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**“Come Monday, It’ll Be All Right”:¹ Buffett, the U.S.
Financial Crisis and the Need for a Reliable,
Private Liquidity Consortium**

*Richard Strasser**

During the 2007–2008 Financial Crisis, several large U.S. financial institutions either faced insolvency or became insolvent as investors lost confidence in the financial system and traditional funding sources evaporated. Self-preservation efforts led many banks and broker-dealers to seek (often unsuccessfully) funding from private equity firms, competitors, and sovereign-wealth funds. Warren Buffett received several such funding requests because he had ready access to large amounts of capital and an investment from a trusted and savvy investor such as Buffett carried an imprimatur that the investment was likely to be sound.² But not even Buffett had sufficient resources to single-handedly recapitalize the many struggling U.S. financial firms. Nevertheless, other avenues for private funding seemed haphazard and potentially hazardous for many U.S. financial firms as they struggled to survive in a dangerous world that they helped to create but that now seemed destined to destroy them. In the absence of trusted and reliable sources of private funding, struggling firms were forced either to submit to an uncertain and unwieldy bankruptcy process or risk being subjected to an ad hoc government-facilitated takeover, the terms for which were opaque and seemingly subject to change at a

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1. JIMMY BUFFETT, COME MONDAY (Dunhill 1974). Although Warren Buffett and Jimmy Buffett appear not to be related, they are longtime friends and Warren occasionally advises Jimmy on investing. Ethan Smith, “Uncle” Warren Buffett and “Cousin” Jimmy Make Beautiful Music, WALL ST. J., May 2, 2005, at A1. Throughout the 2007–08 Financial Crisis, U.S. regulators and financial firm management often hurried to arrange funding deals or install credit facilities over the weekend before Asian markets opened on Sunday night. They hoped that, come Monday, markets would be buoyed by their weekend endeavors. Unfortunately, the mood on many Monday mornings during the Crisis was more akin to that one feels after a long weekend in Margaretville.

2. Mr. Buffett only half-heartedly entertained most of these pleas for capital before finally investing in Goldman Sachs as the crescendo of the Crisis peaked. See Andrew Bary, *Warren Buffett Makes an Offer Goldman Sachs Can’t Refuse*, WALL ST. J. (Sept. 28, 2008), <http://online.wsj.com/article/SB122256922970483051.html>.

moment's notice. Transactions involving public funding were sure to provoke public outrage and a painful berating by Congress.

The failure of Lehman Brothers in September of 2008 and the subsequent fall-out highlighted limitations in Chapter 11 of the Bankruptcy Code.³ Moreover, the public outcry over taxpayer-funded rescues and the absence of more a politically palatable alternative influenced Congress in adopting the Dodd–Frank Wall Street Reform and Consumer Protection Act (Dodd–Frank). Dodd–Frank provides a framework for a government liquidation of a struggling financial firm that is not federally insured and that poses a significant risk to the financial stability of the United States.⁴ Dodd–Frank, along with the rules the Federal Deposit Insurance Corporation (FDIC) promulgated,⁵ codify and clarify the government's authority to take over a struggling, systematically important, non-bank financial firm. However, neither Dodd–Frank nor the FDIC rules make any alternative that is less disruptive than the Chapter 11 process or more politically palatable than the ad hoc approaches used during the Financial Crisis. While the Dodd–Frank liquidation provisions are conceptually similar to those that apply to federally insured institutions, important differences could diminish the effectiveness of the former. For example, the FDIC guarantee for customer deposits of insured entities, a cornerstone of the FDIC liquidation scheme upon which Congress based the Dodd–Frank liquidation provisions, has no counterpart in Dodd–Frank. As a result, customers of struggling, non-insured firms are left to fend for themselves either in proceedings of the Securities Investor Protection Corporation (SIPC), if applicable, or in court where they could be required to battle with competing creditors whom the new law may put on firmer footing. Without clearly defined protections for customers and would-be creditors of uninsured firms, the Dodd–Frank liquidation provisions could increase the risk of a “run on the bank” scenario for such firms if it appeared that a government liquidation of the firm were likely.

