the context of financial distress, institutions tend to interact (“braid,” in the language of contract theory literature). Markets and courts can do so to create incentives to renegotiate financial distress, thus reducing the likelihood of crises. Regulators and markets braid, too. But, large financial firms may dominate the interactions to increase concentration and complexity, and thus create social costs without compensating benefits. Large financial firms may protest, but they benefit

*Harold E. Kohn Professor of Law, Temple University-Beasley School of Law. I thank Daniel Bromley, Anuj Desai, Jeff Dunoff, Jill Fisch, Craig Green, Richard Hynes, Darian Ibrahim, Julapa Jagtiani, Neil Komesar, Bill Kroener, Greg Mandel, Kathleen Noonan, Mark Roe, William Simon, David Skeel, the Hon. Leo E. Strine, and Bill Whitford for comments and suggestions on earlier versions of this Article, and Jessie Bohl, Adria Crowe, Arthur Kerwin, Katherine LaDow, Greg Lockwood, Erica Maier, Minli Tang, and Jeannine Zabrenski for research and administrative assistance. I also thank Cary Coglianese for inviting me to brief an earlier version of this Article at Regblog.org. Dean JoAnne Epps (Temple Law School) and Dean Margaret Raymond (University of Wisconsin Law School) provided generous financial support for this project, for which I am grateful. Prior versions of this Article were presented at Tsinghua University Law School, Renmin (People’s) University (Beijing), The University of Wisconsin Law School, and Temple Law School. Errors and omissions are mine, alone. © 2015 Jonathan C. Lipson, all rights reserved.

from the subsidies and protections of regulatory displacement, and thus ultimately choose it.

Third, courts are an underappreciated institution that may ameliorate the pathologies of concentration and complexity by rethinking the so-called “duty to be informed” on the part of directors of systemically important financial firms. Taking this duty more seriously here might lead directors to simplify and/or reduce the size of those firms, thereby creating conditions and incentives that would support market-oriented re-structuring rather than regulatory displacement if—perhaps when—crisis next strikes.

INTRODUCTION	675
I. CONCENTRATION, COMPLEXITY, AND CAPTURE—THE DOOM LOOP	681
A. <i>Concentration</i>	682
B. <i>Complexity</i>	685
C. <i>Capture</i>	688
II. THEORIES OF INSTITUTIONAL CHOICE	691
A. <i>The Contribution of Hart & Sacks: Institutional Settlement</i> ...	692
B. <i>The Contribution of Komesar—Comparative Institutional Analysis</i>	696
C. <i>The Contribution of Gilson, Sabel and Scott—“Braiding”</i>	699
III. A COMPARATIVE INSTITUTIONAL ANALYSIS OF FINANCIAL DISTRESS SYSTEMS	701
A. <i>Market Resolution</i>	701
B. <i>Judicial Resolution</i>	705
C. <i>Regulatory Resolution</i>	708
IV. DODD-FRANK AND REGULATORY DISPLACEMENT	714
A. <i>Which Firms?</i>	714
B. <i>What Effect?</i>	716
C. <i>Which Entity?—Single Point of Entry</i>	717
D. <i>Which Institution?</i>	721
E. <i>Regulatory Displacement of Market-Based Renegotiation</i>	723
V. AGAINST REGULATORY DISPLACEMENT—JUDICIAL RESPONSES ...	725
A. <i>Bankruptcy Code Chapter 14</i>	726
B. <i>Rethinking the Duty to Be Informed</i>	730
CONCLUSION	737

“They should have let Bear Stearns fail”¹

INTRODUCTION

As we gain perspective on the financial crisis of 2008, it becomes increasingly clear that institutional choice will affect the likelihood and severity of future crises. “Institutional choice” means that different large-scale social processes—here, markets, courts, and regulators—have different capacities to prevent or minimize the effects of financial distress that could cascade into crises.² Although scholars have begun to recognize that financial distress has an institutional dimension, they have largely failed to analyze institutional choice.³

Institutional analysis helps to fill this gap.⁴ “Institutional analysis” starts from the premise that all social institutions have capacities to address similar problems, but their distinct characteristics may produce different results. Thus, the important questions are: Which among them produce better (or worse) outcomes, and how are the choices to be made?

1. Joe Nocera, *Sheila Bair’s Bank Shot*, N.Y. TIMES, July 9, 2011, at MM24, available at <http://www.nytimes.com/2011/07/10/magazine/sheila-bairs-exit-interview.html?pagewanted=all> (quoting Sheila Bair, former chair of the Federal Deposit Insurance Corporation).

2. For discussions of the distinction between isolated failures and crises that induce panic, see, for example, CHARLES P. KINDLEBERGER & ROBERT Z. ALIBER, *MANIAS, PANICS AND CRASHES: A HISTORY OF FINANCIAL CRISES* (6th ed. 2011); Charles W. Calomiris & Joseph R. Mason, *Fundamentals, Panics, and Bank Distress During the Depression*, 93 AM. ECON. REV. 1615 (2003); Douglas W. Diamond & Philip H. Dybvig, *Bank Runs, Deposit Insurance, and Liquidity*, 91 J. POL. ECON. 401 (1983).

3. See *infra* Part III. A notable exception is David Skeel’s excellent paper, David A. Skeel, Jr., *Institutional Choice in an Economic Crisis*, 2013 WIS. L. REV. 629, 630 (analyzing “institutional choice during and after an economic crisis”).

4. The broad literature on institutional analysis typically begins with the work of HENRY M. HART, JR. & ALBERT M. SACKS, *THE LEGAL PROCESS* (1958 tentative edition) (William N. Eskridge, Jr. & Philip P. Frickey eds, 1994) [hereinafter “LEGAL PROCESS”]. Other prominent contributions include ROBERT DAHL & CHARLES LINDBLOM, *POLITICS, ECONOMICS AND WELFARE* (1953); NEIL K. KOMESAR, *IMPERFECT ALTERNATIVES* 31 (1994) [hereinafter, KOMESAR, 1994]; NEIL K. KOMESAR, *LAW’S LIMITS* (2001) [hereinafter, KOMESAR, 2001]; Neil K. Komesar, *The Logic of the Law and the Essence of Economics: Reflections on Forty Years in the Wilderness*, 2013 WIS. L. REV. 265; Neil K. Komesar, *Exploring the Darkness: Law, Economics, and Institutional Choice*, 1997 WIS. L. REV. 465; Neil K. Komesar, *In Search of a General Approach to Legal Analysis: A Comparative Institutional Alternative*, 79 MICH. L. REV. 1350 (1981). As discussed in Part II, *infra*, Komesar has developed especially important insights about how to compare institutional efficacy. An entire symposium issue of the Wisconsin Law Review was recently devoted to his work, *Symposium Issue: 30 Years of Comparative Institutional Analysis: A Celebration of Neil Komesar*, 2013 WIS. L. REV. 266.

Institutional analysis answers these questions as a function of “participation.” Those who have the most at stake will choose the institution that best serves their perceived needs.⁵ In the case of financial distress, for example, markets have historically been the dominant institutional choice.⁶ If, for example, Firm A defaults on its debt, it will most likely negotiate restructured debt contracts with its creditors. This means that market participation solves the problem. If Firm A cannot agree to revised terms with its creditors, some or all of them may go to bankruptcy court. Stakeholders would then participate in a judicial process that either liquidates or reorganizes the debtor.⁷ Although far from perfect, the participatory qualities of markets and courts have generally made them the first line of defense in preventing individual incidents of financial distress from snowballing into financial crises.

Until the crisis of 2008, regulators generally had little role in preventing or resolving financial distress—unless the distressed firm were a bank.⁸ If Firm A were a troubled bank, it would probably not negotiate with its creditors (most of whom would be retail depositors), or go to bankruptcy court, which is statutorily forbidden.⁹ Instead, bank regulators, likely the Federal Deposit Insurance Corporation (FDIC), would seize the bank with little or no warning, and transfer its assets and liabilities to a new bank, or otherwise conserve the bank’s assets for the benefit of depositors and the government as deposit insurer.¹⁰

Why a regulatory resolution for banks but not other types of firms? Again, participation is the answer. Banks presumptively lend long (e.g., 30-year mortgages) and borrow short (on demand) from widely dispersed retail depositors who lack the skill or resources to negotiate with the bank if it gets into trouble. Institutional analysis teaches that the stakes here are

5. See KOMESAR, 1994, *supra* note 4; see also *infra* Part II.B.

6. See *infra* Part III.A.

7. See *infra* Part III.B.

8. Insurance companies and certain stock brokerages are also subject to regulatory resolution. Because Dodd-Frank is modeled on the bank failure system, I do not discuss these other systems. See *infra* Part III.C.

9. 11 U.S.C. § 109(d) (2010).

10. Of course, bank holding companies can go into bankruptcy. The bank holding company (BHC) is not the bank itself, however: It is the parent corporation of the bank. See 12 U.S.C. § 1841(a)(1) (“[B]ank holding company’ means any company which has control over any bank or over any company that is or becomes a bank holding company by virtue of this chapter.”). If a BHC goes into bankruptcy, it will often do so in concert with an FDIC resolution of the bank subsidiary. See, e.g., *In re Washington Mutual, Inc., et al.*, No. 08-12229 (Bankr. Del. Sept. 13, 2011). The Supreme Court has assessed the relationship between bankruptcy and the regulation of bank holding companies in *Board of Governors of the Federal Reserve System of the U.S. v. MCorp Financial, Inc.*, 502 U.S. 32, 37-42 (1991) (sustaining Federal Reserve supervisory power over bankruptcy stay).

quite high, but skewed, because individual depositors are in no position to use market or judicial mechanisms to prevent or resolve bank failure. Market and judicial efforts at bank resolution would be much worse than regulatory resolution because these processes would reveal the bank's condition. This would cause panic and cascades of defaults—the very things the bank regulatory system was meant to prevent. Thus, banks were “special,”¹¹ and so required a special failure regime.

The financial crisis changed this, first through regulators' ad hoc market interventions and then through increased power given to regulators under the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank), the main reform following the crisis.¹² These interventions mean that regulators increasingly crowd out markets and courts as institutional choices to prevent or resolve financial distress of large financial firms. I characterize regulators' expanding role in this context as “regulatory displacement.”

New accounts of the crisis by key regulators such as Tim Geithner (then President of the New York Federal Reserve Bank)¹³ and Henry Paulson (then Secretary of the Treasury)¹⁴ show how this happened.¹⁵ Regulators largely saw themselves as the first line of defense against financial crisis for large financial firms, whether banks or nonbanks, displacing markets and courts. These firms in turn chose regulators because they believed that regulators would provide greater protection at lower individual cost than markets or courts.

11. See, e.g., E. GERALD CORRIGAN, FEDERAL RESERVE BANK OF MINNESOTA, ARE BANKS SPECIAL? (1982), <https://www.minneapolisfed.org/publications/annual-reports/ar/annual-report-1982-complete-text> (arguing that banks play a unique role in the economy and thus warrant regulatory subsidies and constraints not appropriate for other types of financial firms).

12. Pub. L. No. 111-203, 124 Stat. 1376 (2010).

13. TIMOTHY F. GEITHNER, STRESS TEST, REFLECTIONS ON FINANCIAL CRISES, 133 (2014).

14. Hank Paulson, *This is What it was Like to Face the Financial Crisis*, BLOOMBERG BUSINESSWEEK, Sept. 12, 2013, <http://www.businessweek.com/articles/2013-09-12/hank-paulson-this-is-what-it-was-like-to-face-the-financial-crisis> (“People weren't taking [Lehman Brothers CEO] Dick Fuld's calls the weekend before Sept. 15, because Dick had been in denial for a long time. As the CEO of Lehman Brothers, he had asked the New York Fed and the Treasury weeks earlier to put capital into a pool of nonperforming illiquid mortgages that he wanted to put in a subsidiary he called SpinCo and spin off. We had explained that we had no authority to do that. He thought somehow there was something the government could do to help”).

15. See *This American Life*, *The Secret Recordings of Carmen Segarra*, CHICAGO PUBLIC RADIO (Sept. 26, 2014) <http://www.thisamericanlife.org/radio-archives/episode/536/the-secret-recordings-of-carmen-segarra> (revealing secret recordings of the Federal Reserve Bank of New York Made by Carmine Segarra).

Consider, for example, Geithner's response when he learned in March 2008 that Bear Stearns, a large non-bank financial services firm, planned to commence a bankruptcy case: "Yikes!"¹⁶ Its "failure"—meaning a bankruptcy case—would "trigger[] a chain reaction of fear and uncertainty that could imperil the entire system."¹⁷ Thus, when it subsidized JPMorgan Chase's acquisition of Bear, Geithner acknowledged that the Federal Reserve ("Fed") "cross[ed] a line [that it] had not crossed since the Great Depression, indirectly lending to a brokerage house that was supposed to function outside the bank [regulatory] safety net."¹⁸

In retrospect, this was a poor institutional choice. If Bear Stearns had been forced to use market or judicial resolution processes, managers of other large financial firms would likely have done the same.¹⁹ Because Bear's counterparties were not generally retail depositors, but other sophisticated financial firms, the participatory stakes would have been high but fairly evenly distributed across firms. Market negotiations or judicial resolution would have redistributed losses in a more fair and efficient manner than regulatory intervention. This would have been difficult and costly. But, it would likely have reduced damage from the crisis, and promoted greater discipline going forward.

Nevertheless, throughout the crisis, the Fed "crossed the line" repeatedly. Worse, it did so unpredictably. It crossed the line to bail out AIG, but simultaneously refused to do so for Lehman Brothers, which was forced into bankruptcy.²⁰ The Fed and Treasury radically expanded de facto resolution powers through the crisis, largely immune from judicial scrutiny or the rule-of-law values courts tend to advance.²¹

16. GEITHNER, *supra* note 13, at 149. Although "only the seventeenth largest U.S. financial institution at the time"—and not a bank subject to Federal Reserve regulation—it was, in Geithner's view "completely enmeshed in the fabric of the financial system. It had four hundred subsidiaries. It had trading positions with five thousand counterparties around the world." *Id.* at 150.

17. *Id.* at 151.

18. *Id.*

19. See, e.g., Nocera, *supra* note 1 (quoting Sheila Bair ("I think that the Bear deal set up an expectation for government intervention that was not really helpful' Letting Bear Stearns fail would most likely have sent the right message to the rest of Wall Street . . . without creating [a] chain reaction"); FINAL REPORT OF THE FINANCIAL CRISIS INQUIRY COMMISSION 280-291 (2011) [hereinafter "FCIC REPORT"], www.gpoaccess.gov/fcic/fcic.pdf (discussing the implications of the federal bailout of Bear Stearns).

20. The story of the financial crisis—from Bear Stearns through AIG—is told by many authors. A leading summary appears in the FCIC REPORT, *supra* note 19. Of course, regulators did not act without political cover. In particular, they sought and obtained Congressional support for their actions under the Troubled Asset Relief Program, Emergency Economic Stabilization Act of 2008, Pub. Law No. 111-343, §121(a), (f), 122 Stat. 3765, 3788, 3790.

21. It used special power to provide financing to non-bank financial services firms

Dodd-Frank was enacted on the promise that there would be “no more bailouts.”²² Few have faith in this promise.²³ Its “orderly liquidation authority” gives regulators the power to seize a much broader range of firms than just banks—any firm that regulators deem to be “systemically important financial institutions” (SIFIs).²⁴ While there is a very modest judicial check on this, David Skeel has observed that “Dodd-Frank enshrines a system of ad hoc interventions by regulators [] divorced from basic rule of law constraints. The unconstrained regulatory discretion reaches its zenith with the new resolution rules for financial institutions in distress.”²⁵ The current proposal to operationalize the resolution authority through a so-called “single point of entry”—which would give regulators the power to seize the parent company in a large corporate structure—does nothing to address this.²⁶ Dodd-Frank codifies regulatory displacement.

This Article uses institutional analysis to assess Dodd-Frank’s likely effect on financial distress among large financial firms. Institutional

under “unusual and exigent circumstances.” Federal Reserve Act § 13(3), 12 U.S.C. § 343 (2006). Section 1101 of Dodd-Frank amends this in an effort to constrain the Fed’s discretion to “bail out” non-bank financial services firms. Dodd-Frank Wall Street Reform and Consumer Protection Act, H.R. 4173, 111th Cong. § 1101 (2010). According to the Federal Reserve System, the amendment is “for the purpose of providing liquidity to the financial system and not to aid an individual failing financial company.” Press Release, Bd. of Governors of the Fed. Reserve Sys., Emergency Lending Auth. (Dec. 23, 2013), http://www.federalreserve.gov/newsevents/reform_milestones.htm. As discussed in Part I, few have confidence that there will be no more bailouts.

22. According to the Federal Register’s summary of the purpose of the regulations issued under Dodd-Frank, “Regulations and other documents issued under the Dodd-Frank Wall Street Reform Act are intended to promote the financial stability of the United States by improving accountability and transparency in the financial system, to end “too big to fail” bailouts of financial companies, and to protect consumers from abusive financial services practices.” *Dodd-Frank Wall Street Reform*, FED. REG., <https://www.federalregister.gov/dodd-frank-wall-steet-reform> (last visited Apr. 24, 2015).

23. DAVID SKEEL, *THE NEW FINANCIAL DEAL: UNDERSTANDING THE DODD-FRANK ACT AND ITS (UNINTENDED) CONSEQUENCES* 11 (2011) [hereinafter, “SKEEL, NEW DEAL”]. (“The adjustments that purport to end bailouts and ad hoc interventions will do nothing of the kind. Although the restrictions on the Federal Reserve’s emergency lending authority are based on a valuable principle—that the Fed should not single out individual firms for rescue—they will not prevent future bailouts.”); VERN MCKINLEY, *FINANCING FAILURE: A CENTURY OF BAILOUTS* 283 (2011) (“Although the goal of ending taxpayer bailouts once and for all is a noble objective, the likelihood that the Dodd-Frank legislation has accomplished this is quite small.”); see also Peter Conti-Brown, *Elective Shareholder Liability*, 64 *STAN. L. REV.* 409, 412 (2012) (“Any policy reaction to bailouts must deal with [the] complexity [that] bailouts are almost always the wrong policy approach, except when they are not.”).

24. See *infra* note 176.

25. SKEEL, *NEW DEAL*, *supra* note 23, at 9.

26. *Resolution of Systemically Important Financial Institutions: The Single Point of Entry Strategy*, 78 *Fed. Reg.* 76,614, 76,614-24 (Dec. 18, 2013) [hereinafter, “SPOE Proposal”]. See also *infra* Part IV.

analysis makes possible three contributions to advance our understanding of how different institutional choices will affect future crises.

First, institutional analysis shows that regulatory displacement is problematic not only because regulators threaten rule-of-law values but, more practically, prevents regulators from attacking the two pathologies that produce crises in the first place: market concentration and complexity.²⁷ By forcing failed firms to consolidate, and promulgating mind-numbing regulation, regulators may actually exacerbate concentration and complexity. The combination of concentration, complexity, and capture leave us in what Andrew Haldane calls a “doom loop,”²⁸ an unsustainable cycle of boom and bailout.

Second, institutional analysis provides a systematic way to compare the participatory capacities of markets, courts, and regulators to prevent and resolve financial crises, and thus to determine how regulatory displacement arises and becomes problematic. Borrowing from literature on the “braiding” of formal and informal contracts, I show that in the context of financial distress, different institutions also braid.²⁹ Markets and courts tend to reinforce one another through debt restructuring or asset liquidation. In most cases, their participatory qualities should render them the first line of defense against crises, because they tend to reduce information asymmetries, effectively align incentives, and redistribute losses in ways that are, broadly speaking, more likely to be interpreted as legitimate. Regulators, too, braid with markets, but this can be problematic, as it can reflect a “deep capture” that renders regulators the institutional preference of the regulated: large financial firms.³⁰

Third, institutional analysis suggests a solution to the problem of regulatory displacement: courts. As Hart and Sacks, early institutional analysts, observed many years ago, courts are the necessary counterweight to other institutions.³¹ I assess both a proposal to amend the Bankruptcy Code to add a “Chapter 14” for large financial firms, and a novel proposal

27. See *infra* Parts I.B. & I.C.

28. Andrew Haldane, *The Doom Loop*, LONDON REV. OF BOOKS, Feb. 23, 2012, at 21, available at <http://www.lrb.co.uk/v34/n04/andrew-haldane/the-doom-loop>.

29. See *infra* Part III.

30. See Jon Hanson & David Yosifon, *The Situation: An Introduction to the Situational Character, Critical Realism, Power Economics, and Deep Capture*, 152 U. PA. L. REV. 129, 202–84 (2003) (introducing “deep capture” and providing evidence supporting the hypothesis); see also *infra* Parts I.C and III.C.

31. See LEGAL PROCESS, *supra* note 4 at 166 (“It is a postulate of the American legal system that whenever prior official determination is brought forward as a premise of decision, the power of the official or agency under the governing constitution to make the determination is open to judicial inquiry.”).

to subject directors of such firms to a heightened duty of oversight.³² While I find that the case has not yet been made to amend the Bankruptcy Code as proposed, rethinking directors' duties in this context might produce better outcomes. It could lead to more actively engaged directors, or to smaller and simpler financial firms, or (one hopes) both. Although hardly a perfect solution,³³ it also offers a way to better align incentives and governance in the management of large financial firms.

The Article proceeds in five parts. Part I describes the underlying problems of concentration and complexity, and explains why capture prevents regulators from solving them. Part II develops a framework for comparing institutional responses to financial distress and crises. Part III uses the framework from Part II to compare the capacities of markets, courts, and regulators to prevent and manage financial crises, and shows why large financial firms will tend to prefer regulators to markets or courts. Part IV looks more deeply at the problem of regulatory displacement as it is currently playing out in proposals to operationalize Dodd-Frank's orderly liquidation authority, in particular through the so-called "single point of entry," whereby regulators would seize only the parent entity in a financial-firm complex. Part V considers alternatives, assessing both proposed amendments to the Bankruptcy Code to accommodate the failures of large financial firms as well as a novel—and doubtless controversial—proposal that courts should more rigorously review directors' discharge of their duties to oversee systemically important financial institutions.

Institutional analysis cautions that no choice is ideal: we have only "imperfect alternatives," as Neil Komesar has observed.³⁴ Nevertheless, looking closely at the choices we have, and understanding their costs and benefits, are vital if we wish to better manage the financial system to prevent or ameliorate future crises.

I. CONCENTRATION, COMPLEXITY, AND CAPTURE—THE DOOM LOOP

A key observation of institutional analysis is that as problems become larger and more complex, the performance of all institutions will deteriorate, but at different rates. Regulatory responses are typically thought to be more effective than courts or markets for problems that involve many people, great complexity, or both.³⁵ The bank failure regime,

32. See *infra* Part V.

33. As discussed in Part V, it would severely tax courts, which are often ill-equipped to deal with large-scale, complex problems.

34. KOMESAR, 1994, *supra* note 4.

35. KOMESAR, 2001, *supra* note 4, at 159 ("As numbers and complexity increase,

for example, can be justified on grounds that banks typically have many widely dispersed depositors who could neither negotiate nor litigate a solution to the bank's collapse.

Yet, the failures of very large, non-bank financial services firms may be different. While financial crises are clearly problems of scale ("concentration") and complexity, the political dynamics of financial services regulation will render regulators less effective at preventing crises than we might expect or hope, because regulators in this context are especially vulnerable to informational and other forms of capture. This leaves us in Haldane's "doom loop," noted in the Introduction.³⁶ This Part explains the doom loop as a function of three phenomena: industry concentration, complexity in financial transactions and their regulation, and political cycles that result in regulatory capture. To the extent they are captured, regulators cannot be expected to reduce concentration or complexity. Indeed, they may contribute to both.

A. Concentration

Concentration is a compact reference to the "too big to fail" ("TBTF") problem: some financial services firms will be so large that the government will have no choice but to bail them out. Dodd-Frank was enacted on the promise that there would be no more bailouts.³⁷ To the extent that financial firms continue to grow inversely in number and size—fewer but bigger—there is understandable fear that Dodd-Frank will fail.

Title I of Dodd-Frank sets forth rules meant to constrain concentration. In April 2014, banking agencies adopted a final rule requiring U.S. bank holding companies (BHCs) to reduce their leverage.³⁸

judges . . . will be increasingly uncomfortable with what they do not know and with what surprises may be around the adjudicative corner.”)

36. Haldane, *supra* note 28.

37. As President Obama argued in support of Dodd-Frank: “We will not go back to the days of reckless behavior and unchecked excess that was at the heart of the crisis, where too many were motivated only by the appetite for quick kills and bloated bonuses [T]he old ways that led to this crisis cannot stand. And the extent that some have so readily returned to them underscores the need for change and change now. History cannot be allowed to repeat itself.” Barack Obama, Remarks by the President on Financial Rescue and Reform (Sept. 1, 2009), *available at* http://www.whitehouse.gov/the_press_office/Remarks-by-the-President-on-Financial-Rescue-and-Reform-at-Federal-Hall.

38. BHCs with over \$700 billion in total consolidated assets or assets under custody of at least \$10 trillion must maintain a 6% supplementary leverage ratio requirement, and domestic top-tier holding companies must maintain a 5% supplementary leverage ratio requirement. FINANCIAL STABILITY OVERSIGHT COUNCIL, 2014 ANNUAL REPORT 92 (2014) [hereinafter “FSOC 2014 REPORT”], *available at* <http://www.treasury.gov/initiatives/fsoc/Documents/FSOC%202014%20Annual%20Report.pdf>

According to the Financial Stability Oversight Council (FSOC) created by Dodd-Frank, “[t]he rule is intended to constrain the buildup of financial leverage at the largest banking organizations and place additional private capital at risk before the Deposit Insurance Fund or government resolution mechanisms would need to be called upon.”³⁹ Through the so-called “Volcker Rule”⁴⁰ and stricter capital requirements,⁴¹ Dodd-Frank would also reduce firms’ leverage ratios. In this respect, it may render firms at least somewhat less concentrated.

Yet, observers have doubts about these efforts to reduce concentration or its risks. As Haldane notes, even using capital controls more stringent than those envisioned by Dodd-Frank, “. . . an unexpected loss in a bank’s assets of just 4 per cent will be enough to render it insolvent.”⁴² A 2014 report by the United States Government Accountability Office (“GAO”) conceded that “recent regulatory reforms,” such as Dodd-Frank, “have reduced but not eliminated the likelihood the federal government would prevent the failure of one of the largest bank holding companies.”⁴³ The inference is that the market perceives very large banks to be too big to fail, and thus too concentrated.⁴⁴

The financial crisis of 2008 appears to have increased, not reduced, concentration. “Our biggest banks are bigger now than they were in 2008,” a recent story in *Forbes* explains, “when the Troubled Asset Relief Program dedicated billions of taxpayer dollars to make sure they didn’t fail. In part, that has happened because the government forced the merging of Merrill Lynch, Washington Mutual, Bear Stearns, Countrywide, and

39. *Id.*

40. Section 619 of Dodd-Frank added the so-called “Volcker Rule” (name for former Federal Reserve Chairman Paul Volcker, who is credited as its chief architect). This would prohibit a “banking entity” from “engag[ing] in proprietary trading” or “acquir[ing] or retain[ing] any equity, partnership, or other ownership interest in or sponsor[ing] a hedge fund or private equity fund.” Dodd-Frank Act § 619, § 13(a)(1) (amending the Bank Holding Company Act of 1956, 12 U.S.C.A. § 1841 (West 2010)).

41. 12 U.S.C. § 5371 (2011).

42. Haldane, *supra* note 28.

43. U.S. GOV’T ACCOUNTABILITY OFFICE, GAO 14-621, LARGE BANK HOLDING COMPANIES: EXPECTATIONS OF GOVERNMENT SUPPORT para. 1 (2014), <http://www.gao.gov/assets/670/665162.pdf>. This was the second of two reports on market expectations regarding government support for financial services firms. See also U.S. GOV’T ACCOUNTABILITY OFFICE, GAO 14-18, GOVERNMENT SUPPORT FOR BANK HOLDING COMPANIES: STATUTORY CHANGES TO LIMIT FUTURE SUPPORT ARE NOT YET FULLY IMPLEMENTED (2013), <http://www.gao.gov/assets/660/659004.pdf>.

44. See Gretchen Morgenson, *Big Banks Still a Risk*, N.Y. TIMES, Aug. 2, 2014, <http://www.nytimes.com/2014/08/03/business/big-banks-still-a-risk.html> (describing government study showing that largest financial firms still enjoy an implicit government subsidy, usually considered evidence that such firms are considered too big to fail).

Wachovia into the largest banks, making them even larger.”⁴⁵ Economist Philip Strahan thus notes that “[i]n the wake of the Financial Crisis of 2007–2008, it seems increased concentration in the financial industry has worsened the TBTF problem.”⁴⁶ This suggests that Simon Johnson and James Kwak may be correct in arguing that we will ultimately be left with six “oligarch” banks.⁴⁷

The oligarchic quality of concentration stems from growing mutual dependence between financial firms and the government that would regulate them. According to Alessandri and Haldane, the relationship between banks and government has long been deep and intimate,⁴⁸ although the valence of influence has reversed over time. Historically, banks were lenders and governments were borrowers.⁴⁹

For the past two centuries, the tables have progressively turned. As Alessandri and Haldane observe:

The state has instead become the last-resort financier of the banks. As with the state, banks’ needs have typically been greatest at times of financial crisis. And like the state, last-resort financing has not always been repaid in full and on time Today, perhaps the biggest risk to the sovereign comes from the banks. Causality has reversed.⁵⁰

The chief evil of concentration is that it seems to lead inevitably to a government subsidy for large financial firms. As John Coffee explains “[t]he larger the bank, the cheaper it could borrow, in part because all assumed that the government would not allow the bank to fail. Seeing this

45. Ted Kaufman, *An Unhappy Birthday for Dodd-Frank: The “Too Big to Fail” Problem Gets Bigger*, FORBES, Jul. 18, 2013, available at <http://www.forbes.com/sites/tedkaufman/2013/07/18/an-unhappy-birthday-for-dodd-frank-the-too-big-to-fail-problem-gets-bigger>.

46. Philip E. Strahan, *Too Big to Fail: Causes, Consequences, and Policy Responses*, 5 ANN. REV. FIN. ECON. 43 (2013).

47. See SIMON JOHNSON & JAMES KWAK, 13 BANKERS: THE WALL STREET TAKEOVER AND THE NEXT FINANCIAL MELTDOWN 191 (2011) (discussing, in a chapter entitled “The American Oligarchy,” “the enormous growth of top-tier financial institutions and the corresponding increase in their economic and political power”).

48. PIERGIORGIO ALESSANDRI & ANDREW G. HALDANE, BANKING ON THE STATE 1 (2009) available at <http://www.bis.org/review/r091111e.pdf>.

49. *Id.* at 1 (“As awareness of sovereign risk grew, banks began to charge higher loan rates to the sovereign than to commercial entities. In the 15th century, Charles VIII of France paid up to 100% on war loans to Italian banks, which were at the same time charging Italian merchants 5-10%. The Bank of England’s first loan to government carried an interest rate of 8% – double the rate at which the Bank discounted trade bills.” (citations omitted)).

50. *Id.*

subsidy, the shareholders and managers of such financial institutions rationally exploited it by taking on excessive debt and leverage.”⁵¹ This, in turn, presents problems of externality and moral hazard that few would defend.⁵²

B. Complexity

Although Dodd-Frank has made a modest attempt to reduce concentration, it does nothing to reduce complexity. “Complexity” in the context of the financial crisis refers to three specific phenomena: (1) transactional complexity, as is found in securitization and other derivative transactions; (2) structural complexity, as is evident in the many subsidiaries in which financial services (or other) firms may have an interest; and (3) regulatory complexity, as is reflected in the hundreds of pages of Dodd-Frank legislation, and thousands of pages of regulations implemented or proposed in support of Dodd-Frank. As Professor Schwarcz has argued, complexity in the financial markets is “. . . the greatest financial-market challenge of the future.”⁵³ It is both a cause and symptom of regulatory displacement.

Transactional complexity reflects the development of securitization and other financial derivatives that involve multiple steps and parties endowed with highly contingent rights and responsibilities.⁵⁴ A securitization generally involves at least three parties and two sets of transfers to effect what is, in essence, a capital-markets financing: the originator (e.g., a lender who creates a “financial asset”); a special purpose entity that purchases the financial asset; and an underwriter who pools the financial assets and issues securities whose value is determined in part or in whole by the predicted value of the financial assets.⁵⁵ Any given offering of securities in a securitization could involve hundreds, perhaps thousands,

51. John C. Coffee, Jr., *The Political Economy of Dodd-Frank: Why Financial Reform Tends to Be Frustrated and Systemic Risk Perpetuated*, 97 CORNELL L. REV. 1019, 1048 (2012) [hereinafter, “Coffee, Political Economy”].

52. Cf. Adam J. Levitin, *In Defense of Bailouts*, 99 GEO. L.J. 435, 483 (2011) (discussing the need for bailouts under certain circumstances).

53. Steven L. Schwarcz, *Regulating Complexity in Financial Markets*, 87 WASH. U. L. REV. 211, 213 (2009).

54. Jonathan Lipson, *Re: Defining Securitization*, 85 S. CAL. L. REV. 1229 (2012) [hereinafter, “Lipson, Defining”]; Kathryn Judge, *Fragmentation Nodes: A Study in Financial Innovation, Complexity, and Systemic Risk*, 64 STAN. L. REV. 657 (2012) [hereinafter “Judge, Fragmentation”].

55. Lipson, *Defining*, *supra* note 54; Judge, *Fragmentation*, *supra* note 54.

of pages of disclosure.⁵⁶ As Kathryn Judge has observed, this structure produces “fragmentation nodes” that contribute materially to the complexity of the financial system.⁵⁷ Despite its complexity, securitization shows every sign of reviving.⁵⁸

Structural complexity refers to the number of entities (e.g., special purpose entities created in securitizations) that a large financial services firm may have. For example, when it declared bankruptcy on September 15, 2008, Lehman Brothers had 209 subsidiaries registered in twenty-one countries; they were also party to about 900,000 derivatives contracts.⁵⁹ Frequently, large financial firms are connected to one another through shared ownership in these entities, or interests in the assets these entities hold. Interconnectedness among financial services firms significantly increases the likelihood of cascading failures, and crises, because the failure of a sponsoring (parent) bank may impair the value of investments held by other, healthy firms in the failing bank’s subsidiaries.⁶⁰

Regulatory complexity is perhaps the biggest problem because it means that the cure is, in fact, the disease. Financial services regulation has followed a steep trajectory in volume: the Federal Reserve Act (1913)⁶¹ and the Glass-Steagall Act (1933)⁶² are twenty-four and thirty-seven pages, respectively; the Sarbanes-Oxley Act of 2002 is sixty-six pages long and

56. See *The Gods Strike Back: A Special Report on Financial Risk*, ECONOMIST, Feb. 13, 2010, at 2 (“A proper understanding of a typical collateralised debt obligation . . . would have required reading 30,000 pages of documentation.”).

57. See Judge, *Fragmentation*, *supra* note 54, at 661 (“Four specific sources of complexity are highlighted: (1) fragmentation, (2) the creation of contingent and dynamic economic interests in the underlying assets, (3) a latent competitive tendency among different classes of investors, and (4) the lengthening of the chain separating an investor from the assets ultimately underlying its investment.”).

58. See American Bankers’ Association, *Asset-Backed Alert*, Sept. 30, 2013, available at <http://www.abalert.com/ranking.php?rid=2957> (reporting year-on-year average 16.5% increase in securitization as of Sept. 30, 2013); see also *Securitization: It’s Back*, ECONOMIST, Jan. 14, 2014, available at <http://www.economist.com/news/leaders/21593457-once-cause-financial-worlds-problems-securitisation-now-part-solution-its> (reporting that securitization is now a common solution to international financial problems).

59. Michael Fleming & Asani Sarkar, *The Failure Resolution of Lehman Brothers*, LIBERTY STREET ECON. (Fed. Reserve Bank of N.Y., New York, N.Y.), Apr. 3, 2014, available at <http://libertystreeteconomics.newyorkfed.org/2014/04/the-failure-resolution-of-lehman-brothers-.html#.VTrcFmRdXIM>.

60. See Kathryn Judge, *Interbank Discipline*, 60 UCLA L. REV. 1262, 1267 (2013) [hereinafter, “Judge, *Discipline*”] (explaining that “in order to assess whether the types of risks a bank is exposed to are closely correlated to the risk exposures of other banks, a party must not only understand a bank’s risk profile, but also the risk profiles of other banks”).

61. Federal Reserve Act, Pub.L. 63–43, 38 Stat. 251, codified at 12 U.S.C. 226 (Dec. 23, 1913).

62. Banking Act of 1933, Pub.L. 73–66, 48 Stat. 162, codified in portions of 12 U.S.C., (June 16, 1933).

Dodd-Frank weighs in at 849 pages.⁶³ With a little more than half (about 58.5%, or 231 of 395) of its required rulemakings finalized as of this writing, regulations implementing Dodd-Frank run over 13,000 pages.⁶⁴ These regulations have been developed in response to more than 27,000 public comment letters on Dodd-Frank.⁶⁵ This explosion in formal law mirrors and magnifies the transactional and structural complexity in the financial system.

Scholars fear that complexity will stultify efforts to bring stability to the financial system. As Schwarcz points out:

The Dodd-Frank Act puts great stock in the idea of improving disclosure, but its efficacy will be limited. Some financial structures are getting so complex that they are incomprehensible. Furthermore, it may well be rational for an investor to invest in high-yielding complex securities without fully understanding them. Among other reasons, the investor simply may not have the staffing to evaluate the securities, whereas failure to invest would appear to—and in fact could—competitively prejudice the investor vis-à-vis others who invest.⁶⁶

In its 2014 annual report, the Financial Stability Oversight Council found that large financial services firms had modestly reduced their complexity and interconnectedness in 2013, based on the decreased number of assets where fair value measurement is based on unobservable inputs and the estimated size of potential fire-sale externalities.⁶⁷ Yet, most

63. See Mark J. Perry, *Dodd-Frank Act, aka The 2010 Full Employment Act for Lawyers, Accountants, and Consultants*, CARPE DIEM (Jul. 16, 2010, 9:07 AM), <http://mjerry.blogspot.com/2011/09/dodd-frank-2010-full-employment-act-for.html>.

64. This is roughly the combined number of pages of regulation under titles 12 (Banks & Banking), 17 (Commodity and Security Exchanges) and 31 (Money and Finance) in the Code of Federal Regulations. *Id.* Figures are as of July 18, 2014. See generally DAVIS POLK & WARDWELL, LLP, DODD-FRANK PROGRESS REPORT (2015), <http://www.davispolk.com/Dodd-Frank-Rulemaking-Progress-Report/>.

65. This is based on a search of publicly filed comments using the term “Dodd Frank” on regulations.gov, which produced as of October 6, 2014 27,551 individual public comments. See REGULATIONS.GOV, <http://www.regulations.gov/#!searchResults;rpp=25;po=0;s=dodd%25Bfrank;fp=true;ns=true> (listing results for a search of publicly filed comments using the term “Dodd Frank” on regulations.gov, which produced, as of October 6, 2014, 27,551 individual public comments).

66. Steven L. Schwarcz, *Controlling Financial Chaos: The Power and Limits of Law*, 2012 WIS. L. REV. 815, 819 (internal citations omitted).

67. FSOC 2014 Report, *supra* note 38, at 116. Indeed, sophisticated participants in government recognize the need, at least in theory, to reduce complexity, even if they cannot accomplish it in practice. See CASS R. SUNSTEIN, SIMPLER: THE FUTURE OF GOVERNMENT 7

observers are resigned to a future in which complexity is a growing aspect of financial life.⁶⁸ It has grave systemic implications⁶⁹ because it presses the limits of human cognition: it is simply not possible to make good judgments about risk, reward, and the resolution of distress in the face of great complexity.⁷⁰

C. Capture

Among the most despondent observers is Roberta Romano, who fears that regulators will never be able to keep up, and are thus always likely to do more harm than good.⁷¹ Yet, she concedes, politicians (and, thus regulators) are nevertheless forced to take some action in response to crises, so the pattern is that regulation inevitably follows crises.⁷² But, political motives are not pure. Rather, she argues that “policy entrepreneurs” foist “quack” legislation on the financial system, ignorant

(2013) (stating that OIRA frequently rejected rules in order to “reduce cumulative burdens” and to reduce complexity).

68. David M. Driesen, *Legal Theory Lessons from the Financial Crisis*, 40 J. CORP. L. 55, 79 (2014) (“This problem of complexity making identification of an efficient outcome impossible or arbitrary and unreliable exists not just in the area of finance (as we have seen), but in a lot of other areas as well.”); Judge, *Fragmentation*, *supra* note 54, at 660 (“By focusing on sources of complexity that are likely to be present in other financial innovations that shift financing activities out of banks and into the shadow banking system, this Article suggests that these dynamics are likely to arise again.”).

69. Charles K. Whitehead, *Destructive Coordination*, 96 CORNELL L. REV. 323 (2011) (describing systemic risk when banks take on complex risks); Steven L. Schwarcz, *Systemic Risk*, 97 GEO. L.J. 193, 219 (2008) (discussing role of complexity in creating systemic risk).

70. See generally J.B. Ruhl, *Law’s Complexity: A Primer*, 24 GA. ST. U. L. REV. 885 (2008) (exploring the effect of a complex legal system); J.B. Ruhl, *The Fitness of Law: Using Complexity Theory to Describe the Evolution of Law and Society and Its Practical Meaning for Democracy*, 49 VAND. L. REV. 1406 (1996) (comparing the legal system with Complexity Theory).

71. In Romano’s view,

[T]he nub of the regulatory problem derives from the fact that financial firms operate in a dynamic environment in which there are many unknowns and unknowables and state-of-the-art knowledge quickly obsolesces. In such a context, even the most informed regulatory response—which Congress’s reaction in the recent crises was not—will be prone to error and is likely to produce backward-looking regulation that takes aim at yesterday’s perceived problem, rather than tomorrow’s. . . .