Moreover, Dodd–Frank contains provisions to punish current management, creditors, and shareholders of firms that are liquidated. For example, Dodd–Frank expressly requires that the costs of such liquidations be borne by creditors and shareholders of the distressed firm.⁶

3. 11 U.S.C. § 1101 *et seq.* (2006).

4. Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 204, 124 Stat. 1376, 1454 (codified at 12 U.S.C. § 5384 (2010)).

5. *See, e.g.*, Orderly Liquidation Authority Provisions of the Dodd–Frank Wall Street Reform & Consumer Protection Act, 76 Fed. Reg. 4207 (Jan. 25, 2011) (to be codified at 12 C.F.R. pt. 380).

6. Dodd–Frank Act § 204(a)(1) (codified at 12 U.S.C. § 5384 (2010)).

In addition, management “responsible” for the firm’s condition must be dismissed and the FDIC and other regulatory agencies may claw back its compensation.⁷ While these provisions are understandable from a public policy standpoint, in practice, they will likely prove unpalatable to management, shareholders, creditors, and employees of struggling firms. One consequence might be that prospective creditors will be reluctant to lend to all but the strongest firms. Moreover, management and employees of a struggling firm might be more inclined to jump ship at an earlier stage of a firm’s decline, thereby jeopardizing any potential recovery of a struggling firm. In addition, management of a struggling firm could be less inclined to consent to the Dodd–Frank liquidation and perhaps more inclined to make a peremptory Chapter 11 filing, which could introduce layers of uncertainty and delay into a process that is already characterized by both.

Despite the potential shortcomings of the Dodd–Frank liquidation provisions and of the Chapter 11 reorganization process, however, firms may currently have no other viable alternative. Therefore, it may be worth examining other alternatives to the existing liquidation and reorganization approaches that could minimize government involvement in a winddown of a troubled, systemically important non-bank financial firm while offering incentives for private investors willing to risk capital to facilitate an efficient recapitalization. Although some may argue that adding yet another process to the existing statutory liquidation frameworks may further cloud an already murky landscape, a preferable view is that the process proposed herein is more akin to a formal, administrative acknowledgement and facilitation of the extant private mechanism for resolving a moribund financial firm.

This Article discusses the difficulties that certain U.S. financial institutions faced in seeking to obtain emergency funding during the Financial Crisis and explores similarities and differences between the 2007–2008 Financial Crisis and the decline and rescue of the hedge fund, Long-Term Capital Management (LTCM), a decade earlier. It also analyzes the Dodd–Frank provisions that authorize government liquidation of non-bank financial firms and the rules the FDIC promulgated and proposed to implement those provisions. It contends that this framework, although providing regulators with a necessary tool for liquidating struggling firms that was unavailable during the Crisis, contains shortcomings that may make it unworkable.

This Article asserts that there may be benefits to promoting—through favorable regulatory treatment, tax incentives, or otherwise—

7. *Id.* § 204(a)(2)-(3).

the formation of private consortia of liquidity providers, which could include banks, broker-dealers, large institutional investors, and private equity firms with ready sources of cash that have the flexibility to provide short-term capital infusions to financial institutions in times of crisis. It concludes that a formalized structure to promote private liquidity consortia could serve as a preferable alternative to Chapter 11, to the Dodd–Frank liquidation provisions, and to the type of ad hoc consortia formed to address the failure of LTCM and, ten years later, the impending bankruptcy of Lehman Brothers.