Roberta Romano, *Regulating in the Dark*, in REGULATORY BREAKDOWN 87 (Cary Coglianese ed., 2014) [hereinafter, “Romano, *Dark*”]; see also Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521, 1526–27 (2005) [hereinafter, “Romano, *Quack*”] (questioning quality of decision-making that went into SOX legislative process).

72. Romano, *Dark*, *supra* note 71, at 88.

of, or indifferent to, the problems it may create.⁷³ In this sense, politicians are captured by majoritarian bias. To counteract this, she would require that financial regulation enacted in the wake of a crisis come with an automatic sunset provision, presuming repeal unless a later legislature reauthorized the law.⁷⁴

John Coffee has been among Romano's strongest critics, arguing that she fails to understand the dynamics of legislation or the influence that sophisticated financial actors wield both during a crisis and in the deregulatory repose that follows.⁷⁵ Drawing on the work of Mancur Olson, Coffee argues that "once a crisis subsides, more organized interest groups," such as financial services firms, "regain the upper hand and begin to extract concessions, exemptions, or outright repeal."⁷⁶ Coffee then worries about a different kind of capture, one that reflects minoritarian bias.

The term "regulatory capture" is routinely associated with George Stigler's insight that regulators may have greater allegiance to those they regulate than to the public.⁷⁷ Regulation, he argued, is a "good" that regulators sell to the highest bidder. The regulated are willing to pay for it as a way to create barriers to entry for competitors (not to improve the quality of their own products), as this may be a more granular and politically palatable path to (anti)competitive advantage than an outright government subsidy. (In the case of bailouts, it may be both). The regulators are compliant for many reasons, including that they lack the resources and expertise to compete with—and thus to regulate—the regulated.

Whether majoritarian or minoritarian, there is little doubt that capture presents a serious problem in the regulation of financial services.⁷⁸ In the

73. Romano, *Quack*, *supra* note 71, at 158. *Contra* Robert A. Prentice & David B. Spence, *Sarbanes-Oxley as Quack Corporate Governance: How Wise is the Received Wisdom?*, 95 GEO. L.J. 1843 (2007) (viewing SOX optimistically).

74. Romano, *Quack*, *supra* note 71, at 1600–02.

75. Coffee, *Political Economy*, *supra* note 51, at 1026 (arguing that Romano's proposed mandatory sunset provisions would be "an unnecessary fifth wheel, given the ease with which business interest groups can push back, repealing or downsizing legislation whenever they can make a colorable case that the legislation's costs exceed its benefits"); *see also* John C. Coffee, Jr., *Systemic Risk After Dodd-Frank: Contingent Capital and the Need for Regulatory Strategies Beyond Oversight*, 111 COLUM. L. REV. 795, 800–01 (2011).

76. Coffee, *Political Economy*, *supra* note 51 at 1026 (referencing MANCUR OLSON, *THE LOGIC OF COLLECTIVE ACTION: PUBLIC GOODS AND THE THEORY OF GROUPS* 33–36 (2d ed. 1971)).

77. George J. Stigler, *The Theory of Economic Regulation*, 2 BELL J. ECON. MGMT. SCI. 3, 3 (1971). An excellent recent assessment of Stigler's contribution appears in Christopher Carrigan & Cary Coglianese, *Capturing Regulatory Reality: Stigler's The Theory of Economic Regulation*, in *OXFORD HANDBOOK OF THE CLASSICS OF PUBLIC POLICY* (Steven Balla, Martin Lodge & Edward Page eds., Oxford Univ. Press 2015).

78. Perhaps the best early account of the symbiotic relationship between large financial

crisis, a (small) majority supported the Troubled Asset Relief Program (TARP), which became the basis for the massive regulatory “bailout” of (mostly) financial services firms.⁷⁹ Thereafter, the small minority of financial services firms who benefitted from TARP aggressively sought to control the regulatory implementation of Dodd-Frank. Through the laborious notice and comment process they have dulled Dodd-Frank’s impact and become further enmeshed with regulators.⁸⁰ As Alan Greenspan has noted, “Financial regulators . . . know far less than private-sector risk managers”; thus, “the open secret about regulation in the free-market world is that regulators take their cues from private-sector practitioners.”⁸¹

A strong example of this appears to be what Wendy Wagner calls “information capture”: “the excessive use of information and related information costs as a means of gaining control over regulatory decision[-]making.”⁸² This is possible, and a well-known problem in the process of enacting rules under Dodd-Frank, with over 27,000 public comments, because “[t]he law does not permit the agency to shield itself from this flood of information and focus on developing its own expert conception of the project. Instead, the agency is required by law to ‘consider’ all of the input received.”⁸³

To be sure, the foregoing glosses over much nuance in the study of regulatory capture. Some, for example, question whether it exists or, if it exists, is a problem, because it may simply correspond with legislative

firms and regulators appears in ANDREW ROSS SORKIN, *TOO BIG TO FAIL: THE INSIDE STORY OF HOW WALL STREET AND WASHINGTON FOUGHT TO SAVE THE FINANCIAL SYSTEM—AND THEMSELVES* (2009).

79. While Democrats largely supported President Bush’s TARP proposal, Republicans did not. Sixty-five House Republicans voted in favor of H.R. 3997, the original House vehicle for the act. After that legislation failed, on October 1, 2008, 34 Senate Republicans voted for H.R. 1424, the new vehicle for the act, and on October 3, 2008, 20 House Republicans voted for that bill. President Bush, a Republican, subsequently signed it into law. See *House Vote #680 in 2008*, GOVTRACK.US, <http://www.govtrack.us/congress/votes/110-2008/h680> (last visited Apr. 24, 2015); *Roll Call Votes 110th Congress - 2nd Session*, UNITED STATES SENATE, http://www.senate.gov/legislative/LIS/roll_call_lists/roll_call_vote_cfm.cfm?congress=110&session=2&vote=00213#position. TARP funds were also used to subsidize the automaker bankruptcies.

80. For example, over 18,000 comment letters were submitted in response to the Volcker Rule alone. See SCOTT A. CAMMAN, *THE VOLCKER RULE: 2012 BANKING INST. 22* (2012), available at <http://www.law.unc.edu/documents/banking/programs/dodd-frank/combinedpresentations.pdf> (powerpoint presentation); see also REGULATIONS.GOV, *supra* note 65 (discussing the volume of comments in response to Dodd-Frank).

81. ALAN GREENSPAN, *THE AGE OF TURBULENCE* 524 (2008).

82. Wendy E. Wagner, *Administrative Law, Filter Failure, and Information Capture*, 59 DUKE L.J. 1321, 1325 (2010).

83. *Id.* (citing 5 U.S.C. § 553(c) (2006)).

preferences for a particular industry.⁸⁴ Regulators' preference for one sector may reflect the delegation of larger popular will.⁸⁵ Others worry that "deep capture," in the words of Hanson and Yosifon, reveals "disproportionate and self-serving influence that the relatively powerful tend to exert over all the *exterior* and *interior* situational features that materially influence the maintenance and extension of that power—including those features that purport to be, and that we experience as, independent, volitional, and benign."⁸⁶

Whatever one may think of problems of capture, one thing is clear: through crises and recovery, both concentration and complexity have grown. Regulators cannot currently reduce either, and may worsen both. Thus, regulatory capture makes it implausible that regulators will be able to reduce or manage the two factors likely to contribute most to the next financial crisis.

II. THEORIES OF INSTITUTIONAL CHOICE

If regulators appear unlikely to reduce concentration and complexity, what other institutional choices might be better, and why? In order to answer these questions, it helps to understand the role of institutional analysis, because regulators are but one of several possible institutional choices in this context. Although the term "institution" is subject to many definitions,⁸⁷ institutions are, for purposes of developing a better understanding of financial distress and crises "large-scale social decision-making processes," in particular markets, courts, and regulators.⁸⁸ This

84. See, e.g., Lawrence G. Baxter, *Capture in Financial Regulation: Can We Redirect It Toward the Common Good?*, 21 CORNELL J.L. & PUB. POL'Y 175, 177 (2011) ("it might be that the regulatory regime appears "captured" because the legislature that created this regime was itself captured by "special interests" and, as a result, has produced a regime predestined to captured results favoring those interests.").

85. See Office of the Comptroller of the Currency, *History: 150 Years of the OCC*, available at <http://www.occ.gov/about/what-we-do/history/index-history.html> (last visited Aug. 15, 2014) (discussing legislative support for National Bank Act and its role in protecting national banks); see also *Tiffany v. Nat'l Bank of Miss.*, 85 U.S. 409, 413 (1873) ("National banks have been National favorites.").

86. Hanson & Yosifon, *supra* note 30, at 218.

87. As Jepperson points out, the following list of things could all in common understanding be considered "institutions": "marriage, sexism, the contract, wage labor, the handshake, insurance, formal organization, the army, academic tenure, presidency, the vacation, attending college, the corporation, the motel, the academic discipline, voting." Ronald L. Jepperson, *Institutions, Institutional Effects, Institutionalism*, in *THE NEW INSTITUTIONALISM IN ORGANIZATIONAL ANALYSIS* 143, 144 (Walter W. Powell & Paul J. DiMaggio eds., 1991).

88. KOMESAR, 2001, *supra* note 4, at 31 ("I use the choice among these institutional processes to clarify basic issues such as the role of regulation, rights, governments, and

Section develops a three-part framework that summarizes the development of institutional analysis, in order to show how institutional choice affects the likelihood and severity of financial crises.

A. *The Contribution of Hart & Sacks: Institutional Settlement*

The analysis of institutional choice is not new,⁸⁹ but scholars are just now beginning to consider its implications for financial failure.⁹⁰ Institutional analysis is rooted in the work of Henry M. Hart and Albert M. Sacks, who taught at Harvard Law School from 1932-1969⁹¹ and 1952-1991,⁹² respectively. They famously observed that courts are but one of many institutions available to solve social problems: “different procedures and personnel of different qualifications invariably prove to be appropriate for deciding different kinds of questions,” they taught generations of law students.⁹³ “So it is that every modern society differentiates among social

capitalism. These processes are alternative mechanisms by which societies carry out their goals.”).

89. One could argue that it began at the end of the 19th century, when Holmes opined that “[t]he duty to keep a contract at common law means a prediction that you must pay damages if you do not keep it—and nothing else.” Oliver Wendell Holmes, *The Path of the Law*, 10 HARV. L. REV. 457, 462 (1897). So stating, he recognized the institutional optionality embedded in promissory relations. One can perform a contract one may have come to regret, in which case one has chosen the market as the institution to solve his or her problem. If, instead, one chooses to pay damages, one is adverting directly or indirectly to courts, which (in general) determine whether damages must be paid and, if so, in what amounts.

90. See Skeel, *supra* note 3 (using Komesar’s theory of institutional choice to assess responses to crises). Work that implicitly recognizes institutional dimensions in the financial crisis includes: Judge, *Fragmentation*, *supra* note 54; RICHARD A. POSNER, *A FAILURE OF CAPITALISM: THE CRISIS OF ‘08 AND THE DESCENT INTO DEPRESSION* (2009); RICHARD A. POSNER, *THE CRISIS OF CAPITALIST DEMOCRACY* (2010); Eric A. Posner, & Glen E. Weyl, *An FDA for Financial Innovation: Applying the Insurable Interest Doctrine to 21st Century Financial Markets*, 107 NW. U. L. REV. 1307 (2012); Schwarcz, *supra* note 66, at 815; Richard Squire, *Shareholder Opportunism in a World of Risky Debt*, 123 HARV. L. REV. 1151, 1158–59 (2010); Charles K. Whitehead, *The Goldilocks Approach: Financial Risk and Staged Regulation*, 97 CORNELL L. REV. 1268 (2012). This list is meant to be neither exhaustive nor critical. Rather, these and many other good studies of the financial crisis recognize that markets alone—one institution—can no longer assure stability. Yet, they fail to assess rigorously the various alternatives.

91. Hart, *Henry Melvin. Papers, 1927-1969: Finding Aid*, HARVARD U. LIBRARY, available at <http://oasis.lib.harvard.edu/oasis/deliver/~law00107> (last visited Apr. 24, 2015).

92. Alfonso Narvaez, *Albert M. Sacks, 70, Harvard Law Dean and Noted Teacher*, N.Y. TIMES, Mar. 23, 1991.

93. LEGAL PROCESS, *supra* note 4, at 4. As Wisconsin’s Lloyd Garrison and Willard Hurst, early classroom teachers of institutional analysis wrote, “the various agencies of the law, such as legislatures, courts and commissions, are themselves often in conflict; and that they together are only one of the many means of social control, which includes churches,

questions, accepting one mode of decision for one kind and other modes for others—e.g., courts for “judicial” decisions and legislatures for “legislative” decisions.”⁹⁴

Through their legendary teaching materials, Hart and Sacks had an enormous effect on generations of lawyers.⁹⁵ Their starting point was not controversial: social institutions exist to “maximiz[e] the total satisfactions of valid human wants, and its corollary of a fair division of the presently available benefits of group living.”⁹⁶ The important question for Hart and Sacks was not the meaning of words such as “maximize,” “satisfaction,” “valid,” “fair” or “benefits.” Rather, meaning would be invested in those terms procedurally, through what they called “institutional settlement.”⁹⁷

“The principle of institutional settlement,” they explained, “expresses the judgment that decisions which are the duly arrived at result of duly established procedures of this kind ought to be accepted as binding upon the whole society unless and until they are duly changed.”⁹⁸ The key for Hart and Sacks, therefore, was process quality: If enough people accepted the process enough of the time, the result would probably be good enough, enough of the time. While this would not necessarily produce ideal results, the alternative was much worse, a Hobbesian war of all against all. “[R]egularized and peaceable methods of decision,” they argued, were the “alternative to disintegrating resort to violence.”⁹⁹

schools, families, newspapers and so on.” See LLOYD K. GARRISON & WILLARD HURST, LAW IN SOCIETY: A COURSE DESIGNED FOR UNDERGRADUATES AND BEGINNING LAW STUDENTS, 272 (rev. ed. 1941) (quoted in William N. Eskridge, Jr. & Philip P. Frickey, *An Historical and Critical Introduction to The Legal Process*, in Hart and Sacks, *supra* note 4, at lxxiv). Volume I of the 1941 edition of the Garrison/Hurst materials may be found at <http://libcd.law.wisc.edu/hurst/SERIES%202/BOX%203/FOLDER%201/ITEM%201.PDF>.

94. LEGAL PROCESS, *supra* note 4.

95. The materials were never published in their lifetimes. William Eskridge & James Frickey, *Commentary: the Making of the Legal Process*, 107 HARV. L. REV. 2031, 2046 (1994). They were later organized and published by Eskridge and Frickey as LEGAL PROCESS, *supra* note 4. Hart and Sacks’ work has been called “the most influential work not produced in movable type since Gutenberg.” Eskridge & Frickey, *id.* at 2031 (quoting J. D. Hyman, *Constitutional Jurisprudence and the Teaching of Constitutional Law*, 28 STAN. L. REV. 1271, 1286 n. 70 (1976)).

96. LEGAL PROCESS, *supra* note 4, at 105.

97. *Id.* at 4 (emphasis in original) (“[T]he principle of institutional settlement . . . builds upon the basic and inescapable facts of social living . . . namely, the fact that human societies are made up of human beings striving to satisfy their respective wants under conditions of interdependence, and the fact that this common enterprise inevitably generates questions of common concern which have to be settled, one way or another, if the enterprise is to maintain itself and to continue to serve the purposes which it exists to serve.”).

98. *Id.*

99. *Id.*

The concept of institutional settlement exists in a complex, reciprocal relationship with rule-of-law values, without which process would have little (or less) meaning.¹⁰⁰ According to Eskridge and Frickey, Hart and Sacks “designated the judiciary as the guardians of rule-of-law values and envisioned the duty of judges to be the ‘reasoned elaboration’ of ‘neutral principles’ and legislative ‘purposes.’”¹⁰¹ They developed the now common distinction between “rules” and “standards” by which judges would have discretion to apply edicts from other branches (i.e., Congress) depending in part on the nature of the language and purpose of the law or rule.¹⁰² They would not, of course, be permitted unfettered discretion.

A difficult question for Hart and Sacks was how courts should apply “neutral principles” when confronted with rules (or standards) that judges found problematic because indeterminate in application or recruited to address changing social conditions.¹⁰³ Because they tended to prefer deference to legislative majorities or administrative experts, they were sometimes accused of creating an intellectual justification for opposition to landmark jurisprudence that deviated from the rule of (extant) law (*e.g.*, *Brown v. Board of Education*).¹⁰⁴ Yet, for Hart and Sacks, the rule of law, and the role of courts in deciding what the rule of law would mean, were critical protections against overreaching by other branches. While courts may not be able to solve all problems, judicial review and negation play a powerful role in determining choices among, and the boundaries of, other social institutions.

100. For example, in discussing the interplay between contract doctrine and federal agricultural regulation, they observed that “private decisions and official decisions” developed in ways that reflect a “chicken-and-egg relationship” that “def[ies] any facile description.” *Id.* at 8-9.

101. Eskridge & Frickey, *supra* note 95, at 2048 (quoting LEGAL PROCESS, *supra* note 4, at 15 (“reasoned explanation”); 1407-26 (“principles”); 1178-1203, 1405-17 (legislative “purposes”)).

102. See, *e.g.*, MARK KELMAN, A GUIDE TO CRITICAL LEGAL STUDIES 15-63 (1987); Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 DUKE L. REV. 557 (1992); Kathleen M. Sullivan, *The Supreme Court, 1991 Term-Forward: The Justices of Rules and Standards*, 106 HARV. L. REV. 22, 57-69 (1992); FREDERICK SCHAUER, PLAYING BY THE RULES: A PHILOSOPHICAL EXAMINATION OF RULE-BASED DECISIONMAKING IN LAW AND IN LIFE 104 (1991).

103. See Charles F. Sabel & William H. Simon, *Contextualizing Regimes: Institutionalization as a Response to the Limits of Interpretation and Policy Engineering*, 110 MICH. L. REV. 1265 (2012) (discussing Hart and Sacks’ response to indeterminacy and uncertainty).

104. See, *e.g.*, Virginia E. Nolan & Edmond Ursin, *The Deacademification of Tort Theory*, 48 KAN. L. REV. 59, 68 (1999) (arguing that the “most influential articulation of” the “neutral principles” perspective “is found in the classic 1958 materials by Henry M. Hart, Jr. and Albert M. Sacks.”).

Perhaps even more difficult are problems of scale and complexity. Lacking resources or the capacity to inflict violence, courts could only rarely tackle very large problems. Scale was especially problematic, because courts have been tempted to address large social problems through mechanisms such as the class-action lawsuit and the nationwide injunction. While these mechanisms are sometimes effective in the short-run, other institutions, particularly legislatures, are more likely to have the institutional infrastructure to address large social problems. “As numbers and complexity increase,” Neil Komesar argues, “judges . . . will be increasingly uncomfortable with what they do not know and with what surprises may be around the adjudicative corner.”¹⁰⁵ And, yet, increasing scale and complexity place strain on all social institutions, and may thus leave courts wary of relying too heavily on other institutional actors, such as government or markets.¹⁰⁶

It is hard to overstate the influence of Hart and Sacks’ analysis.¹⁰⁷ Yet, they could not answer certain basic questions. First, their analysis treated social goals as exogenous to the institutions through which the goals would be implemented. How would we know, for example, what constituted “valid” human wants that social institutions should maximize? Because the analysis expected judges to be “neutral,” this was a question for other institutions, particularly politicians and regulators. Critics such as Duncan Kennedy were, however, suspicious and concerned that legal process was merely a mask for political bias.¹⁰⁸

Second, if social goals were exogenous, what role remained for formal law, as such? The logic of the model led inexorably to the view that law was politics by other means. Politics would reflect the biases of political participants, whether voters in an electoral process or participants in “contextualizing regimes,” in Sable and Simon’s terms, that advance

105. KOMESAR, 2001, *supra* note 4, at 159.

106. *Id.* at 160 (“As numbers and complexity increase, courts want more help, but there is less help available. We can expect tougher institutional choices with more compromises and more uncomfortable partnerships with these other institutions.”).

107. Eskridge & Frickey, *supra* note 95.

108. The most prominent challenge of this form comes from the Critical Legal Studies movement, whose literature is too voluminous to cite usefully here. *See, e.g.*, Duncan Kennedy, *Form and Substance in Private Law Adjudication*, 89 HARV. L. REV. 1685, 1685 (1976) (“[S]ubstantive and formal conflict in private law cannot be reduced to disagreement about how to apply some neutral calculus that will ‘maximize the total satisfactions of valid human wants.’ The opposed rhetorical modes lawyers use reflect a deeper level of contradiction. At this deeper level, we are divided, among ourselves and also within ourselves, between irreconcilable visions of humanity and society, and between radically different aspirations for our common future.”) (quoting LEGAL PROCESS, *supra* note 4, at 113); Robert W. Gordon, *Critical Legal Histories*, 36 STAN. L. REV. 57 (1984).

special interests, such as those in financial services.¹⁰⁹ Law, of whatever character, was limited in its ability to expose or remedy political biases because it was always a product of those biases.¹¹⁰ Regulatory capture is simply a strong example of this.