I. FLASHBACK TO THE LONG-TERM CAPITAL MANAGEMENT RESCUE

At the time of the Financial Crisis, the near-collapse and industry rescue of LTCM was still fresh in the collective memory of the financial community. The LTCM rescue by a consortium of private financial institutions raised many of the same issues as those involved in the 2007-2008 Crisis. Therefore, a brief discussion of LTCM and the lessons of that rescue are warranted.⁸

A. *As Global Crisis Spread, High Leverage and Illiquid Assets Drained LTCM's Capital*

Prior to 1998, LTCM, which was formed in 1994,⁹ had a capital base of approximately \$4.8 billion.¹⁰ LTCM built its portfolio on sophisticated arbitrage trading strategies and a significant degree of leverage thanks to favorable credit offered by several large banks to increase LTCM's expected returns.¹¹ One of the strategies LTCM employed involved shorting Treasury bond futures while taking long positions in higher yielding (and higher risk) mortgage-backed or corporate debt securities.¹² Using this and other trading strategies, LTCM produced

8. During the LTCM crisis, I worked as an attorney at the Securities and Exchange Commission (SEC) and helped draft Congressional testimony regarding LTCM.

9. *Hedge Fund Operations: Hearing Before the H. Comm. on Banking and Fin. Servs.*, 105th Cong. 30 (1998) [hereinafter *Hedge Fund Operations Hearing*] (statement of William J. McDonough, President, Federal Reserve Bank of New York), available at http://commdocs.house.gov/committees/bank/hba51526.000/hba51526_of.htm.

10. *Id.* at 177 (testimony of Hon. Brooksley Born, Chairperson, Commodity Futures Trading Commission).

11. *Progress Report by the President's Working Group on Financial Markets: Hearing before the S. Comm. on Agric., Nutrition, and Forestry*, 105th Cong. (1998) (statement of Patrick M. Parkinson, Assoc. Dir., Div. of Research and Statistics, Bd. of Governors of the Fed. Reserve Sys.).

12. LTCM maintained a global portfolio of debt, equity and arbitrage positions in both developed and emerging markets. See ROGER LOWENSTEIN, *WHEN GENIUS FAILED: THE RISE AND FALL OF LONG-TERM CAPITAL MANAGEMENT* 234 (2000).

annual returns of more than forty percent in two of its first few years of operation.¹³ At the beginning of 1998, however, LTCM management determined that investment opportunities were not sufficiently attractive to support adequate returns on LTCM's capital base and LTCM returned approximately \$2.7 billion (or roughly one-half of its capital base) to its investors.¹⁴

In the summer of 1998, as financial turmoil spread in Russia and other emerging markets, prices for high quality sovereign debt like U.S. Treasuries spiked as investors fled riskier debt instruments.¹⁵ As the global financial crisis worsened, it became clear to LTCM that many of the assumptions in the positions it held were incorrect. LTCM's portfolio suffered losses greatly exceeding those that LTCM's models had predicted were possible, which eroded its already-depleted capital base.¹⁶

Recognizing LTCM's tenuous financial condition, its counterparties marked LTCM's positions to market daily and required additional collateral to compensate for the mark-to-market losses.¹⁷ As word leaked out about LTCM's positions, some in the markets suspected that competing traders expressly targeted LTCM's portfolio to drive the fund lower and possibly make LTCM an attractive takeover target.¹⁸ As the crisis came to a head, LTCM's capital shrank to \$600 million.¹⁹ Potential sources of liquidity and additional capital evaporated, and the firm faced insolvency.²⁰

13. *Hedge Fund Operations Hearing*, *supra* note 9, at 31 (statement of William J. McDonough).

14. *Hedge Fund Operations Hearing*, *supra* note 9 (statement of Alan Greenspan, Chairman, Federal Reserve Board).

15. On August 17, 1998, Russia effectively devalued the ruble and declared a moratorium on the payment of ruble-denominated foreign debt, which greatly increased volatility in the world's equity and debt markets. Spreads between U.S. Treasury securities and higher-yielding debt instruments widened sharply and unexpectedly. See *Hedge Fund Operations Hearing*, *supra* note 9, at 31 (testimony of McDonough); see also John Montgomery & Steven Vames, *Bonds Trade Narrowly, Rising on Devaluation of the Ruble but Checked by Strong U.S. Stocks*, *WALL ST. J.*, Aug. 18, 1998, at 1.

16. From January through August 1998, LTCM lost \$2.5 billion, fifty-two percent of its \$4.8 billion of equity. Most of those losses occurred in August. As of August 31, 1998, LTCM's capital base was a mere \$2.3 billion. This diminished capital base supported \$107 billion of recorded trading positions, yielding a leverage ratio in excess of fifty-to-one. *Hedge Fund Operations Hearing*, *supra* note 9, at 30 (statement of Richard R. Lindsey, Director, Division of Market Regulation, SEC). At one point LTCM was a party to 7,000 derivative contracts with a notional value of \$1.4 trillion. LOWENSTEIN, *supra* note 12, at 179-80.

17. Marking to market means assigning a value to a position held in a financial instrument based on the current fair market price for the instrument or similar instruments.

18. See LOWENSTEIN, *supra* note 12, at 172-73.

19. *Hedge Fund Operations Hearing*, *supra* note 9, at 30 (statement of Lindsey).

20. *Id.*

The Federal Reserve Bank of New York (FRBNY) and the Department of Treasury determined that an abrupt and disorderly close-out of LTCM's positions would pose unacceptable risks to the U.S. economy. The perceived risks were manifold. First, had LTCM defaulted, its counterparties would have immediately closed out their positions simultaneously. The regulators concluded that LTCM's counterparties would have been unable to liquidate collateral or establish offsetting positions at previously existing prices, which would have led to sharp market moves and heavy losses for some of those counterparties. The regulators also anticipated that LTCM's counterparties' rush to close out their positions would have harmed other market participants that had no direct exposure to LTCM. Regulators believed that as anticipated losses spread to these additional market participants, credit and interest rate markets risked extreme price moves and might temporarily cease to function. The regulators concluded that a disorderly wind-down of LTCM ultimately could increase the cost of capital to U.S. businesses.²¹

B. *Regulators Host a Consortium of Financial Firms to Address LTCM's Imminent Failure*

The regulators determined that "the responsible public policy objective was to get together those with a direct financial interest in an orderly rescue of Long-Term Capital, to discuss its problems openly and objectively, to provide a sounding board for solutions, and if necessary, [to provide] a calming influence."²²

On September 22, 1998, the FRBNY hosted the three firms with the greatest knowledge of LTCM's plight, Goldman Sachs, Merrill Lynch, and JP Morgan. The firms discussed various approaches to stabilizing LTCM, including the concept of a "collective industry" or consortium approach. They all agreed, however, that if any firm or group of firms wished to step forward and buy LTCM itself or buy LTCM's positions, this outcome would be the most desirable. In the absence of other solutions, however, the firms studied the possibility of "lifting" the equity and fixed income positions out of LTCM, or, in the alternative, the formation of a consortium to take over the entire firm.²³ The

21. *Id.* at 125 (statement of McDonough).

22. *Id.* at 35 (testimony of McDonough).

23. The group of firms was soon expanded to include UBS, which had a large stake in LTCM. See *id.*; Greg Steinmetz, *Fallout From Long-Term Capital's Near Failure Spreads Across the European Banking Sector*, WALL ST. J., Sept. 28, 1998, at 1. The number of firms was eventually expanded to thirteen. *Hedge Fund Operations Hearing*, *supra* note 9, at 36 (testimony of McDonough).

firms determined that lifting LTCM's positions would not be feasible but that an industry consortium takeover might be. Nevertheless, such an approach was still viewed as a last ditch effort.²⁴

At this point, the firms learned that an "investor group" was prepared to make an offer for LTCM. The investor group, which Goldman Sachs had reportedly lined up, was headed by none other than Warren Buffett.²⁵ The Goldman–Buffett investor group reportedly would have forced the resignation of LTCM's founder, John Meriwether, and over time may have been less financially generous to the original LTCM owners than the consortium approach that was being considered.²⁶ LTCM did not accept Buffett's short-fused bid, reportedly because of "legal complications."²⁷

With no other offer on the table, the consortium of firms agreed to recapitalize LTCM. Fourteen banks and securities firms agreed to participate in the recapitalization plan, with three firms contributing smaller amounts than the others.²⁸ The total contribution was \$3.65

24. *Hedge Fund Operations Hearing*, *supra* note 9, at 51 (testimony of McDonough).