Third, it offered no insight into how choices among institutions would or should be made. It made little effort to compare rigorously different institutions' attributes or their efficacy at solving particular problems. Nor did it offer a descriptive or prescriptive theory about how choices would or should be made. Of course, courts could not act on their own initiative, needing always a case or controversy to trigger involvement. But, under what conditions would or should courts be a better institutional choice than markets or regulators or other institutional actors? While few would quibble with the goal of institutional settlement—"legitimacy" in modern parlance¹¹¹—more work would be needed in order to understand how different institutional choices would make this more likely.

B. The Contribution of Komesar—Comparative Institutional Analysis

That work would be undertaken by Neil Komesar. Komesar made two significant contributions to institutional analysis. First, he recognized that the minoritarian bias reflected in interest group analysis is only half of the story: consistent with the political cycling of financial regulation described in Part I, there are important moments when political institutions will reflect majoritarian biases. Institutional choices and performance are thus subject to what he calls a "two-force" model reflecting both minoritarian and majoritarian forces. In the case of financial distress,

109. See Sabel & Simon, *supra* note 103. In a "contextualizing regime" "officials charged with decisionmaking adopt the normative output of one or more specialized bodies of stakeholders." *Id.* at 1266.

110. A word about the word "bias." I use it here to refer to preferences of stakeholders. Bias is an inevitable feature of stakeholder participation, and so is not necessarily problematic. Bias becomes troublesome, however, when it produces net social costs (however measured) not internalized by active stakeholders. Economists would refer to the product of bias as "externalities," "transactions costs," or "market failures." To the extent bias is problematic, better institutional choices will help to reduce—but never eliminate—the costs of those biases.

111. "Legitimacy" "posits that a system perceived as providing fair process and just laws promotes compliance with the law and respect for and deference to law enforcement authorities." See Lauren M. Ouziel, *Legitimacy and Federal Criminal Enforcement Power*, 123 YALE L.J. 2236, 2239 (2014). Important discussions of legitimacy in criminal law appear in e.g., PAUL ROBINSON, *DISTRIBUTIVE PRINCIPLES OF CRIMINAL LAW: WHO SHOULD BE PUNISHED HOW MUCH?* (2008); PAUL ROBINSON & JOHN DARLEY, *JUSTICE, LIABILITY AND BLAME: COMMUNITY VIEWS AND THE CRIMINAL LAW* (1995); TOM R. TYLER, *WHY PEOPLE OBEY THE LAW* (1990).

majoritarian preferences will dominate in the wake of a crisis, when public desperation or ire were at their peak; thereafter, as Coffee noted, well-resourced minorities gain the upper hand in recovery.¹¹²

Second, and perhaps more important, he developed a theory about how and why institutional choices are and should be made, through what he called a “participation centered” model.¹¹³ This recognizes that different institutions have different comparative advantages, and different stakeholders will choose the institution that best suits their interests.¹¹⁴ All institutions will perform imperfectly, but some will perform better than others depending on their characteristics (e.g., resources, expertise, and so on). The important work is to compare the costs and benefits of the available choices.

Using the simple example of tort law, Komesar showed how the distribution of stakes affects participants, and thus institutional performance and choice.¹¹⁵ Ordinarily, manufacturers will have higher per capita stakes in the sales of their products than will consumers. In most cases, no single product will affect an individual purchaser as much as all sales will affect the seller. If a product is defective, the manufacturer in many cases will want to repair or replace it. The market is an effective institution for both sales of goods and for correcting occasional errors. Manufacturers thus prefer the market, which is unburdened by judicial or regulatory intervention. Having the most at stake relative to consumers, that is the institution that will be chosen.

If, however, the product turns out to be significantly harmful, there may be what Komesar calls a “shifted distribution.” In a shifted distribution, “victims’ low distribution *ex ante* becomes a high uniform distribution *ex post*.”¹¹⁶ In these cases, courts may be the better institutional choice, because through the litigation process, harms will be measured and (roughly speaking) redressed. As in the famous exploding

112. See discussion *supra* Part I.C.

113. KOMESAR, 1994, *supra* note 4, at 6.

114. Participation, Komesar has argued,

[I]s determined by the interaction between the benefits of that participation and the costs of that participation. The benefit side focuses on the characteristics of the distribution of benefits or stakes across the relevant populations. The central determinants are the average per capita stakes and the extent to which per capita stakes vary within the population. The cost side focuses on the costs of participating in the institutions—transaction costs, litigation costs, political participation costs. These costs generally fall into one of two broad categories—the cost of information and the cost of organizing collective action.

KOMESAR, 2001, *supra* note 4, at 30.

115. *Id.*

116. *Id.* at 135.

Ford Pinto case, *Grimshaw v. Ford Motor Co.*,¹¹⁷ for example, courts will not be perfect, because many think the award there too high. Nevertheless, a court's ability to assess liability and provide a mass remedy made it a better choice than markets or regulators, which could not determine or remedy the harm caused. Moreover, because judicial opinions are presumptively public they will have an important deterrent effect on other manufacturers, for whom the risk of multi-million dollar liability creates very high stakes.

Two particular factors are likely to affect how participation occurs, and thus make Komesar's theory of institutional choice especially useful in understanding financial distress: "complexity and numbers."¹¹⁸ These largely map onto factors central to the financial crisis—concentration (scale) and complexity, discussed in Part I. Komesar's analysis generally assumes that courts are at a decided disadvantage given their inherent limitations.¹¹⁹ Yet, as discussed below, courts' power to channel conduct through judicial opinions may be an important but under-appreciated tool in controlling concentration and complexity in large financial firms.

Prior to a shift in distribution, markets and regulators tend to be better at managing problems of scale and complexity than courts. When most debtors first default, for example they will probably use market mechanisms to resolve the problem, if possible. If not, a shifted distribution may occur, in which case courts are likely to be the institution chosen by the stakeholders with the greatest interest in the outcome. If, however, the shift in distribution presents significant disparities in bargaining power (scale) or complexity—as in bank runs—then other institutional actors, particularly regulators, may offer a more effective response. It is only when we lack confidence in regulatory resolution that we must search for other institutional choices.

Thus, as noted in the Introduction, the deeply symbiotic relationship between regulators and those regulated made it difficult for key regulators such as Geithner or Paulson to ignore pleas for help from large financial

117. *Grimshaw v. Ford Motor Co.*, 119 Cal. App. 3d 757 (1981).

118. KOMESAR, 2001, *supra* note 4, at 23 ("Numbers and complexity are variables of great import. They generate shifts and cycles in law and rights. Viewed through the lens of comparative institutional analysis, it is a pattern of shifts and cycles more compelling and intriguing than that generated by single institutional analysis.").

119. "[T]he courts' ability decreases as the number of parties and the complexity of the issues increases." KOMESAR, 2001, *supra* note 4, at 21. "As the number of potential plaintiffs or defendants increases, the costs of bringing actions increase and the dynamics of litigation become more complex. . . . The problems of collective action that plague market transactions as numbers increase also plague adjudication: larger numbers mean more hold-outs and greater likelihood of a failed settlement." *Id.*

firms, and force them to accept market or judicial resolution.¹²⁰ Given regulators' willingness to help, it would have been equally difficult for those who managed large, complex financial firms to resist regulatory aid for their firms. Thus, regulators—acting on their own and later under the Troubled Asset Relief Program—were an irresistible choice for the regulated. Despite claims to the contrary, Dodd-Frank codifies many aspects of this dynamic. As explained in Part III, this is likely to be a choice with significant social costs.

C. The Contribution of Gilson, Sabel and Scott—“Braiding”

Institutional analysis tends to study institutions in isolation: we compare the effectiveness of markets to courts, for example, abstracting away from the reality that they (or persons participating in them) are likely to interact in complex and subtle ways. Yet, it seems implausible that institutions act in isolation, and Komesar himself recognizes that under stress they may “partner” with one another.¹²¹

One way to understand their interactions is by analogy to contract literature on the “braiding” of formal and informal contracts. Braiding is a concept developed in contract theory by Professors Gilson, Sabel and Scott. In an important 2010 paper, they argued that braiding bridges a long-standing gap in contract theory about the role of “formal” and “informal” contract enforcement mechanisms.¹²² By “formal” they mean chiefly the work of courts, recruited by disappointed parties to enforce promises and provide a remedy for their breach.¹²³ By “informal” they mean non-judicial, interpersonal adjustments that often accompany default, and which resemble market-based (negotiated) solutions.¹²⁴ To resolve the seeming

120. See GEITHNER, *supra* note 13, at 158-61.

121. KOMESAR, 2001, *supra* note 4, at 160.

122. Ronald J. Gilson, Charles F. Sabel & Robert E. Scott, *Braiding: The Interaction of Formal and Informal Contracting in Theory, Practice, and Doctrine*, 110 COLUM. L. REV. 1377 (2010) [hereinafter, “Gilson et al., *Braiding*”]. They thus develop both prior work of their own, e.g., Ronald J. Gilson, Charles F. Sabel & Robert E. Scott, *Contracting for Innovation: Vertical Disintegration and Interfirm Collaboration*, 109 COLUM. L. REV. 431, 458-71 (2009), as well as that of pioneers at boundary between formal and informal contracting. See, e.g., Stewart Macaulay, *Non-Contractual Relations in Business: A Preliminary Study*, 28 AM. SOC. REV. 55, 56-57, 62-63 (1963).

123. Gilson et al., *Braiding*, *supra* note 122, at 1379 (“Parties may choose by formal contract to enlist the judicial system to assess the parties’ performance of their specified rights and obligations and impose remedies in the event of breach.”).

124. *Id.* at 1379 (“[P]erformance is encouraged and breach penalized by the cancellation of expected future dealings with the counterparty, by the loss of reputation (with the resulting reduction in future business with other potential counterparties in the relevant

dichotomy, they argue that, at least in certain classes of contracts—in particular, those involving innovation and new technologies—parties will choose not one or the other, but both:

These [braiding] parties write contracts that intertwine elements of formal and informal contracting in a way that allows the parties to assess each other’s disposition and capacity to respond cooperatively and effectively to unforeseen circumstances. In these contracts, the informal obligations interact within a formal governance structure that regulates the exchange of highly revealing information, but does not necessarily impose legally enforceable obligations to buy or sell anything. All such contracts share a common focus: collaborative innovation in a world of heightened uncertainty.¹²⁵

“Braiding” is thus a “contract [that] combines formal and informal methods of enforcement.”¹²⁶ The concept has captured academic imaginations. It has been extended to analyses of secured credit,¹²⁷ contractual information sharing,¹²⁸ and even the development of “special purpose acquisition corporations.”¹²⁹

“Braiding” in contract theory can be analogized to institutional performance. Courts and regulators will tend to be more formal, in the sense that they are subject to more elaborately drawn rules and restrictions on their conduct. Markets tend to be less formal, in the sense that parties have a broader range of discretion to choose the rules (if any) that govern their relationship. So analogized, braiding offers two insights into how institutions prevent and resolve financial distress.

First, Gilson, Sabel and Scott focus on contracts for innovation, in particular technology-related contracts, where they assume uncertainty to be quite high. Like contracts for innovation, contracts for the resolution of financial distress—renegotiated debt contracts—involve high degrees of uncertainty and creativity best addressed through both informal and formal mechanisms, such as markets and courts. Second, and more important,

economic and social communities), or by an individual disposition toward reciprocity (and thus a willingness to reward cooperation and punish defection).”).

125. *Id.* at 1382.

126. *Id.* at 1383.

127. Nicholas J. Houpt, *Financing Innovation: Braiding, Monitoring, and Uncertainty*, 62 SYRACUSE L. REV. 337 (2012).

128. Clayton P. Gillette, *Tacit Agreement and Relationship-Specific Investment*, 88 N.Y.U. L. REV. 128, 151-52 (2013).

129. Usha Rodrigues & Mike Stegemoller, *Exit, Voice, and Reputation: The Evolution of SPACs*, 37 DEL. J. CORP. L. 849, 868-70 (2013).

institutions themselves braid in the prevention and resolution of financial distress. Both are explored in the next Part.

III. A COMPARATIVE INSTITUTIONAL ANALYSIS OF FINANCIAL DISTRESS SYSTEMS

The prior Part developed a three-step institutional framework: (i) per Hart and Sacks, institutional settlement (legitimacy) is the goal; (ii) per Komesar, scale and complexity will influence institutional competence, while participation will determine institutional choice; and (iii) by analogy to Gilson, Sabel, and Scott, institutions braid in addressing financial distress. This Part applies the framework to compare the three major institutional choices available in the prevention and resolution of financial distress: markets, courts, and regulators.¹³⁰ It explains why markets and courts will often be better first-line responses, even though they are being displaced by regulators. It also explains why large financial services firms would choose regulatory resolution as it is currently proposed.

A. Market Resolution

There is a tendency to assume that financial distress is a problem that courts—in particular bankruptcy courts—chiefly solve.¹³¹ But this is a law- (and lawyer-) centered view that is incomplete.¹³² Rather, debtors and creditors are far more likely to renegotiate financial distress inter se—or simply to walk away—than to use any other single institution.¹³³ This institutional choice has important benefits, which often outweigh its costs.

130. Needless to say, other social institutions may matter in this context, as well. In particular, “communities” may form social decision-making processes that influence the prevention and resolution of financial distress. Some of these communities are discussed in Jonathan C. Lipson, *The Shadow Bankruptcy System*, 89 B.U. L. REV. 1609 (2009) [hereinafter, “Lipson, *Shadow*”] (describing rise of close-knit networks of professional distress investors) and Jonathan C. Lipson, *Governance in the Breach: Controlling Creditor Opportunism*, 84 S. CAL. L. REV. 1035 (2011) [hereinafter, “Lipson, *Governance*”] (same).

131. See, e.g., ELIZABETH WARREN & JAY LAWRENCE WESTBROOK, *THE LAW OF DEBTORS AND CREDITORS* 94 (6th ed. 2009) (“[B]ankruptcy is the chief legal relief of choice for most debtors and creditors when financial disaster strikes”); Stephen J. Lubben, *Financial Institutions in Bankruptcy*, 34 SEATTLE U. L. REV. 1259, 1264 (2011) (“Save for when the Dodd-Frank Act’s new resolution authority applies, [C]hapter 11 remains the primary instrument for resolving financial institutions. Unless a specialized regime is in place, such as those for banks or insurance companies, [C]hapter 11 will apply.”).

132. An early recognition that courts did not have to be the chief institutional choice for financial distress appears in DAVID T. STANLEY & MARJORIE GIRTH, *BANKRUPTCY* 147–72 (1971). They argued for an administrative resolution mechanism for individual debtors, in order to reduce the cost and delay of individual filings in bankruptcy courts.

133. The work of Nini, et al., for example, shows that fewer than 7% of distressed

As in other contexts, the institutional choice will turn in large part on the number of participants and the complexity of their stakes. In the simplest case—a single debtor and creditor—only a market transaction is needed. It is unlikely that any other institution would offer superior prevention or resolution mechanisms. While creditors may have to use the state court collection process to enforce their claims, this would seem to be a fairly unusual result given the ease with which debtors and creditors can either rewrite the debt contract or the debtor can cede its assets to the creditor (“walk away”).¹³⁴ In most cases, judicial process in binary debtor-creditor disputes is not cost justified, and so is not chosen by either party.

As the number and/or complexity of stakeholders and claims grow, however, judicial process becomes more appealing. The debtor may be recalcitrant in negotiations or some creditors may hold out for a better deal. The debt contracts may be interwoven in complex ways that leave the parties in doubt about their relative rights. When a debtor with many creditors in complex contracts defaults, there will be a shifted distribution of stakes. Prior to default, the debtor’s many creditors may have paid little attention to their rights against the debtor, or *inter se*. After a general default, creditors will need to understand and act on those rights.

In the first instance, this shifted distribution will usually produce the classic “workout” negotiation, which will more likely than not result in resolution. Yet, because it always occurs in the shadow of some court—either a state court for collection purposes or a federal bankruptcy court for broader and deeper defaults—it is important to recognize that markets and courts “braid” in this context. Here, braiding means that neither informal renegotiation nor formal judicial resolution (e.g., through judgment and execution) is likely to be the exclusive institutional choice. Rather, each reinforces the other. Markets will be the dominant institution, with courts performing a second, *in terrorem*, role. The promise of contractual

publicly-traded firms (defined as those announcing a debt-covenant default) declare bankruptcy or liquidate through a judicial proceeding. See Greg Nini, David C. Smith & Amir Sufi, *Creditor Control Rights, Corporate Governance, and Firm Value*, 25 REV. FIN. STUD. 1713, 1724-27 (2012). For smaller firms, the percentage is higher, nearly 10%. In 2010, for example, 690,504 businesses closed (some of which may have been public firms), while 56,282 businesses (less than 10%) went into bankruptcy. See Douglas E. Castle, *Business Restructurings, Turnarounds And Remobilization Of A Nation's Economy*, DOUGLAS E. CASTLE: BLOG, July 22, 2013, <http://douglasecastleblog.com/2013/07/22/business-restructurings-turnarounds-and-remobilization-of-a-nations-economy/> (reproducing the American Bankruptcy Institute’s quarterly data for business bankruptcy filings from 1994 to 2012).

134. Article 9 of the Uniform Commercial Code, enacted in all states, permits self-help repossession of collateral following default. U.C.C §§ 9-601, 9-609 (2010).

renegotiation forms the “carrot”; the threat of judicial action is the “stick.”¹³⁵

This kind of participation has three important benefits. First, the parties are better positioned to make judgments about their capacity to commit credibly to a revised payment schedule (in the case of a debtor) or to absorb a loss (in the case of a creditor) than other institutional actors. This will, on average, lead them to align their incentives with their capacities to perform, if they believe performance is plausible. This, in turn, is likely to reduce both economic (e.g., transactions) and normative (e.g., moral hazard) costs.

Second, it is an *ex ante* solution, in the sense that it comes prior to other institutional involvement. Because preventing (or quickly resolving) individual cases of distress is the first line of defense in preventing crises, market resolution has a greater capacity to avoid the need for *ex post* resolution efforts, e.g., through bankruptcy or regulatory intervention.

Third, market resolution can reflect an important kind of institutional settlement. Absent significant information asymmetry or externalities, a consensual workout is one that most would recognize as “duly” authorized by the parties directly involved. If debtors and creditors of roughly comparable bargaining power renegotiate defaulted debt contracts, it would be hard to see who loses—especially if this avoids cascading losses that could lead to a crisis.

Yet, institutional analysis requires us to assess both the benefits and the costs of any institutional choice, and market resolution is not perfect. First, information asymmetry can be highly problematic in this context. As I have observed elsewhere, the pre-bankruptcy workout process can be fraught with sharp dealing.¹³⁶ Investors, for example, may hold short positions through credit default swaps (CDS) that pay off if the debtor’s workout fails. This presumptively creates incentives to undermine the workout. Because such positions are not publicly registered, other stakeholders would not know how to bargain around them.¹³⁷ Such positions may not rise to the level of fraud, yet they will create opacity and suspicion that can make market resolution prohibitively costly.¹³⁸ Because

135. See Lipson, *Governance*, *supra* note 130, at 1046-49 (describing dynamics of prebankruptcy workouts).

136. See Lipson, *Shadow*, *supra* note 130, at 1653-59 (discussing creditors’ temptations to engage in short-selling and other practices that may harm distressed debtors); Lipson, *Governance*, *supra* note 130, at 1051-59 (describing sharp practices in pre-bankruptcy workouts).

137. Dodd-Frank has proposed to create clearinghouses for certain such instruments. But, as with other aspects of Dodd-Frank, there are concerns that regulation will not keep pace with transactional developments. See, e.g., Romano, *Dark*, *supra* note 71, at 87.

138. Lipson, *Defining*, *supra* note 54, at 1253 n.77 (2012) (discussing the confusion

they are inherently complex instruments to begin with—and can involve enormous sums of money—information failures of this sort can cause asset values to plummet precipitously. It is not surprising that the information asymmetry created by short positions made renegotiating pre-crisis transactions difficult. It may also have contributed to panic in the market and a rapid decline in asset values.

Second, as debtors grow in scale and complexity, the problem of holdouts becomes more acute. A debtor can only work out debt privately if all or a vast majority of creditors agree. A debtor with publicly-traded bonds, for example, cannot generally restructure the bonds, such as by reducing payments, without the consent of all or most bondholders.¹³⁹ Given the rise of distressed-debt investing, it is not surprising that sophisticated creditors may be tempted to hold out for a better deal, foiling market-based resolution.

Third, there are transaction costs. Corporate restructurings usually involve professionals such as lawyers, accountants, and bankers, who do not work for free. Moreover, given the uncertainty that is always present in restructurings, the parties could restructure the debt only to see the debtor default again. This would either require further negotiations or, more likely, a bankruptcy filing.

Finally, there may be social costs not internalized by the principal parties to the workout. Some stakeholders may have little or no say in the outcome of the restructuring, but are nonetheless affected by it. The classic examples will be tort creditors, low-level, non-union employees and smaller trade and tax creditors of the corporate debtor.¹⁴⁰ From an institutional perspective, we would say that these creditors may have small stakes relative to those of large creditors, but nevertheless, the loss of a job or pension means a great deal to that creditor. The workout process may not protect these stakeholders, because they will lack the resources or sophistication to participate in it. Yet if, as is entirely plausible, a restructuring results in outsourcing or downsizing, these stakeholders would surely be adversely affected by the negotiations of the larger stakeholders.