25. Anita Raghavan & Mitchell Pacelle, *To the Rescue? A Hedge Fund Falts, So the Fed Persuades Big Banks to Ante up*, WALL ST. J., Sept. 24, 1998, at A1. LTCM reportedly sought capital from Buffett on multiple occasions prior to his being contacted by Goldman. *Id.* LTCM also unsuccessfully sought funding from Soros Fund Management, Merrill Lynch, PaineWebber (now part of UBS), Tiger Management, Ziff Brothers, and LTCM's own investors. Michael Siconolfi et al., *All Bets Are Off: How the Salesmanship and Brainpower Failed at Long-Term*, WALL ST. J., Nov. 16, 1998, at 1.

26. Jacob M. Schlesinger & Michael Schroeder, *Greenspan Defends Long-Term Capital Plan*, WALL ST. J., Oct. 2, 1998, at 1. Buffett reportedly told Goldman that "[t]he only way I'll do this is if we jointly buy the portfolio and you [Goldman] take over the portfolio company." Siconolfi et al., *supra* note 25. In addition to Buffett, who was prepared to invest at least three billion dollars in LTCM, Goldman was prepared to invest \$300 million and committed to enlist AIG to contribute \$700 million, for a total of four billion dollars. *Id.*

27. Meriwether purportedly did not accept Buffett's bid before it expired because he could not get the approval of his partners to accept the bid on such short notice. Siconolfi et al., *supra* note 25. See also Mitchell Pacelle et al., *How Buffett, AIG and Goldman Sought Long-Term Capital, but Were Rejected*, WALL ST. J., Sept. 30, 1998, at C1. It also has been suggested that the Goldman–Buffett bid, which totaled five paragraphs, had an hour-long deadline, and exhibited a clear misunderstanding of the complexity of LTCM's partnership structure, may have been too simple and arbitrary. LOWENSTEIN, *supra* note 12, at 203–05. After signing off on the bid, Buffett was "bizarrely unreachable" until after the bid was withdrawn. *Id.*

28. *Hedge Fund Operations Hearing*, *supra* note 9, at 37 (testimony of McDonough). For example, Lehman Brothers, which itself was facing financial difficulties, contributed only \$100 million. Siconolfi et al., *supra* note 25. Several other firms made contributors: Bankers Trust Corporation; Barclays PLC; Chase Manhattan Corp.; Credit Suisse First Boston Company; Deutsche Bank AG; Goldman Sachs Group LP; J.P. Morgan & Co.; Merrill Lynch & Co. Inc.; Morgan Stanley Dean Witter & Co.; Paribas; Salomon Smith Barney (Traveler Group); Société Generale; and UBS AG. U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-GGD-00-3, LONG-TERM CAPITAL MANAGEMENT: REGULATORS NEED TO FOCUS GREATER ATTENTION ON SYSTEMIC RISK, 5 n.7 (1999) [hereinafter LTCM GAO REPORT], <http://www.gao.gov/assets/230/228446.pdf>. Paribas and Société Generale were only willing to contribute \$125 million each, while the others contributed \$300 million each. See LOWENSTEIN, *supra* note 12, at 207.

billion for ninety percent of the equity in the fund.²⁹ LTCM's existing partners would receive the remaining ten percent, valued at \$400 million.³⁰ The banks agreed to a three-part agenda: (1) reduce the fund's risk exposure; (2) return capital to new investors; and, if possible, (3) realize a profit.³¹ Although the consortium considered removing LTCM's management, it concluded that given the size and complexity of LTCM's positions, doing so could compromise efforts to quickly and efficiently unwind LTCM's portfolio. Ultimately, to ensure that LTCM management did not bolt to start a new fund, the consortium agreed to pay LTCM executives bonuses to continue managing the portfolio.³²

Bear, LTCM's clearing firm, declined to contribute to the rescue, noting that Bear Stearn's clearing risk to LTCM was "a helluva lot more than \$250 to \$300 million,"³³ the amount that the FRBNY encouraged consortium members to contribute.³⁴ The decision not to participate in the consortium raised suspicion among some consortium members that Bear knew something that they did not.³⁵ Although Bear assured the consortium members that Bear's decision was not motivated by unique information about LTCM's financial condition, its decision not to participate was a lingering source of resentment among consortium members. No public funds were spent or committed on the LTCM recapitalization.³⁶

29. LTCM GAO REPORT, *supra* note 29, at 5 n.7. See also LOWENSTEIN, *supra* note 12, at 207–08.

30. LOWENSTEIN, *supra* note 12, at 208.

31. *Id.* at 207.

32. *Id.* at 216.

33. Siconolfi et al, *supra* note 25.

34. Clearing firms for large and complex hedge funds are often referred to as prime brokers. In addition to execution and clearance of transactions, prime brokers provide margin financing, centralized custody, securities lending, and administrative services, such as risk reporting. SENIOR SUPERVISORS GROUP, RISK MANAGEMENT LESSONS FROM THE GLOBAL BANKING CRISIS OF 2008, at 32 (2009), <http://www.sec.gov/news/press/2009/report102109.pdf>. As LTCM's prime broker, it could be argued that Bear was in the best position to determine the consolidated risk that LTCM had assumed and second, to take the necessary steps to require LTCM to limit LTCM's exposure to Bear and to the markets generally. Indeed, even before LTCM began to raise concerns for the broader market, Bear was anxious about the amount of capital it was risking with LTCM. Unlike many other Wall Street firms, Bear generally required LTCM to take "hair cuts" on the securities it used to collateralize its financing with Bear and agreed to keep clearing for LTCM only if the hedge fund maintained \$1.5 billion at Bear. See LOWENSTEIN, *supra* note 12, at 85–86. Moreover, Bear was holding \$500 million in collateral from LTCM. *Id.* at 205.

35. Siconolfi et al., *supra* note 25.

36. *Hedge Fund Operations Hearing*, *supra* note 9, at 137 (statement of Hon. Donna Tanoue, Chairman, Federal Deposit Insurance Corporation).

After the rescue of LTCM, the consortium oversaw all trading by the firm and had the authority to veto decisions made by LTCM's partners. Although the firm continued to lose money immediately after the bailout, as the market rebounded, LTCM began to recover before its holdings were liquidated.³⁷

After the rescue, many criticized the government's role in facilitating the rescue. Indeed, at a subsequent hearing, one congressman asserted that LTCM may have rejected the Goldman–Buffett-led offer knowing that the Federal Reserve Board (FRB) was worried enough about the fallout to ensure that firms rescued LTCM.³⁸ Nevertheless, the government also won some praise for its role.³⁹

C. Takeaways From the LTCM Crisis

The LTCM rescue framed a number of issues that would be amplified in the broader crisis a decade later. Therefore, it is useful to highlight a few details of the LTCM matter to compare and contrast it with the tumult to come.

1. Consortium Was Effective but May Have Undermined Alternatives

The LTCM consortium accomplished two important goals: (1) it limited what could potentially have been a much more severe market crisis by neutralizing LTCM as a potential catalyst for a broader crisis; and (2) it liquidated LTCM's positions in an orderly manner, thereby preventing a fire sale of those assets and related asset classes. It accomplished these two goals by taking over all assets and liabilities of LTCM and used only private financing. The consortium had the authority to dismiss current management, but it retained key LTCM

37. See Siconolfi et al., *supra* note 25; Jenny Strasburg, *As Markets Swing, Meriwether Hears Echoes of His Own Collapse*, WALL ST. J., Sept. 20, 2008, at B1 (detailing the struggles of JWM Partners LLC, another Meriwether-managed fund which he subsequently liquidated). See also Jenny Strasburg, *Meriwether is Shutting Hedge Fund, Sans Drama*, WALL ST. J., July 9, 2009, at C1. Lowenstein also stated,

Though Wall Street recovered, Long-Term's brand of arbitrage did not. Under its new owners, the fund enjoyed a good last quarter in 1998 and a good start to the new year; then it went into a tailspin In the first year after the bailout, the fund earned 10 percent [T]he fund redeemed the consortium's \$3.65 billion in capital. For practical purposes, the fund had liquidated by early 2000.