The market cannot correct for all of these costs. Indeed, the presence of these costs—from holdouts to externalities—is sometimes good reason

created by short positions in the “Abacus” and “Magnetar” transactions that were controversial in the financial crisis).

139. Lipson, *Governance*, *supra* note 130, at 1055.

140. See Jonathan C. Lipson, *Directors’ Duties to Creditors: Power Imbalance and the Financially Distressed Corporation*, 50 UCLA L. REV. 1189, 1245-51 (2003) (discussing effect of distress on “non-adjusting” creditors such as tort creditors, tax authorities, and trade creditors).

to resort to other institutions, in particular bankruptcy courts. Yet, the important question is not whether market-based solutions are optimal or costly, but how the costs and benefits of this choice compare to the costs and benefits of other available choices. When stakeholders can participate in resolution in some meaningful way that produces institutional settlement, other institutions are unlikely to do a better job. Other institutions will outperform the market only when participants are, in aggregate, unable to come to some reasonably fair and efficient resolution of financial distress.

B. Judicial Resolution

It is at this point that courts and markets flip, with courts (usually bankruptcy courts) becoming the dominant institution and markets playing a secondary role. Bankruptcy offers essentially two models: straight liquidation (usually under Chapter 7 of the Bankruptcy Code) or reorganization (usually under Chapters 11 or 13), which are in essence moderately coerced workouts.

Both models depend on several basic judicial mechanisms. First, a stay is automatically imposed on most collection efforts (as discussed below, derivatives contracts are an important exception).¹⁴¹ Although this halts one form of participation—the collection suit—it actually promotes more direct participation because it channels all stakeholders into a single forum, where they can more efficiently assess, and negotiate, their relative rights against the debtor. Second, an estate is created that is composed of all of the debtor’s property.¹⁴² This preserves the debtor’s assets with the goal of maximizing recoveries, whether through reorganization or liquidation.

Third, the level of participation in resolution will largely be determined by the size and complexity of the debtor involved. Consumer cases will usually be liquidations under Chapter 7 or “wage earner” plans under Chapter 13. Neither involves voting by creditors. A corporation with meaningful going concern value is likely to propose a plan of reorganization under Chapter 11, on which creditors would get a vote.¹⁴³ Presumptively, Chapter 11’s more elaborate disclosure and voting rules create opportunities for greater stakeholder participation.

141. 11 U.S.C. § 362(a).

142. 11 U.S.C. § 541(a).

143. Under 11 U.S.C. § 1126(c), “impaired” classes of creditors are entitled to vote on the plan. Under 11 U.S.C. § 1129, a court cannot approve the plan unless it has the requisite number and amount of creditor support. There are, of course, variations on this, but the details are unimportant to the institutional analysis presented here.

As in market resolution, judicial resolution involves braiding, here chiefly with markets. Thus, in the corporate context, the workout negotiations that began and failed prior to bankruptcy are highly likely to resume once the debtor enters bankruptcy. These negotiations perform filtering and sorting functions that enable bankruptcy courts to manage the large and complex cases that they are often asked to resolve. Institutional braiding provides the flexibility to produce more nuanced results than either judicial or market-based resolution could produce in isolation.

Moreover, unlike judges in courts of general jurisdiction, bankruptcy judges are usually expert in the problems that are asked to deal with. Most large corporate bankruptcies, for example, are filed in the Southern District of New York or the District of Delaware.¹⁴⁴ The clustering of complex cases in these jurisdictions has likely contributed to the expertise of the judges in these courts, who are widely recognized as among the nation's most sophisticated.¹⁴⁵ These judges are aided by an extremely sophisticated bar, which also benefits from repeat play. While these judges are hardly infallible—and some worry that they defer too readily to the bar and “insiders” in the process¹⁴⁶—there is little question that they are not daunted by the size or complexity of the cases before them.

Judicial resolution in bankruptcy has other benefits. First, to the extent that disputes are actually litigated, they will be adjudicated using ordinary rule-of-law mechanisms. The common law, precedent, the rules of proceeding and proof all apply in bankruptcy. Bankruptcy courts write reasoned, published opinions that affect both the parties to the dispute and the incremental development of the law. Bankruptcy courts' decisions are subject to appellate review, more or less, as would be the case for other federal courts.¹⁴⁷ Thus, to the extent the judiciary ever has the capacity to produce institutional settlement, so, too in bankruptcy.

Second, bankruptcy reorganization can be a reasonably transparent process. This is due largely to the fact that it is subject to court supervision, so most important matters will be subject to pleading and judicial approval.¹⁴⁸ Because pleadings are presumptively public, the process itself will be far less opaque than a market-based resolution, which is ordinarily subject to no mandatory disclosure (outside of federal

144. Jonathan C. Lipson, *Understanding Failure: Examiners and the Bankruptcy Reorganization of Large Public Companies*, 84 AM. BANKR. L.J. 1 (2010).

145. LYNN LOPUCKI, COURTING FAILURE HOW COMPETITION FOR BIG CASES IS CORRUPTING THE BANKRUPTCY COURTS (2005) [hereinafter, “LOPUCKI, COURTING FAILURE”].

146. *Id.*

147. 28 U.S.C. § 158 (2012).

148. 11 U.S.C. § 107 (2012).

securities laws, if they apply). Transparency contributes to the legitimacy of bankruptcy resolutions.

The third, and perhaps most important, benefit of this institutional interaction, is its *ex ante* effect: the costs of the bankruptcy process—transaction costs, delay, etc.—may be the most important incentive parties have to work out financial distress consensually, in lieu of bankruptcy. Bankruptcy is, in other words, the legal process in whose shadow market resolution typically occurs.

Yet, as with all institutional choices, choosing bankruptcy has costs. First, the reality that large, complex cases are concentrated in two districts has led many to worry that the judges in these courts are captured by the bar, much as regulators may be captured by sophisticated financial firms.¹⁴⁹ While there is not the kind of “revolving door” that worries many about regulation, the transparency that can give bankruptcy its legitimacy also produces a deluge of information that no judge can fully absorb. Judge Peck, who presided over the *Lehman Brothers* case, may have been just as vulnerable to “information capture” as financial regulators, given the thousands of pages in the examiner’s reports, disclosure statements supporting reorganization plans, and other pleadings in that case. The volume of information, in turn, will place pressure on judges to rely more on counsel in the cases before them. The lawyers may, in turn, feel pressure to get a reorganization plan approved once the parties have come to agreement. Thus, the worry is that judges in Manhattan and Wilmington defer too much to the lawyers before them, confirming reorganization plans that are not truly feasible.¹⁵⁰ Infeasible plans may produce “serial bankruptcies,” such as those of US Airways (three bankruptcy cases), which are presumptively wasteful.

Second, bankruptcy can depress values. There is concern that Chapter 11 has become little more than a venue for the sale of distressed business, mergers and acquisitions by other means.¹⁵¹ Bankruptcy sales—like all judicial sales—are unlikely to produce as much value as an arms-length, negotiated sale out of court. This has led some to worry that bankruptcy increasingly produces “fire sales” rather than reorganizations “in place,”

149. LOPUCKI, *COURTING FAILURE*, *supra* note 145, at 137-81 (discussing various allegedly forms of “corruption” among certain bankruptcy courts).

150. “Feasibility” is one of the standards required to confirm a reorganization plan. 11 U.S.C. § 1129(a)(3). It means that the court has concluded that the debtor under the plan is not likely to need further bankruptcy proceedings.

151. See Jonathan C. Lipson & Christopher diVirgilio, *Controlling the Market for Information in Reorganization*, 18 AM. BANKR. INST. L. J. 647, 653 (2010) (“Instead of providing a substitute for a market sale, Chapter 11 now serves as the forum where such sales are conducted.”).

which are generally thought to preserve greater value.¹⁵² Many are cautioned by the low price at which Barclay's snapped up Lehman Brothers' brokerage business only several days into the case.¹⁵³ Jacoby and Janger note that Chapter 11 has come to recognize a "speed premium" that may benefit purchasers more than the reorganizing debtor whose assets are being sold.¹⁵⁴

Thus, bankruptcy is not a perfect institutional choice, but under many circumstances will be better than alternatives. As explained in the Introduction, there is good reason to believe that if Bear Stearns had been permitted (or forced) to go into bankruptcy in 2008, the crisis would have had very different characteristics. Tim Geithner is likely correct that a Bear Stearns bankruptcy would have been problematic.¹⁵⁵ But, the very fear that such a bankruptcy would have created should have led market participants—that is, the CEOs of other large financial firms—to begin the hard work of renegotiating amongst themselves. So far as we can tell, this did not occur. Instead, as explained in the Introduction, they sought (and mostly received) support from regulators. But, as shown in the next Part, regulators should be a last line of defense—not the first.

C. Regulatory Resolution

Regulatory resolution in the United States has historically been limited to specialized industries, in particular commercial banks, which are not permitted to be debtors under the Bankruptcy Code.¹⁵⁶ Instead, they are subject to a well-established federal regime, the Federal Deposit Insurance Act ("FDI Act").¹⁵⁷ Moreover, Dodd-Frank's process for resolving what it

152. See Lynn M. LoPucki & Joseph W. Doherty, *Bankruptcy Fire Sales*, 106 MICH. L. REV. 1, 3-4 (2007) (discussing how reorganization can double value as compared to selling).

153. One day after Lehman went into bankruptcy, Barclays purchased such core Lehman assets as its prime brokerage, investment bank and headquarters for about \$1.3 billion. Judge Peck was quoted as saying "I have to approve this transaction because it is the only available transaction." See *Judge approves \$1.3bn Lehman deal*, BBC NEWS (Sept. 20, 2008), <http://news.bbc.co.uk/2/hi/business/7626624.stm>.

154. See Melissa B. Jacoby & Edward J. Janger, *Ice Cube Bonds: Allocating the Price of Process in Chapter 11 Bankruptcy*, 123 YALE L.J. 862 (2013).

155. See discussion *supra* note 16.

156. See 11 U.S.C. §§ 109(b), (d) (2006) (banks may not be debtors under Bankruptcy Code). American banks have long been barred from commencing a bankruptcy case. See Bankruptcy Act of 1898, ch. 541 § 4(b), 30 Stat. 544, 547 (explaining "who may become bankrupt" under the Act).

157. The relevant statutory provisions of the FDI Act are 12 U.S.C. §§ 1821-1825. See also Robert R. Bliss & George G. Kaufmann, *U.S. Corporate and Bank Insolvency Regimes: A Comparison and Evaluation*, 2 VA. L. & BUS. REV. 143, 145 (2007). Insurance companies are generally regulated at the state level, so their resolution procedures are subject to greater variation.

calls “systemically important financial institutions” (SIFIs) was expressly modeled on the federal bank resolution model.¹⁵⁸

Under federal banking law, the Federal Deposit Insurance Corporation (FDIC) or other designated regulator may seize a bank that is “critically undercapitalized,” a minimum of two percent equity capital to total assets.¹⁵⁹ When a bank is insolvent, the bank’s charter will be revoked and the primary regulator will appoint a conservator or receiver to administer the insolvency proceedings.¹⁶⁰ If the FDIC is appointed receiver, it has complete power over the assets and liabilities of the failed bank.¹⁶¹ These powers are largely outside the judicial system and few FDIC decisions are subject to judicial review.¹⁶²

When appointed receiver, the FDIC must decide what to do with the failed institution. In theory, it has a range of options. It can “liquidate the institution, organize a new bank or a temporary bridge bank, take over some or all of the assets and liabilities, or arrange a merger or purchase of assets and assumption of liabilities.”¹⁶³ In fact, federal law requires the FDIC to choose a resolution method that imposes the “least cost on the insurance fund, unless it determines that doing so is necessary to avert systematic risk.”¹⁶⁴ Data indicate that in most cases, the FDIC found a

158. As Assistant Treasury Secretary Michael Barr said in testimony on behalf of the legislation that became Dodd-Frank: “Our proposal does little more than apply to” systemically important non-bank institutions “the same model that Congress has developed, that the FDIC has executed, and that courts have respected, over the course of more than three-quarters of a century.” Press Release, Assistant Secretary Michael Barr Written Testimony, House Judiciary Committee Subcommittee on Commercial and Administrative Law (Oct. 22, 2009), available at <http://www.treasury.gov/press-center/press-releases/Pages/tg327.aspx>; see also Paul L. Lee, *The Dodd Frank Act Orderly Liquidation Authority: A Preliminary Analysis and Critique*, 128 BANKING L.J. 771, 786 (2011).

In what could be seen in hindsight as a political misstep, the Treasury Department noted in its press release that the new authority was modeled on the FDIC’s existing resolution authority for depository institutions and on the Federal Housing Finance Agency’s resolution authority for government sponsored entities. The indirect allusion to the conservatorship of treatment of Fannie Mae and Freddie Mac exposed the Treasury to the criticism that its proposal would provide a source of ongoing federal assistance to other companies on financial life support.

Id. at 784. As noted below, regulators have since then modulated this message somewhat.

159. Bliss & Kaufmann, *supra* note 157, at 156.

160. *Id.*; William J. Fellerhoff & Robert D. Aicher, *Avoidance Powers Available to the FDIC in a Bank Insolvency*, 1 J. BANKR. L. & PRAC. 59, 61 (1991).

161. 12 U.S.C. § 1821(c)(5).

162. Bliss & Kaufmann, *supra* note 157, at 160.

163. Lubben, *supra* note 131, at 1266.

164. Richard M. Hynes & Steven D. Walt, *Why Banks Are Not Allowed in Bankruptcy*, 67 WASH. & LEE L. REV. 985, 1003 (2010). An exception has only been invoked once in the past decade. *Id.* at 1003-04.

bank that was willing to assume some or all of the failed bank's liabilities and purchase some or all of the failed bank's assets, typically through a transaction known as a "purchase and assumption" (P&A).¹⁶⁵

In a P&A, the government secures the commitment of a "healthy" bank to take over the assets of the troubled bank. This is how the FDIC is able to "seize the bank at the close of business on a Friday, and some of the failed bank's offices will reopen as part of the acquiring bank the following Monday."¹⁶⁶ This means, in essence, that the government and markets must work together—again, a kind of "braiding"—quickly and quietly to resolve the bank's distress. Courts effectively have no role here.

Commentators on bank insolvency procedures have suggested various policy reasons for the procedures outlined above. In theory, they create a resolution before an "actual event of economic insolvency or financial default."¹⁶⁷ This advances one very obvious—and vital—policy goal: the prevention of bank runs.¹⁶⁸ While it is easy to exaggerate the severity of bank panics, they nevertheless have a long history of worrying public officials. One observer characterized the English bank panic of 1825 as follows: "A panic seized upon the public, such as had never been witnessed before: everybody begging for money—money—but money was hardly on any condition to be had."¹⁶⁹ Common images of bank panics include lines of anxious depositors clamoring to withdraw their savings from banks that suffer from what economists euphemistically call a timing problem. If you have seen the movie *It's a Wonderful Life*, you know that there is nothing wonderful about bank failures.

Another major policy goal is the need to protect the FDIC's insurance fund.¹⁷⁰ This is reflected in Congress' requirement that the FDIC choose a resolution plan that has the lowest impact on the fund unless the FDIC determines that doing so is necessary to avert systemic risk.¹⁷¹ Foreshadowing Dodd-Frank's distributed-authority resolution procedures, the FDIC may deviate from the least-cost method only with the approval of the Chairman of the Federal Reserve and the Treasury Secretary, and they

165. *Id.* at 1002.

166. *Id.* at 989.

167. Bliss & Kauffman, *supra* note 157, at 152.

168. See Peter P. Swire, *Bank Insolvency Law Now That it Matters Again*, 42 DUKE L.J. 469, 491 (1992) (explaining why bank runs deserve special regulation); Diamond & Dybvig, *supra* note 2, at 404 (discussing regulation and prevention of bank runs).

169. KINDLEBERGER & ALIBER, *supra* note 2, at 105 (quoting THOMAS JOPLIN, CASE FOR PARLIAMENTARY INQUIRY INTO THE CIRCUMSTANCES OF THE PANIC, IN A LETTER TO THOMAS GISBOURNE, ESQ. M.P. (London: F. Ridgeway & Sons, n.d. [after 1832], pp. 14-15)).

170. Swire, *supra* note 168, at 474.

171. 12 U.S.C. § 1823(c)(4)(A) (2006).

must consult with the President.¹⁷² Not surprisingly, it has been invoked rarely in cases of bank failures.¹⁷³

It would appear that the bank failure system is a reasonable institutional choice given the nature of banks and the institutional alternatives. If the goal in the first instance is to instill confidence in the banking system, and thus to broaden participation in it at the retail level, deposit insurance was probably the most effective mechanism available. While markets could have invented this, it appears that they either did not do so in the 1930s, or simply lacked government's credibility as ultimate insurer. While markets are secondarily important in the event a failed bank is the subject of a P&A, regulators will call the shots, acting by proxy both in lieu of the managers they have displaced and the retail depositors they are assigned to protect.

Given this dynamic, it is not surprising that courts play an attenuated role in bank failures. While courts certainly could supervise bank failures—and do so in many nations¹⁷⁴—there are sound institutional reasons for leaving that choice with government. Among other things, the bank regulatory system appears to depend on a very constricted flow of information and prompt corrective action. Unlike courts, regulators do not generally make reports about troubled banks available in real time (although they will do so after the fact).¹⁷⁵ Nor should they: to release

172. See *id.* § 1823(c)(4)(G) (stating that “the Corporation may take other action or provide assistance under this section . . . as necessary to avoid or mitigate such effects” with the approval of the Board of Directors, the Board of Governors of the Federal Reserve System, and the Secretary of the Treasury).

173. It appears to have been used twice since 1995 in order to provide assistance to Citigroup and Bank of America (and their subsidiaries). The FDIC also invoked this exception when approving financing for Citibank's bid to buy Wachovia. See Editorial, *Who's Too Big to Fail?*, WALL ST. J., Sept. 13, 2009, at A14 (“To provide assistance, the [FDIC] board had to invoke the ‘systemic risk’ exception in the Federal Deposit Insurance Act”). However, this transaction was not consummated, as Wells Fargo purchased Wachovia instead. See *id.* (“Yet days later, Wachovia cut a better deal to sell itself to Wells Fargo, instead of Citi.”).

174. A recent study shows that a majority of nations (56% in a sample of 142 countries) require judicial intervention in a bank failure. See Matej Marin & Vasja Rant, *A cross-country analysis of bank bankruptcy regimes*, 13 J. FIN. STAB. 134, 140 (2014). The authors find an association between the presence of an administrative model and pronounced effects from the crisis. But, consistent with the observations above, they also find that a judicial model is associated with higher transaction costs and value depreciation. *Id.* at 135 (“We find some support that an administrative bank bankruptcy regime is positively associated with the presence of the global financial crisis compared to a court-led bank bankruptcy regime. On the other hand, court involvement in bank bankruptcy is associated with higher output loss and fiscal costs in the global financial crisis.”).

175. See Sumit Agarwal, David Lucca, Amit Seru & Francesco Trebbi, *Inconsistent Regulators: Evidence From Banking*, 129 Q.J. ECON. 889, 889-90 (2014) (discussing use of bank regulatory reports); see also Joe Adler, *Bank Exam Ratings Might Not Be as Secret as*

information about troubled banks in real time would risk inducing the very thing—panicked withdrawals—the system seeks to avoid.

Courts, by contrast, depend to a much greater degree on transparency. In theory, pleadings filed in court are public records. Transparency, in turn, facilitates participation in the bankruptcy process. While a bankruptcy system could be modified to exempt retail depositors from the stay (in order to preserve their liquidity), the optical effect of a bank's bankruptcy may damage the bank's reputation and individual depositor's confidence in it and the banking system as a whole.

The bank resolution model also involves braiding. Here, regulators are the dominant institution, working with the market (through a P&A) in a secondary role. The braiding works when it enables regulators and the regulated to respond more quickly and efficiently to bank failure than market- or court-dominant choices. As with braiding in contracts, it permits flexibility across more and less formal mechanisms in order to preserve stability in the banking system. While it severely constricts stakeholder participation—neither depositors nor bank shareholders are likely to be consulted in the resolution process—concerns about the chaotic nature of participation (bank panics) would appear to make regulatory resolution a sensible choice for banks with retail depositors. It avoids the anarchy that Hart and Sacks feared.

As with all institutional choices, there are costs to this model. First, braiding here is weak because it is unlikely there is robust market participation. It is possible that regulators engage in some kind of competitive bidding when they find a healthy bank to take over a failed bank. But the need for speed and secrecy in the process make this implausible. Thus, to the extent that market resolution involves a kind of braiding that depends heavily on stakeholder participation, one can say that regulatory resolution is significantly less participatory than other forms of resolution. Indeed the lack of participation may be perceived as one of the key benefits of regulatory resolution.

Yet, this places great pressure on the quality of decision-making by regulators. In the context of bank failure, there is no serious claim that bank regulators are corrupt or incompetent. But, there is also no reason to believe that they are immune from the public-choice challenges that burden other regulators. As in other regulatory settings, the regulated may well have the upper hand, whether because of the revolving door or informational overload or significant disparities in resource deployment.

You Think, AM. BANKER (Aug. 12, 2011), http://www.americanbanker.com/issues/176_157/fdic-bank-failures-1041141-1.html?zkPrintable=1&nopagination=1 (describing market efforts to approximate regulatory bank-safety ratings through independent analysis due to the official confidentiality of the process).

Thus, the second cost of regulatory resolution will be the loss of the legitimacy that we otherwise associate with market or judicial resolutions.

Third, as noted above, the unpredictability of regulatory resolution materially affects *ex ante* incentives. Unlike market or judicial resolution, regulators intentionally keep the market in the dark about potential bank receiverships. Some workout activity may occur at the bank holding company level. Bank holding companies may be publicly-traded entities, which will disclose financial information. The information needed to engage in a pre-resolution workout of the bank itself is, however, unlikely to be available to the full range of potential participants. It will be available to those participants regulators choose to share the information with. Of course, bank managers themselves should know that the bank is in trouble. If so, they may seek market-based resolution, through additional capital infusions or other transactions—assuming regulators permit it. But, if managers believe that a regulator will provide support, they might consider that preferable, depending on the terms. Alternatively—and as contemplated by Dodd-Frank (discussed below)—regulators may remove managers before they have the chance to negotiate a resolution. In any case, the same fear of panic that motivates regulators to conceal failure from the public should caution potential rescue partners for the troubled bank. Those who would rescue banks should always worry that their efforts will be rewarded with a receivership—which may be no reward at all.

To be sure, the bank regulatory model produces a kind of institutional settlement, in that it preserves the stability of the system. But the process is intentionally and necessarily opaque, giving regulators enormous discretion to pick winners and losers largely free of either market or judicial checks and balances. While Congress may have “duly” vested regulators with authority to seize failed banks, there is far less process and accountability in this model than in those in which markets or courts are the dominant institutions.

Yet, once we expand the regulatory umbrella to reach non-bank firms, as Dodd-Frank will do, many of the costs and few of its benefits follow because the braiding dynamic inverts: the size and complexity of the regulated will give them leverage over the regulators, and neither markets nor courts will be in a position to check or balance the excesses of regulatory decisions so made. This, then, is regulatory displacement: large financial services firms will choose participation through regulatory resolution—rather than markets or courts—because it holds the promise of increasing their size and potential government subsidy, without the hard costs of renegotiation or bankruptcy.

IV. DODD-FRANK AND REGULATORY DISPLACEMENT

Regulatory displacement is perhaps most prominently evidenced by the “orderly liquidation authority” (OLA) created by Dodd-Frank.¹⁷⁶ A central goal of Dodd-Frank was to create a mechanism for the resolution of failed financial firms that was neither a bailout nor bankruptcy.¹⁷⁷ Bailouts were politically untenable, and the bankruptcy of Lehman Brothers was evidence to some that (bankruptcy) courts could not be trusted to resolve the failure of nonbank financial firms in an orderly fashion. The orderly liquidation authority created by Dodd-Frank was thus meant to be a third way: liquidations through FDIC receiverships.

The key institutional problem with the OLA is that it creates uncertainty, which exacerbates Dodd-Frank’s regulatory complexity. It will thus likely undermine an important form of participation by deterring or eliminating the negotiations that should precede and ameliorate the resolution of most financial failures. Intentionally or not, regulators will displace market and judicial processes. This will, in turn, result in more concentration and regulatory subsidy—exactly the opposite of what Dodd-Frank seeks to achieve.

A. *Which Firms?*

The first uncertainty is at the threshold: which firms are potentially subject to an orderly liquidation process? The decision whether to put a financial company into the resolution regime is made by regulators, not market actors (*e.g.*, creditors or the firm itself). If the Secretary of the Treasury concludes that a systemically important company is “in default or in danger of default,” two-thirds of the Federal Reserve Board and two-thirds of the FDIC board have recommended resolution, and he (or she) has

176. Pub. L. No. 111-203, 124 Stat. 1376 (2010).

177. 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”); see also 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”). As noted above, regulators initially characterized the OLA as simply an expansion of the bank-failure model. See discussion *supra* note 158.

also consulted with the President, the Secretary can initiate the new resolution process.¹⁷⁸ The Treasury Secretary's decision is subject to 24-hour, confidential review by the United States District Court in the District of Washington, D.C.¹⁷⁹ Dodd-Frank defines "default" loosely, at best.¹⁸⁰ Observers expect that judicial review is unlikely to be a significant check on the administrative process.¹⁸¹

The Financial Stability Oversight Council (FSOC) has already designated a number of firms to be systemically important financial institutions (SIFIs) eligible for orderly liquidation, including thirty very large bank holding companies (BHCs), three non-banking financial services firms and eight "financial market utilities."¹⁸² A key distinguishing feature of a SIFI is that it is "predominantly engaged in financial activities," generally defined as 85% or more of revenue or assets.¹⁸³

178. 12 U.S.C. § 5382(a)(1)(a)(iii).

179. 12 U.S.C. § 1582.

180. Dodd-Frank lists factors to be considered when determining whether a systemically important financial firm is in "default." See 12 U.S.C. § 5383(c)(4) (establishing "For purposes of this subchapter, a financial company shall be considered to be in default or in danger of default if, as determined in accordance with subsection (b)—(A) a case has been, or likely will promptly be, commenced with respect to the financial company under the Bankruptcy Code; (B) the financial company has incurred, or is likely to incur, losses that will deplete all or substantially all of its capital, and there is no reasonable prospect for the company to avoid such depletion; (C) the assets of the financial company are, or are likely to be, less than its obligations to creditors and others; or (D) the financial company is, or is likely to be, unable to pay its obligations (other than those subject to a bona fide dispute) in the normal course of business."). For a variety of reasons beyond the scope of this Article, Dodd-Frank's use of the term "default" could easily be manipulated to find (or avoid finding) a firm was in "default."

181. See Kenneth E. Scott, *A Guide to the Resolution of Failed Financial Institutions: Dodd-Frank Title II and Proposed Chapter 14* 12 n.31 (Stanford Law and Econ. Olin Working Paper No. 426, 2012) (arguing "A creditor can file suit to have a court determine the validity or amount of a claim against the failed institution (§210(a)(4)), but judicial review of FDIC's decisions on claim transfers is prohibited. §210(a)(9)(D)(ii)."); see also Thomas H. Jackson et al., *Resolution of Failed Financial Institutions: Orderly Liquidation Authority and a New Chapter 14* (Apr. 25, 2011) (unpublished manuscript), available at <http://media.hoover.org/sites/default/files/documents/Resolution-Project-Booklet-4-11.pdf> (arguing that Bankruptcy Code should be amended to resolve failures of large financial firms).

182. See *Financial Stability Oversight Council: Financial Market Utility Designations*, U.S. DEPARTMENT OF THE TREASURY, available at <http://www.treasury.gov/initiatives/fsoc/designations/Pages/default.aspx#nonbank> (last updated Apr. 2, 2015, 2:13 PM).

183. See 12 U.S.C. § 5311(a)(4)(B) (defining U.S. nonbank financial company); see also 12 U.S.C. § 5311(a)(6) (defining "predominantly engaged in financial activities").

This presumably takes Google off the table—but what about Apple, if its new “Apple Pay” feature becomes a major portion of its revenue?¹⁸⁴ Conversely, what if fear of an OLA proceeding leads a financial firm’s counterparties to flee, such that revenues fall below the 85% threshold? What about types of firms that might well be financial in nature, but claim not to be “systemically important,” such as very large hedge funds?¹⁸⁵ Neither Dodd-Frank nor its thousands of pages of implementing regulations fully answer these questions.

B. What Effect?

If a firm is subject to the OLA, it would be treated as a receivership run by the Federal Deposit Insurance Corporation (FDIC), akin to a bank resolution discussed in the Introduction.¹⁸⁶ Managers of the firm would presumably be fired, and the assets and liabilities of the firm transferred to a third party¹⁸⁷ or to a temporary “bridge” company to hold until some sort of orderly liquidation or sale was possible.¹⁸⁸ As noted above, a common strategy in bank failures is the so-called “purchase and assumption,” whereby a healthy bank purchases the assets and assumes the liabilities (in particular, deposits) of the failed bank.¹⁸⁹ The FDIC may mimic this strategy under OLA.

The effect of an OLA proceeding is uncertain in at least two respects. First, a true liquidation would destroy significant value, so there is little reason to believe that the FDIC would in all cases seek to sell off the failed firm’s assets.¹⁹⁰ Indeed, because a failed financial firm’s main assets are likely to be contracts with other financial firms, a true liquidation could rapidly deflate their value, thus impairing counterparties and creating knock-on effects Dodd-Frank seeks to avoid. The orderly liquidation authority therefore cannot mean what it says: it will not really produce a

184. See *[Apple] Pay*, APPLE, <http://www.apple.com/apple-pay/?cid=wwa-us-kwg-features-com> (last visited Apr. 24, 2015) (showing the features of Apple’s new payment system for customers).

185. See OFFICE OF FINANCIAL RESEARCH, REPORT ON ASSET MANAGEMENT AND FINANCIAL STABILITY (2013), available at http://www.treasury.gov/initiatives/ofr/research/Documents/OFR_AMFS_FINAL.pdf (“[T]he activities and risks posed by hedge funds, private equity, and other private funds are not addressed in detail”).

186. Dodd-Frank, Pub. L. No. 111-203, 124 Stat. 1376-2223 (2010); 12 U.S.C. § 5384(b) (2006). See also discussion *supra* Part III.C.

187. 12 U.S.C. § 210(a)(1)(G) (2006); 12 U.S.C. § 5386(4) (2006).

188. 12 U.S.C. § 210(h) (2006); 12 U.S.C. § 5390(a)(1) (2006).

189. See Hynes & Walt, *supra* note 164, at 1002-03 (discussing the “purchase and assumption” strategy used by healthy banks).

190. See SKEEL, NEW DEAL, *supra* note 23, at 150 (arguing Dodd-Frank liquidations “increase[] the potential for value to be squandered”).

liquidation, but instead some sort of covert reorganization, along the lines of a purchase and assumption transaction the FDIC has used when banks fail. Whether or to what extent the resolution is a true liquidation or a purchase and assumption is, however, unclear.

This suggests a second uncertainty about effect: How will the purchasers (winners?) be chosen? Market and judicial (bankruptcy) regimes typically use negotiated or competitive bidding. While the bankruptcy process is replete with imperfections—indeed, so is the market, which is one reason we have bankruptcy—they are minor when compared to the error costs likely to flow from poor regulatory decision-making in the heat of a crisis. Because crises happen quickly, and regulators are subject to little judicial review, significant errors seem inevitable.

This is not to say that regulators would necessarily choose “friends” over “enemies” (although they might). Instead, it means that they are likely to respond exactly as they did in 2008-2009: They will seek ostensibly healthy institutions—JPMorgan Chase, in the recent crisis—to take over and absorb the weaker institution. While Dodd-Frank imposes some limits on regulators’ ability to sweeten the deal for the acquirer, the net effect will be the same: greater concentration. This, however, was something Dodd-Frank was meant to reduce.

C. Which Entity?—Single Point of Entry

Given the structural complexity of large financial firms, a key question for regulators under Dodd-Frank was how to pick the right entities in a large firm to put into receivership—some or all? Either choice—known as “multiple point of entry”—would present significant challenges for regulators, because they would have to make difficult, fairly granular decisions in very short order, with limited information about the impact of these decisions on contractual counterparties as well as entities in the group not placed in receivership.¹⁹¹ Given the complexity of the firms in question, regulators would face great difficulty making good choices.

To solve this problem, the FDIC has proposed “single point of entry” (SPOE). Under SPOE, the FDIC would not need to decide *ex ante* which of a firm’s hundreds or thousands of subsidiaries or affiliates to liquidate: it would only look at the top-tier (parent) entity, and seize that one.¹⁹² That entity would be placed in receivership, its assets (subsidiaries) remaining technically outside the process. A “bridge” financial company would continue to perform the same functions as the holding company of the

191. SPOE Proposal, *supra* note 26, at 76,615.

192. *Id.* at 76,616.

covered financial company, which would then convert to a “NewCo” successor to the failed firm.¹⁹³ Independent experts would perform a valuation of the bridge financial company, and upon the FDIC’s approval of the value, payments of claims in the receivership would be made through issuance of securities in a securities-for-claims exchange.¹⁹⁴ In theory, the exchange would avoid liquidating the bridge financial company’s assets while providing value to its creditors by issuing to the receiver new debt and equity in NewCo, which the receiver would exchange for the creditors’ claims.¹⁹⁵ In essence, equity holders of the parent would likely be eliminated, and debt-holders of the corporate parent would become its new shareholders.

The FDIC believes that the SPOE resolution strategy would minimize disruption and instability because the subsidiaries will continue to perform critical operations for the financial system, instead of causing disruption by closing.¹⁹⁶ The FDIC also claims that the SPOE strategy would reduce the risk of spillover effects to counterparties because the subsidiaries would remain in operation and the bridge financial company would assume any obligations supporting subsidiaries’ contracts.¹⁹⁷ Thus, the FDIC has said that “counterparties to most of the financial company’s derivative contracts would have no legal right to terminate and net out their contracts. Such action would prevent a disorderly termination of these contracts and a resulting fire sale of assets.”¹⁹⁸

Although SPOE creates the appearance of a simplifying regime, it would in fact appear to defer rather than solve the informational problems created by the need to prevent or resolve the failure of large financial firms deeply interconnected with one another and their regulators. Commentators have focused on three problems with SPOE.

First, David Skeel has observed that SPOE does little to solve problems of uncertainty under the FDIC’s orderly liquidation authority, because it does not impose a time requirement for the FDIC to act or take other measures to mitigate this problem.¹⁹⁹ The chance that regulators will either jump the gun or delay interfering increases if a major subsidiary suffers severe financial distress and capital and liquidity are not sufficient to resolve it, as SPOE does not give regulators additional means to provide

193. *Id.*

194. *Id.* at 76,618.

195. *Id.*

196. *Id.* at 76,616.

197. *Id.*

198. *Id.*

199. David A. Skeel, *Single Point of Entry and the Bankruptcy Alternative*, in *ACROSS THE GREAT DIVIDE: NEW PERSPECTIVES ON THE FINANCIAL CRISIS* 323-24 (Martin Neil Bailly & John B. Taylor eds., 2014).

support to the subsidiary.²⁰⁰ Even if the government attempts to interfere in such a situation, the resolution may fail or the SIFI could be under the regulators' authority for much longer than planned under the SPOE strategy.²⁰¹

Second, Stephen Lubben has noted that focusing on the holding company may be unhelpful, because it is unlikely to be the cause of the SIFI's financial distress, or have the proper location in the capital structure to provide a basis for effective resolution.²⁰² For example, with respect to the proposal to recapitalize operating subsidiaries by forgiving intercompany debt owed to the parent company, it "seems unreasonable" that managers and regulators would be able to ensure that there is enough intercompany debt at the struggling subsidiary when cosigning the debt.²⁰³ Therefore, the FDIC must consider additional sources of recapitalization for the subsidiary, such as "the creation of a new, post-OLA intercompany debt funded by the parent's own borrowing."²⁰⁴ Furthermore, because the FDIC has not clarified how it will value the holding company's assets, this lending could become a "disguised bailout" because a loan to an insolvent subsidiary could only be secured by the value of the SIFI's other subsidiaries, which may not be sufficient to support the liquidity needs of the insolvent subsidiary.²⁰⁵ Nor has the FDIC explained how it will resolve a SIFI that has multiple struggling subsidiaries.²⁰⁶

Third, others worry that SPOE may not be the only strategy used.²⁰⁷ This may cause creditors, counterparties, and foreign regulators to resist reliance on an SPOE because they worry that the FDIC will instead (or in addition) use its Title II resolution authority to resolve a global financial services firm in other ways that harm their interests. If this occurs, "creditors and counterparties with the legal right and practical ability to run

200. *Id.*

201. *Id.*

202. Stephen J. Lubben, *Thoughts on Single Point of Entry* (Seton Hall Pub. Law Research Paper No. 2392450, 2014).

203. *Id.*

204. *Id.* at 2.

205. *Id.*

206. *See id.* (discussing how in such a situation, the FDIC may have used SPOE as an ideal approach but realistically would have to use a strategy more similar to a multiple point of entry approach because "in many cases it seems likely that the FDIC might have to conduct receivership proceedings with respect to an offending subsidiary, in addition to the holding company, and that in many such cases it might not be possible to do anything but liquidate that subsidiary to avoid complete devastation of the remaining group").

207. Letter from Bipartisan Policy Center, to Robert E. Feldman, Exec. Sec'y, Federal Deposit Insurance Corporation 7 (Mar. 6, 2014), [hereinafter "BPC Comment Letter"] available at <http://bipartisanpolicy.org/sites/default/files/BPC%20SPOE%20Comment%20Letter.pdf>; Lubben, *supra* note 202, at 4.

may run, and foreign regulators may ring-fence local assets rather than rely on and cooperate with the FDIC.”²⁰⁸ Therefore, SPOE could aggravate financial instability if counterparties and the public are not confident that the FDIC is fully committed to implementing it.²⁰⁹

In addition to these regulatory uncertainties, consider some more prosaic doctrinal problems single point of entry might raise:

Entity Integrity. The law presumes that separate corporate subsidiaries are separate legal persons for most purposes.²¹⁰ While the corporate parent in a SIFI may have direct or indirect control of subsidiaries or affiliates, it would do so only through ordinary governance or contractual mechanisms. If the FDIC wishes to exert greater control over these subsidiaries, will it respect these mechanisms, and the independence of the subsidiaries (especially special purpose entities created in securitizations or similar transactions)? Or will it attempt a kind of “substantive consolidation,” as sometimes occurs in Chapter 11 cases involving large corporate groups? If so, on what legal authority would it do so?²¹¹

Intercompany Claims. Similarly, how would SPOE treat intercompany claims? In theory, the corporate parent’s creditors and shareholders are “structurally subordinate” to the creditors of subsidiary entities.²¹² If, however, the parent (controlled by an FDIC receiver or bridge company) seeks to withdraw (*e.g.*, through dividend) assets of the subsidiaries, what becomes of the subsidiaries’ creditors or other stakeholders? What about horizontal netting or set-off among affiliates?

Termination of Qualified Financial Contracts. Many subsidiaries of a SIFI parent will be parties to swaps, repurchase agreements, and other so-called “qualified financial contracts” (QFCs).²¹³ If a bank fails, the FDIC has special powers as receiver to preserve these contracts for about one business day.²¹⁴ While Dodd-Frank would extend this power to entities

208. BPC Comment Letter, *supra* note 207, at 7.

209. *Id.*

210. See *In re Owens Corning*, 419 F.3d 195 (3d Cir. 2005) (discussing the presumption that corporate subsidiaries are separate legal persons for the most part).

211. See, *e.g.*, *Union Sav. Bank v. Augie/Restivo Baking Co. (In re Augie/Restivo Baking Co.)*, 860 F.2d 515 (2d Cir. 1988) (discussing the fact that in substantive consolidation, the independent identities of affiliates will be disregarded in bankruptcy).

212. See *Owens Corning*, 419 F.3d 195 (3d Cir. 2005) (addressing the theory that corporate parent’s creditors and shareholders are structurally subordinate to the creditors of subsidiary entities).

213. See 12 U.S.C. § 1821(e)(8)(D) (stating that the term “qualified financial contract” is defined broadly in connection with the FDIC’s receivership powers to include swap, derivative and similar contracts likely to be a significant part of a large financial firm’s portfolio).

214. See 12 U.S.C. § 1821(e)(10)(B)(i)(I) (stating “A person who is a party to a

actually in a receivership, it is not clear how the FDIC could prevent termination of QFCs to which subsidiaries are parties where the subsidiaries themselves are not in a receivership.²¹⁵ While QFC contracts could be modified to stay termination upon the parent's liquidation, they could also contain "ipso facto" clauses that permit termination in such event.²¹⁶

To be sure, single point of entry is not the law yet. The FDIC proposed the strategy in 2013 and has been receiving comments since then. At this point, it seems likely to be the preference of both the FDIC and large financial firms.²¹⁷ Institutional analysis would predict that, because it appears to be the participatory choice of both regulators and the regulated, SPOE is likely to become the resolution mechanism of choice.

D. Which Institution?

A final, perhaps essential, class of uncertainty under Dodd-Frank is which regime—and therefore which institution—will resolve the distress: bankruptcy or receivership? As written by Congress, Dodd-Frank's orderly liquidation authority proposed a process akin to a bank receivership that would promote the orderly resolution of the distress of large financial firms.²¹⁸ More recently, however, it appears that regulators want to

qualified financial contract with an insured depository institution may not exercise any right that such person has to terminate, liquidate, or net such contract . . . until 5:00 p.m. (eastern time) on the business day following the date of the appointment of the receiver . . .").

215. See FEDERAL FINANCIAL ANALYTICS, INC., WHAT IT TAKES TO MAKE THE FDIC RESOLUTION PROPOSAL WORK 5 (2014) [hereinafter "FedFin"], available at https://www.fdic.gov/regulations/laws/federal/2013/2013-single-point-entry-c_10.pdf (arguing that SPOE "may not address QFCs, especially those with cross-default clauses, in a definitive fashion or in a manner that quashes TBTF expectations").

216. See *id.* at 4 (pointing out that "the FDIC and several global regulators have petitioned QFC counterparties to revise contractual standards to provide for an automatic stay when a resolution authority seizes a financial institution, giving the resolver time to assess resources and structure an orderly payment process that blocks the race to the exit generally called fire-sale risk."). It is not clear whether such contractual modifications will be made or would remain in effect in the run up to the collapse of a SIFI.

217. See *id.* (discussing the reality that single point of entry is the preference of the FDIC and large financial firms).

218. See, e.g., *Regulation and Resolving Institutions Considered "Too Big to Fail" Before the S. Comm. on Banking, Housing & Urban Affairs*, 111th Cong. 51-52 (2009) (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 Bankruptcy 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"). The FDIC has claimed 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. See Fed. Deposit Ins. Corp.,

encourage such firms to use Chapter 11 of the Bankruptcy Code if possible, in particular through the development of so-called “living wills” that would spell out in advance how a bankruptcy would work for the firm.²¹⁹

Among other things, a living will requires a covered financial firm to develop a plan for “rapid and orderly resolution,” which is defined as “a reorganization or liquidation of the [firm] . . . under the Bankruptcy Code that can be accomplished within a reasonable period of time and in a manner that substantially mitigates the risk that the failure of the [firm] would have serious adverse effects on financial stability in the United States.”²²⁰ Although firms can be penalized for failing to develop adequate living wills,²²¹ the living wills apparently have no binding force in any subsequent resolution procedure, under the Bankruptcy Code or otherwise.²²² Nor can they be used in any “private cause of action” that may follow the firm’s failure.²²³ Even regulators currently appear skeptical of their value.²²⁴

While living wills create a number of uncertainties—What is their legal effect? Who can see them? Who is responsible for defects in

The Orderly Liquidation of Lehman Brothers Holdings Inc. under the Dodd-Frank Act, FDIC Q., 2011, at 4-5, available at https://www.fdic.gov/bank/analytical/quarterly/2011_vol5_2/lehman.pdf (suggesting that the FDIC prefers receivership over bankruptcy).

219. See 76 Fed. Reg. 211 (Nov. 1, 2011) [hereinafter “Living Will Rule”] (outlining the final rules implementing the so-called “living will” requirements).

220. *Id.*

221. See 12 U.S.C. § 5365(d)(5)(A) (stating that “If a nonbank financial company supervised by the Board of Governors or a bank holding company described in subsection (a) fails to timely resubmit the resolution plan as required under paragraph (4), with such revisions as are required under subparagraph (B), the Board of Governors and the Corporation may jointly impose more stringent capital, leverage, or liquidity requirements, or restrictions on the growth, activities, or operations of the company, or any subsidiary thereof, until such time as the company resubmits a plan that remedies the deficiencies.”).

222. See 12 U.S.C. § 5365(d)(6) (stating that “A resolution plan submitted in accordance with this subsection shall not be binding on a bankruptcy court, a receiver appointed under subchapter II, or any other authority that is authorized or required to resolve the nonbank financial company supervised by the Board, any bank holding company, or any subsidiary or affiliate of the foregoing.”).

223. See 12 U.S.C. § 5365(d)(7) (stating that “No private right of action may be based on any resolution plan submitted in accordance with this subsection.”). Needless to say, the meanings of “private right of action” and “based on” are unclear. If the board of directors was grossly negligent in developing a living will, would a suit against them by a Chapter 11 trustee on behalf of the estate of the debtor be barred under this provision? One of many litigation questions to be considered in the future.

224. See Thomas M. Hoening, Vice-Chairman, Fed. Deposit Ins. Corp., Statement on the Credibility of Living Wills (Aug. 5, 2014), available at http://www.americanbar.org/content/dam/aba/events/business_law/2014/11/banking/living-wills-201411.authcheckdam.pdf (observing that “Despite the thousands of pages of material these firms submitted, the [living will] plans provide no credible or clear path through bankruptcy that doesn’t require unrealistic assumptions and direct or indirect public support.”).

them?—the basic problem is the institutional ambivalence they signal. If Congress wants regulators under Title II of Dodd-Frank to oversee orderly liquidations, why encourage planning under the Bankruptcy Code? These are fundamentally different institutional choices, with different implications for the processes and outcomes likely to ensue. This is especially troubling because we have no idea whether, or to what extent, a living will would play any role at all, in whatever institutional choice was ultimately made about the distress of the firm. If regulators give mixed signals about which institution should govern the failure of large financial firms, how can we expect market actors to engage in the planning and negotiation that would ordinarily be preferable when financial distress occurs?

E. Regulatory Displacement of Market-Based Renegotiation

From an institutional perspective, these uncertainties impede participation when it should matter most: when the large financial firm's management has recognized a serious problem, and should seek to renegotiate the contracts creating the distress. To do so would have the virtues of aligning participation with incentives: those with the most at stake in the firm's failure will likely attempt to renegotiate a solution in the shadow of bankruptcy. If renegotiation fails, the debtor may either commence (or be forced into) a bankruptcy or hand the company over to creditors. While this may be somewhat costly and messy, it avoids the (presumptively greater) cost and stigma of bailouts and moral hazard otherwise associated with regulatory resolution. More importantly, it has the potential to contain losses at the troubled firm and its counterparts, who will presumably agree only to those losses they reasonably believe they can absorb.

Dodd-Frank is not insensible to the possibility of market-based renegotiations. Section 165(i) of Dodd-Frank requires large bank holding companies and certain other financial services firms to undergo "stress tests."²²⁵ Certain aspects of the results are made public. Similarly, living wills might give market participants information they need to work out a troubled financial firm's distress. But the legal force and effect of stress

225. See Dodd-Frank § 165(i), 12 U.S.C. § 5365(i)(1)(A) (stating that "The Board of Governors, in coordination with the appropriate primary financial regulatory agencies and the Federal Insurance Office, shall conduct annual analyses in which nonbank financial companies supervised by the Board of Governors and bank holding companies described in subsection (a) are subject to evaluation of whether such companies have the capital, on a total consolidated basis, necessary to absorb losses as a result of adverse economic conditions.").

tests and living wills is unclear. Nor is there any clear connection between which firms must undergo stress tests, create living wills, or be the subject of a potential OLA proceeding. A single firm could be the subject of all three—or not, as regulators may choose. The many layers of uncertainty created by Dodd-Frank’s resolution (and related) regimes compound the complexity created by this enormous expansion of regulatory power.

Moreover, the participatory justifications for the FDIC’s resolution authority are weaker here than would be the case in traditional bank failures. Non-bank firms that are likely candidates for orderly resolution are not like banks in a key participatory way: they are unlikely to have retail depositors, for whom regulators proxy. After all, the bank-holding company (corporate parent) in an SPOE likely has only interests in subsidiaries, which may include regulated depositaries as well as many other types of financial firms. But the distress of the target of the current regulatory resolution strategy—the parent entity—is unlikely to experience the kind of shifted distribution that legitimates the bank failure regime. Bank holding companies can and do engage in workouts and if those fail, they seek Chapter 11 protection.²²⁶ Thus, bank holding companies have long been eligible for bankruptcy, even as the banks they own are not.²²⁷

Instead, the most important stakeholders in the parent of a SIFI are likely to be other financial firms run by highly sophisticated, well-resourced professionals, or the government itself (*e.g.*, if it is purchasing securities under a “quantitative easing” program). In the first instance, these counterparties are, or should be, capable of the monitoring and renegotiation generally found in non-bank distress renegotiations. While stress tests and living wills are laudable, they seem unlikely to overcome the uncertainty and complexity of Dodd-Frank’s resolution regime, and the incentive effects it will have on potential pre-failure negotiations.

Which means that, if (when) distress hits a very large financial firm, we could end up roughly where we were in March 2008, after the Bear Stearns bailout: managers of large financial firms were increasingly worried about their counterparties’ viability, but were uncertain what to do about it. While market-oriented resolution may be preferable on normative and efficiency grounds, the complexity and uncertainty of Dodd-Frank make this much less likely. Rather, it would seem more sensible for managers of these firms to seek regulatory help—exactly as they did in 2008-2009. While regulators ostensibly cannot provide the sort of direct financial assistance associated with the crisis, they—in particular the Federal Reserve—retain many powers to subsidize market actors in order

226. *Supra* note 10.

227. *Id.*

to provide stability, including through the “broad-based” repurchase of troubled securities, such as mortgage-backed securities in the most recent crisis.²²⁸ But that simply means that—as many fear—bailouts will remain a feature of the system.

This is not to suggest that regulators should have no role in preventing or resolving the financial distress of large financial firms. Perhaps the most useful function they could serve would be to facilitate renegotiations among distressed financial firms, as happened with Long-Term Capital Management in the 1990s.²²⁹ Nothing prevents them from doing this. But, if managers of large financial firms understand that the complexities and uncertainties of Dodd-Frank compound the transactional and structural complexity of their firms, they will in times of trouble be hard pressed to do anything but seek government assistance. They will remain stuck in the “doom loop” described in Part I because it is in their collective and respective interests to do so.

V. AGAINST REGULATORY DISPLACEMENT—JUDICIAL RESPONSES

If regulatory displacement is likely to maintain Haldane’s doom loop, how do we get out of it? Given the political economy of financial regulation, it is unlikely that Congress or regulators will address the underlying pathologies of concentration, complexity, and capture. Nor do markets alone have the incentive to do so. Regulators and large firms appear to braid with one another, notwithstanding the economic and normative costs associated with this trend. This leaves the judiciary to produce what Hart and Sacks call “institutional settlement,” aided perhaps by market forces.²³⁰ This part discusses two strategies to reassert the institutional authority of the judiciary to prevent or resolve financial distress, the proposed “Chapter 14” amendment to the Bankruptcy Code and a novel approach to fiduciary review of directors’ duty of oversight.

228. 12 U.S.C. § 222-223 (2010); *see also* Alexander Mehra, *Legal Authority in Unusual and Exigent Circumstances: The Federal Reserve and the Financial Crisis*, 13 U. PA. J. BUS. L. 221, 267 (2010) (arguing that “the amended statute, with its requirement that the Fed establish schemes of ‘broad-based eligibility,’ may even contemplate such asset purchases—so long as they occur on a wide scale.”).

229. *See* FCIC REPORT, *supra* note 19, at 57 (discussing resolution of failed hedge fund brokered by New York Fed, which “involved no government funds”).

230. *See* LEGAL PROCESS, *supra* note 4, at 4.

A. *Bankruptcy Code Chapter 14*

Many recognize that courts should play a larger role in preventing and resolving financial distress, and so look to the judicial process that has traditionally addressed failure: bankruptcy. Perhaps the most ambitious effort comes from Stanford's Hoover Institute, which has proposed an entirely new chapter to the Bankruptcy Code, Chapter 14, which would be available exclusively to the same systemically important financial firms that title II of Dodd-Frank purports to regulate, but would use a different institution—courts.²³¹ Bowing to the political reality that Dodd-Frank is a law whose repeal is unlikely, however, it is offered “either in addition to or as an alternative to” Dodd-Frank.²³²

The main contribution of Chapter 14 can be understood in institutional terms: it would dilute regulatory authority by making a judicial alternative—bankruptcy—more palatable.²³³ The goal of Chapter 14 is, according to its proponents, “to ensure that the covered financial institutions, creditors dealing with them, and other market participants, know in advance, in a clear and predictable way, how losses will be allocated if the institution fails.”²³⁴ The theoretical justification is familiar: the possibility of bailouts distorts incentives. Jackson writes that “[i]f the creditors of a failed financial institution are protected (bailed out), then the strongest and most rapidly responding constraint on risk-taking by the financial institution's management is destroyed, and their losses are transferred to others.”²³⁵

The functional heart of the proposal would limit derivatives counterparties from closing out their positions upon bankruptcy, as happened in *Lehman Brothers* with problematic consequences.²³⁶ The

231. As Thomas Jackson, the principal author of the proposal and one of the nation's leading experts on bankruptcy explains, the Chapter 14 proposal is designed “especially for the complexity and potential systemic consequences, of the failure of [a] large financial institution[.]” Thomas Jackson, *Bankruptcy Code Chapter 14: A Proposal 2* (Feb. 28, 2012) (unpublished manuscript), <http://media.hoover.org/sites/default/files/documents/Bankruptcy-Code-Chapter-14-Proposal-20120228.pdf>.

232. *Id.*

233. *Id.* at 2 (noting that “we believe it is possible to take advantage of a judicial proceeding . . . in such a way as to minimize the felt necessity to use the alternative government agency resolution process recently enacted as a part of [Dodd-Frank].”).

234. *Id.*

235. *Id.*

236. See Mark J. Roe, *The Derivatives Market's Payment Priorities as Financial Crisis Accelerator*, 63 STAN. L. REV. 539 (2011) (discussing the disruptive effects of derivative counterparties who have the right to jump ahead of even secured creditors for repayment); see also Thomas Jackson & David Skeel, *Transaction Consistency and the New Finance in Bankruptcy*, 112 COLUM. L. REV. 152 (2012) (discussing the importance of transaction

Bankruptcy Code creates a series of “safe harbors” under which parties to certain kinds of derivatives are not stayed by bankruptcy from enforcing their rights.²³⁷ Originally meant to promote market stability, they have apparently permitted the kinds of “runs” that bankruptcy was meant to prevent, acting as a financial crisis “accelerator,” in Mark Roe’s words.²³⁸ The “single most important ‘fix’” in the Chapter 14 proposal would give financial firm debtors in Chapter 14 three days to decide whether to perform these contracts, or let the counterparties terminate them (which they can currently do immediately).²³⁹ There is much to be said for this element of the Chapter 14 proposal.

The problem is that the case to amend the Bankruptcy Code to create a whole new chapter has not yet been made, and especially not as evidenced by the Chapter 14 proposal. First, the proposals on derivative contracts should apply not only to large financial firms under Chapter 14, but to all firms in bankruptcy. Those safe harbors have become problematic for a wide range of firms, not simply systemically important financial institutions.²⁴⁰ While large financial firms may be more likely to be parties to these contracts, many other debtors are, as well, and they are often equally problematic.

Second, the Chapter 14 proposal’s political pragmatism undermines its goal of creating institutional predictability. The authors sensibly recognize that Dodd-Frank is not likely to be repealed. So, they cagily suggest that Chapter 14 could comfortably co-exist with Dodd-Frank. But if we do not know when or to whom Dodd-Frank is to apply, why would a dual judicial track create greater certainty? Just as more recent efforts to promote Chapter 11 planning under “living wills” create institutional uncertainty, it would not.

consistency by removing derivatives’ exemptions from a number of bankruptcy’s core provisions).

237. See 11 U.S.C. §§ 362(b)(6), (7), 559, 560 (codifying the exemptions from the automatic stay and contractual rights in relation to repurchase or swap agreements).

238. See Roe, *supra* note 236 (explaining that the Bankruptcy Code’s favored treatment of firms’ derivative and financial repurchase contracts facilitated the firms’ failures and undermined market discipline); see also Jonathan C. Lipson, *The Loophole that Became a Wormhole: Why the Fed Had to Bail out AIG*, CONCURRING OPINIONS (Sept. 19, 2008), available at http://www.concurringopinions.com/archives/2008/09/the_loophole_th.html (explaining that the 2005 amendments to the Bankruptcy Code provided a large loophole for special treatment in bankruptcy for credit default swap holders such as AIG).

239. Jackson, *supra* note 231, at 36.

240. See Roe, *supra* note 236, at 549 (“It is no surprise that sophisticated finance players seek to structure their transactions as derivatives or repo agreements, because it protects them. By doing so, the superprioritized counterparties have fewer incentives to ration their dealings with financially weak debtors.”).

Third, the proposal recognizes that bankruptcy courts currently have uncertain authority. This is due to a series of Supreme Court decisions holding that bankruptcy judges, as Article I actors, lack authority under Article III of the Constitution to enter final judgments on claims “that constitute ‘the stuff of the traditional actions at common law tried by the courts at Westminster in 1789.’”²⁴¹ While it is far from clear what this means in practice, the Chapter 14 proposal would avoid the problem by taking these resolutions away from bankruptcy judges, too. Instead, such cases would be “‘funnel[ed]’” to “a limited set of pre-picked Article III district judges.”²⁴²

The Chapter 14 proponents may be correct that placing these decisions with U.S. District Judges avoids possible constitutional challenges over bankruptcy judges’ authority. But this is not their rationale. Rather, they argue, somewhat surprisingly, that “it is unlikely that the nation’s several hundred bankruptcy judges—all of whom can be presumed to have important knowledge of the Bankruptcy Code itself—will have the requisite financial expertise to deal, in real time, with the nation’s largest financial institutions.”²⁴³ They also question the independence of bankruptcy judges who, as Article I actors, may be susceptible to political influence (e.g., from the Congress that sets their pay). Jackson states:

[T]he essential need for complete independence from any perception of influence by the financial institution, the government, or a particularly significant creditor, suggests that any bankruptcy system designed for the nation’s largest financial institutions would want those institutions to have their cases and ancillary proceedings heard before an Article III judge . . . [the] ‘gold-plated’ standard of independence from government.²⁴⁴

This is troubling, because it trades the appearance of independence against the expertise of experienced bankruptcy judges. There is no doubt that a truly independent Article III judicial check on the resolution of a large financial firm’s failure would promote the appearance of legitimacy. The problem is that the Chapter 14 proposal and Dodd-Frank both choose the Article III District of Columbia District Court – a court that may not be as independent as one would hope, as appointments to that bench are

241. See also Jonathan C. Lipson & Jennifer Vandermeuse, Stern, *Seriously: The Article I Judicial Power, Fraudulent Transfers and Leveraged Buyouts*, 2013 WIS. L. REV. 1161, 1175 (quoting *Stern v. Marshall*, 131 S Ct. 2594, 2609 (2011)).

242. Jackson, *supra* note 231, at 9.

243. *Id.* at 8.

244. *Id.* at 9.

notoriously politically fraught.²⁴⁵ Indeed, a large body of empirical literature has shown that Article III judges are often as likely to vote their ideology as to follow precedent.²⁴⁶

At the same time, it is hard to imagine judges with greater expertise in dealing with the failures of large financial institutions than the bankruptcy (Article I) judges who oversaw the mega-cases of the crisis, including Robert Drain, who presided in *Refco*, Mary Walrath, who presided in the case of WaMu's parent holding company, or James Peck, who oversaw the *Lehman Brothers* case. There may be pragmatic arguments for taking this work away from them—or more plausibly providing for dual bankruptcy-district judge appointments—but it is inappropriate to question their expertise or independence in this sense. While there will always be concerns about political taint in any process for resolving the failure of a large financial firm, there will not be a second chance to capitalize on expertise and experience. There are simply no other judges who have the experience of these and similarly situated bankruptcy judges.

Finally, any effort to amend the Bankruptcy Code is, itself, likely to be politically volatile. The last major amendment to that statute occurred in 2005, in a highly politicized process that produced amendments considered to be harmful to all but the large financial institutions that aligned to support them.²⁴⁷ Given the political cycle that characterizes financial regulation described in Part I—special interests dominate except (perhaps) in a crisis—it is not clear why financial services firms would permit Chapter 14 to become law in any way that does not advance their interests. If so, then it would not likely reduce problems of concentration or complexity.

I am sympathetic to the intuition behind the Chapter 14 proposal. There is good reason to believe that the bankruptcy process brings with it participatory virtues lacking in Dodd-Frank. As a general proposition, it

245. See Scott C. Shine, *Losing streak in D.C. Circuit impacts SEC rule-making*, LEXOLOGY, Nov. 21, 2011, at 14, available at <http://www.lexology.com/library/detail.aspx?g=0032687e-e8e0-490e-8a9a-4f6f33da0705> (discussing the shift in SEC rule-making due to the D.C. Circuit striking down rules based on the SEC's failure to adequately consider effects on efficiency, competition, and capital formation as required by law).

246. See, e.g., Lee Epstein et al., *Ideological Drift Among Supreme Court Justices: Who, When and How Important?*, 101 NW. U. L. REV. 1484, 1536 (2007) (illustrating the preference change and doctrinal development and shift of the Roberts court).

247. Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA), Pub. L. No. 109-8, 119 Stat. 23 (codified as amended in scattered sections of 11, 18, 28 U.S.C.). See also Jonathan C. Lipson, *Debt & Democracy: Towards a Constitutional Theory of Bankruptcy*, 83 NOTRE DAME L. REV. 605, 688-89 (2008) (discussing political history of BAPCPA); see generally William C. Whitford, *A History of the Automobile Lender Provision of BAPCPA*, 2007 ILL. L. REV. 143 (discussing history of lobbying for BAPCPA).

can force parties into a single forum where renegotiation under threats of various (worse) alternatives (e.g., liquidation or cramdown) can often produce better outcomes than those the market or regulators could deliver on their own.

Nevertheless, it is not clear why we need a whole new chapter of the Bankruptcy Code to do this. As discussed in Part III, there is already a Chapter 11 of the Bankruptcy Code. With some of the adjustments discussed in the Chapter 14 proposal—in particular re-thinking the derivatives safe-harbors—Chapter 11 could work for SIFIs. Without clarifying limits on regulatory OLA authority, adding Chapter 14 as proposed only makes for greater complexity and uncertainty, significant factors contributing to regulatory displacement. In short, while I support an expanded role for the judiciary in preventing financial crises, I am not sure the case has yet been made for a new Chapter 14 of the Bankruptcy Code.

B. Rethinking the Duty to Be Informed

A potentially more effective, albeit imperfect, way to reduce scale and complexity in large financial services firms might be to look at those closer to the problem, and their incentives for managing certain aspects of these phenomena: corporate directors. Corporate law has long recognized that directors have duties of care and loyalty,²⁴⁸ as well as a “duty to be informed” (DTBI), although the scope and force of that duty are disputed.²⁴⁹ Discussions of the DTBI usually begin with *Caremark*, a controversial opinion that said—but did not hold—that directors’ “sustained or systematic failure . . . to exercise oversight” may be evidence of a “lack of good faith.”²⁵⁰ In the wake of the financial crisis, angry shareholders recalled this language, and sued directors of financial services firms alleging that directors had failed to satisfy their oversight duties. With one exception, the cases have provided little relief to the shareholders.²⁵¹

248. See *Guth v. Loft, Inc.*, 5 A.2d 503, 510 (Del. 1939) (stating that the rule requires corporate officers and directors to have an undivided and unselfish loyalty to the corporation).

249. *In re Caremark Int’l Inc. Derivative Litig.*, 698 A.2d 959, 971 (Del. 1996). Of course, everything about the duty to be informed in *Caremark* may have been dicta, since the opinion merely approved the settlement of a shareholder lawsuit stemming from a board’s failure to detect and stop fraud by corporate managers. *Id.* at 972.

250. *Id.* at 971-72.

251. In all but the *Countrywide* case, shareholders’ complaints were dismissed at the pleadings stages. Compare *In re JPMorgan Chase & Co. Derivative Litig.*, No. 12 Civ. 03878(GBD), 2014 WL 1297824, at *1 (S.D.N.Y. Mar. 31, 2014) (granting defendant’s motion to dismiss the second amended complaint); *Staeher v. Mack*, No. 07 Civ.

Consider, for example, the *Goldman Sachs Shareholders* litigation.²⁵² Here, shareholders sued officers and directors of Goldman Sachs for breaching their duty of oversight by approving excessive compensation for employees, which allegedly “led to overly-risky business decisions and unethical and illegal practices.”²⁵³ Goldman Sachs had experienced substantial growth since it went public in 1999, and plaintiffs argued that its management “achieved this growth ‘through extreme leverage and significant uncontrolled exposure to risky loans and credit risks’” and that this business growth strategy was not in the shareholders’ best interest.²⁵⁴ During 2008, Goldman Sachs suffered losses of billions of dollars, and plaintiffs alleged that “but for a cash infusion from Warren Buffet, federal government intervention and Goldman’s conversion into a bank holding company, Goldman would have gone into bankruptcy.”²⁵⁵

In dismissing the case, the Delaware Chancery Court observed that:

[t]o face a substantial likelihood of oversight liability for a *Caremark* claim, the Director Defendants must have ‘(a) . . . utterly failed to implement any reporting or information system or controls’ (which the Plaintiffs concede is not the case here); ‘or (b) having implemented such a system or controls,

10368(DAB), 2011 WL 1330856, at *1 (S.D. N.Y. Mar. 31, 2011) (granting defendant’s motion to dismiss because a demand on the board was not futile); *In re American Int’l Group, Inc. Derivative Litig.*, 700 F. Supp. 2d 419, 424 (S.D. N.Y. 2010); *Louisiana Mun. Police Employees Ret. Sys. v. Blankfein*, 08 CIV. 7605, 2009 WL 1422868, at *1 (S.D.N.Y. May 19, 2009); *Louisiana Mun. Police Employees Ret. Sys. v. Pandit*, 08 CIV. 7389LTSRLE, 2009 WL 2902587 (S.D.N.Y. Sept. 10, 2009); *In re Citigroup Inc. S’holder Derivative Litigation*, 964 A.2d 106, 111 (Del. Ch. 2009); *In re Goldman Sachs Grp., Inc. S’holder Litig.*, CIV.A. 5215-VCG, 2011 WL 4826104, at *2 (Del. Ch. Oct. 12, 2011) with *In re Countrywide Fin. Corp. Derivative Litig.*, 554 F. Supp. 2d 1044 (C.D. Cal. 2008) (allowing plaintiffs to proceed because the shareholders’ allegations raised a strong inference of scienter, and the demand requirement was excused).

Regulators have tried to improve disclosure regarding risk management practices, although it is not clear whether these changes would have any impact on discharging duties of oversight. See Proxy Disclosure Enhancements, Exchange Act Release Nos. 33-9089, 34-61175, IC-29092, 74 Fed. Reg. 68,334 (Dec. 29, 2009) (amending 17 C.F.R. §§ 229, 239, 240, 249, 274); see also N.Y. Stock Exch., NYSE Listed Company Manual § 303A.07(b)(i)(D) (2009) (mandating that listed companies have an audit committee charged with, among other things, “discuss[ing] policies with respect to risk assessment and risk management”).

252. *Goldman Sachs*, 2011 WL 4826104 at *2. Although the *Citigroup* case was the first major case in the DTBI context connected to the financial crisis, its progeny (such as *Goldman*) show how the doctrine has developed. Cf. *Citigroup*, 964 A.2d at 114 (describing Citigroup’s exposure to the subprime crisis).

253. *Goldman Sachs*, 2011 WL 4826104 at *2.

254. *Id.*

255. *Id.*

consciously failed to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention.²⁵⁶

Plaintiffs only alleged “unethical” conduct, which “is not the type of wrongdoing envisioned by *Caremark*.”²⁵⁷ The plaintiffs described only legal business decisions, and “[l]egal, if risky, actions that are within management’s discretion to pursue are not ‘red flags’ that would put a board on notice of unlawful conduct.”²⁵⁸

Only one significant case has come out the other way, the *Countrywide Shareholders* litigation.²⁵⁹ Here, plaintiffs alleged that from 2002-2006, defendants increased production of non-conforming loans, which were riskier than conforming loans.²⁶⁰ Furthermore, plaintiffs alleged that Countrywide increased the riskiness of the loans by offering them to homebuyers without requiring proof of income, which “often violated the Company’s own loan underwriting policies,” and the complaint provided “the accounts of numerous confidential witnesses, who are mostly former employees such as underwriters and loan officers, relating how Countrywide departed from its strict underwriting standards by generating large numbers of loans without proper regard for their quality.”²⁶¹ Plaintiffs further alleged that the individual defendants, as well as Countrywide’s Audit Committee, Credit Committee, Finance Committee, and Operations and Public Policy Committee ignored “red flags” that Countrywide’s loan portfolio had taken on too much risk.²⁶² In addition, plaintiffs alleged that defendants made false and misleading statements about the health of the loans that Countrywide was originating.²⁶³

256. *Id.* at *19 (quoting *Stone v. Ritter*, 911 A.2d 362, 370 (Del. 2006)).

257. *Id.* at *20.

258. *Id.*

259. See generally *In re Countrywide Fin. Corp. Derivative Litig.*, 554 F. Supp. 2d 1044, 1044 (C.D. Cal. 2008) (denying defendants’ motion to dismiss).

260. *Id.*

261. *Id.* at 1051.

262. The “red flags” included: “(1) the shift to riskier loan products; (2) the rising delinquencies in pay-option ARMs and HELOCs; (3) sharply rising rates of negative amortization and associated ‘phantom earnings’; (4) the ‘dramatic increase in retained interests held on Countrywide’s balance sheet’; (5) the fact that the Company’s valuation of MSR, retained interests and loans held for sale ‘fluctuate[d] wildly without any basis’; (6) the pitfalls of other mortgage lenders; and (7) industry publications about nontraditional loans, including those that were critical of low-documentation pay option ARMs.” *Id.* at 1053.

263. *Id.* at 1053.

Applying Delaware law, the U.S. District Court in California denied a motion to dismiss the complaint, finding that it “establishes a strong inference of deliberate recklessness for several of the [i]ndividual [d]efendants” because it shows that the committees on which the individual defendants sat “were directly responsible for monitoring Countrywide’s risk exposures and the financial performance of its loan portfolio, both of which implicate a fundamental part of the Company’s business—the quality of the loans originated and adherence to underwriting standards.”²⁶⁴

Furthermore, the court accepted testimony which “suggest[ed] a widespread Company culture that encouraged employees to push mortgages through without regard to underwriting standards.”²⁶⁵ Because the defendants sat on committees which were directly responsible for monitoring the risk that led to Countrywide’s losses, and they had knowledge of the “red flags,” the court concluded that “the Complaint pleads evidence of a “sustained or systematic failure of the board to exercise oversight” as required by *Caremark*.²⁶⁶ The court went on to say, “It defies reason, given the entirety of the allegations, that these Committee members could be blind to widespread deviations from the underwriting policies and standards being committed by employees at all levels. At the same time, it does not appear that the Committees took corrective action.”²⁶⁷

The duty to be informed has been characterized as “possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment,”²⁶⁸ and thus—*Countrywide* notwithstanding—appears to be a frequent loser.²⁶⁹ This is because the inquiry is effectively about the board’s scienter—whether it knowingly disregarded its duty of oversight.²⁷⁰

264. *Id.* at 1081.

265. *Id.* at 1081-82.

266. *Id.* (quoting *In re Caremark Int’l Inc. Derivative Litig.*, 698 A.2d 959, 971 (Del. 1996)) (internal quotation marks omitted).

267. *Id.*

268. *Caremark*, 698 A.2d at 967.

269. See, e.g., *Stone v. Ritter*, 911 A.2d 362, 373 (Del. 2006) (discussing oversight claims related to criminal conduct by corporate employees); *Desimone v. Barrows*, 924 A.2d 908, 940 (Del. Ch. 2007) (discussing oversight claims related to criminal conduct by corporate employees); *David B. Shaev Profit Sharing Account v. Armstrong*, No. 1449-N, 2006 Del. Ch. LEXIS 33, at *19-20 (Del. Ch. Feb. 13, 2006) (discussing oversight claims related to facilitating fraudulent transactions by third parties); *Guttman v. Huang*, 823 A.2d 492, 506-07 (Del. Ch. 2003) (discussing oversight claims related to accounting irregularities); *Caremark*, 698 A.2d at 971 (discussing oversight claims related to criminal conduct by employees). But see *Fin. Corp. v. Araneta*, No. 489-N, 2006 Del. Ch. LEXIS 215, at *76-77 (Del. Ch. Dec. 21, 2006) (discussing oversight claims involving looting of a close corporation).

270. See, e.g., *Barrows*, 924 A.2d at 940 (“in order to state a viable *Caremark* claim . . . a plaintiff must plead the existence of facts suggesting that the board knew that internal

Thus, Robert Miller has observed, “[t]he Delaware courts have [] set a high standard in oversight liability cases, much higher than in ordinary business judgment cases.”²⁷¹

Observers are divided about the role the DTBI should have played in the wake of the financial crisis. On one hand, some worry that courts (in particular the Delaware Chancery Court) failed to use the crisis as an “opportunity to define meaningful responsibilities by the board.”²⁷² On the other hand, some would sustain decisions such as that in *Goldman Sachs* on grounds that risk management is an evolving art, and that judicial intervention may stifle innovation.²⁷³ Cases such as *Countrywide* should be limited to facts peculiar to the nature of that company’s business, critics argue.²⁷⁴

Framed within the contours of conventional corporate doctrine, skepticism about the DTBI is understandable. We want directors of firms to take risks because that is how they make money for the corporations they manage. The judiciary cannot both demand that they maximize value for shareholders and punish them for attempting to do so.²⁷⁵ Applied to

controls were inadequate, that the inadequacies could leave room for illegal or materially harmful behavior, and that the board chose to do nothing about the control deficiencies that it knew existed.”).

271. Robert T. Miller, *Oversight Liability for Risk-Management Failures at Financial Firms*, 84 S. CAL. L. REV. 47, 84 (2010).

272. J. Robert Brown, *Delaware Courts and Exonerating the Board from Supervising Risk: In re Citigroup Derivative Litigation (Introduction)*, THE RACETOTHEBOTTOM.ORG (March 12, 2009, 9:00 AM), <http://www.theracetothetbottom.org/preemption-of-delaware-law/delaware-courts-and-exonerating-the-board-from-supervising-r-4.html>; see also Eric J. Pan, *A Board’s Duty to Monitor*, 54 N.Y.L. SCH. L. REV. 717, 739 (2010) (“It seems fantastic that the duty to monitor . . . incentivizes boards to take no responsibility for the business results of the company—a complete disregard for the principle that the corporation shall be managed by or under the direction of the board.”).

273. Stephen M. Bainbridge, *Caremark and Enterprise Risk Management*, 34 J. CORP. L. 967, 982 (2009) (“If, in applying *Caremark* to risk management failures, courts are perceived as imposing liability on boards for failing to adopt some specific model of risk management, the evolutionary market processes by which optimal best practices emerge may be aborted.”).

274. Christine Hurt, *The Duty to Manage Risk*, 39 J. CORP. L. 253, 268 (2014) (“The lasting impact of *Countrywide* may be limited to cases involving issuers that have one line of business and make statements—even generalized statements, regarding that business model that are fundamentally untrue where this disconnect is common knowledge within the company.”).

275. As Bratton and Wachter have explained, directors of large firms that did not invest in mortgage-related securities were punished in the market, at least in the short run. William W. Bratton & Michael L. Wachter, *The Case Against Shareholder Empowerment*, 158 U. PA. L. REV. 653 (2010); see also Richard Squire, *Strategic Liability in the Corporate Group*, 78 U. CHI. L. REV. 605, 607–08 (2011) (arguing that shareholders will use intragroup credit guarantees to increase value for shareholders at the expense of creditors who will be unable to recover in the event the corporate group as a whole goes bankrupt).

ordinary firms, it is difficult to see the objection to the DTBI as it has developed to this point. Institutional analysis would suggest that market forces—duly elected directors—are usually in a far better position to assess risk than courts, and so the judiciary should play little role.

However, comparative institutional analysis also indicates that a different approach to the DTBI is in order with respect to very large financial firms. Specifically, courts in this context should relax the focus on board scienter, to consider whether risks taken were appropriate given the institutional setting in which these firms operate.²⁷⁶ Were the risks willfully ignored (an easier case), or known but at a very high level of generality, given their systemic implications (a harder case)? Complexity both creates the conditions that lead to regulatory displacement and, perhaps ironically, makes it harder to pin down a director's state of mind: complexity permits plausible deniability, and thus an incentive to ignore or downplay risk at the margins.

Of course, judges will not have greater expertise than directors (or presumably regulators) in this context. Nevertheless, a more searching use of the DTBI here would be valuable because the institutional alternatives are worse. Unmotivated by fiduciary review, directors have only modest incentives to police concentration and complexity at large financial firms. Regulators should, of course, proxy for courts in this context. But their deep capture by large financial firms makes it unlikely that regulators can help, either. When market and regulatory responses fail in a significant way, correction falls to the judiciary.

Put another way: if directors of large financial firms are not in a position to monitor their firms' risks and manage them appropriately, who is? While executives will likely be better informed than directors, there is little reason to believe that they have the long-term incentives to manage risk appropriately. The crisis demonstrates that they were rewarded by ignoring long-term risks.²⁷⁷ Rather, if they believe that regulators will save

276. I recognize that some may worry that this would amount to “piling on” given that Dodd-Frank creates a power to recapture board compensation after a SIFI has failed. Section 210(s) of the Dodd-Frank Act provides:

The Corporation, as receiver of a covered financial company, may recover from any current or former 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.

12 U.S.C.A. § 5390(s). This will be meaningful only after a resolution and only if the FDIC chooses to proceed. Given regulatory displacement, the latter seems improbable. A suit alleging breach of a duty to be informed would be a private action.

277. See, e.g., Lucian A. Bebchuk, Alma Cohen & Holger Spamann, *The Wages of*

them—as happened in the crisis and as seems likely under regulatory displacement—they would find it difficult to manage less aggressively. Counterparties, meaning other large financial firms (or the government itself), will not impose “market discipline” because they, too, braid with regulators, and tacitly (perhaps unconsciously) expect that they will likely be immune from the consequences of many highly risky and problematic decisions.

Directors, however, are in a somewhat different position. Their duties are chiefly to the firm, not to its executives. We expect them to maintain some independence from executives. While some boards are no doubt captured by the executives of the firms for which they serve, there is simply no one else in a better position to assess the firm’s long-term risks and rewards than the board. The buck must stop somewhere, and that should be with those who manage and control the firm—its directors. If financial services firms are so large or complex (or both) that directors cannot meaningfully assess their risk profiles, then they are in the best position to change this. They can require executives to divest or simplify firm assets and structures, or they can employ better technologies to manage risk, or some combination thereof.²⁷⁸ Indeed, perhaps the stress tests and living wills proscribed by Dodd-Frank would aid this effort.²⁷⁹ If they do not, courts should take more seriously directors’ duties to oversee very large financial firms.²⁸⁰

I have no illusions that this would be easy for courts. The very size and complexity that make it difficult for regulators to prevent and manage crises will make it hard for courts to assess whether boards of troubled financial firms did such a poor job of oversight as to warrant liability.

Failure: Executive Compensation at Bear Stearns and Lehman 2000-2008, 27 YALE J. ON REG. 257 (2010) (pointing out that top-five executives at the failing firms cashed out large amounts of performance based compensation during risky periods).

278. BASEL COMM. ON BANKING SUPERVISION, BANK FOR INT’L. SETTLEMENTS, PRINCIPLES FOR EFFECTIVE RISK DATA AGGREGATION AND RISK REPORTING 6 (2013), available at <http://www.bis.org/publ/bcb239.pdf>.

279. Although note, as indicated above, that a living will apparently cannot form the basis for a “private right of action.” See 12 U.S.C. § 5365(d)(7) (stating that “No private right of action may be based on any resolution plan submitted in accordance with this subsection.”).

280. An obvious objection here is that it appears to be an ex post remedy, meaning that a court would scrutinize directors’ oversight only after the collapse of a large financial firm—something I would hope to avoid. This need not be true, however, as the Delaware judges and the opinions they write, as well as their other pronouncements (e.g., in law review articles) have important expressive functions independent of resolving specific cases. Indeed, *Caremark*, which set off discussion about the DTBI, can be seen as such an “expressive” use of the judicial dais. See Jonathan C. Lipson, *The Expressive Function of Directors’ Duties to Creditors*, 12 STAN. J. L. FIN. & B. 224 (2007).

Compounding the problem will be the regulatory complexity created by the interactions of regulators and the regulated, discussed in Part I. How culpable should directors be for risks imposed upon them by a regulatory system that they influenced in part, but not in whole? As proposals such as single-point of entry take shape—which will require holding companies to increase their debt-load—questions about risk assessment and liability for errors in those assessments will present significant challenges for all involved.

Thus, the most that can be said for recognizing a heightened duty to be informed on the part of directors of systemically important financial institutions is that it appears to be the least bad of a host of poor choices. Perhaps a collateral virtue is that it would restore some institutional balance. As others have observed, courts were disturbingly quiescent in the financial crisis, ignoring serious legal problems with the Bear Stearns bailout and the Chrysler bankruptcy, among others.²⁸¹ Courts can decline the opportunity to independently influence the conditions that give rise to financial crises. But in doing so, they risk their own institutional legitimacy. Rethinking a director's duty to be informed in the context of systemically important financial institutions may be a way to help restore (maintain) that legitimacy.

CONCLUSION

The watchwords of institutional analysis are “participation” and “tradeoffs.” This Article has shown that regulatory displacement is, like all problems of institutional choice, ultimately one of participation. Regulators and large financial firms increasingly appear to braid in ways that give the regulators and the regulated participatory incentives to displace markets and courts as institutional choices to prevent or resolve financial distress. Yet, this interaction appears incapable of addressing the pathologies that lead to crises: concentration and complexity. While this may benefit the firms themselves in the short run, the cautionary tale from the crisis of 2008—the doom loop in which we appear to be stuck—is that there are long-term financial and social costs associated with this institutional choice.

No institutional choice is perfect; choices can only be made intelligently by assessing the costs and benefits—tradeoffs—associated

281. See Lipson & Vandermeuse *supra* note 241, at 1161 (discussing Supreme Court's handling of *Chrysler* bankruptcy); David Zaring, *Litigating the Financial Crisis*, 100 VA. L. REV. 1405, 1406 (2014) (arguing that “the courts have had almost nothing to say about either the crisis or what the other two branches of government did during it.”).

738 U. OF PENNSYLVANIA JOURNAL OF BUSINESS LAW [Vol. 17:3

with each choice. This Article has shown both how to do this in thinking about financial crises, and why doing so may lead to better outcomes. It reveals the causes and cures of regulatory displacement, and a credible (albeit imperfect) path to restoring judicial balance in the institutional mix. While every institutional choice is flawed, ignoring institutional analysis does assure one kind of perfection: It guarantees failure.