LOWENSTEIN, *supra* note 12, at 229.

38. See Siconolfi et al., *supra* note 25.

39. See, e.g., Jathon Sapsford, *Hedge-Fund Bailout Allows Japanese to Lecture U.S.*, WALL ST. J., Sept. 28, 1998, at A23 (stating that the U.S. earns praise for preventing LTCM crisis from spreading to the broader market amidst accusation of hypocrisy for criticizing Japanese "convoy system" of prodding stronger financial institutions to mask problems of the weak while encouraging that approach with LTCM).

managers and staff to promote continuity. By providing a government-facilitated alternative, however, the consortium may have emboldened LTCM's management not to accept the bid from the Goldman–Buffett-led investment group, which was less favorable to LTCM's management, although not necessarily to LTCM's shareholders.

Under this rationale, the consortium effectively established a floor value for LTCM, potentially emboldening management of distressed firms in the future to wait for government intervention before agreeing to a private takeover. As a practical matter, however, the Goldman–Buffett bid appeared to be little more than an expression of interest, which neither Buffett nor Goldman appeared to fully support.⁴⁰ Nevertheless, it is difficult gauge what effect, if any, the presence of the consortium had on the Goldman–Buffett bid. And while it is possible that the government's involvement in organizing the LTCM rescue could have discouraged future private liquidity providers from bidding on troubled firms in the future, such effect, if any, would be difficult, if not impossible, to quantify.⁴¹ It is important to distinguish this issue from the related issue of whether LTCM's creditors were more likely to loan to LTCM because they assumed that if the firm got into trouble the government would lead the charge to bail them out. Some commenters at the time viewed the government's involvement in the rescue as the “camel's nose under the tent” with respect to extending the “too big to fail” doctrine to non-regulated hedge funds.⁴² The FRB did not dispute that government involvement may have created some moral hazard.⁴³

2. Capital Required Was Modest

Although LTCM was able to accumulate trading positions in excess of \$100 billion, the rescue package, which effectively staved off a broader market crisis, was only \$3.6 billion. Presumably, the structure of the deal, the contributors, and the role of the government—and not

40. It is difficult to fault LTCM for not jumping at the Goldman–Buffett bid given that Buffett had, prior to the bid, repeatedly said he was not interested in investing in LTCM and the bid was little more than a few paragraphs of deal points on a one-page fax that mischaracterized the partnership structure of LTCM and allowed no opportunity for amendment or clarification. See LOWENSTEIN, *supra* note 12, at 181, 202–04. Never mind the fact that LTCM (and others) suspected that Goldman traders had downloaded LTCM's positions, taken LCTM's proprietary information, and were using the information to trade against them. *Id.*

41. *But see* Craig Furfine, *The Costs and Benefits of Moral Suasion: Evidence from the Rescue of Long-Term Capital Management*, 79 J. Bus. 593 (2006) (attempting to quantify the “Too Big To Fail” impact of the LTCM rescue on large banks).

42. See LOWENSTEIN, *supra* note 12, at 208.

43. See *id.* at 229–30.

the size of the rescue package alone—sent a strong message to the markets that decisive action would be taken to prevent LTCM's fall from spreading to the broader market.⁴⁴

3. Major Counterparties Were Relatively Stable

Although LTCM was on the verge of bankruptcy when the consortium formed, those most likely to suffer as a result of LTCM's failure (e.g., the consortium members and LTCM's clearing firm) were financially stable. Even Lehman, whose own viability was rumored to be at issue during the market crisis that led to LTCM's demise, was able to contribute \$100 million to the consortium.⁴⁵ Bear's unwillingness to contribute appears not to have been motivated by an inability to contribute but rather by a belief, obviously not shared by consortium members, that its role as LTCM's clearing broker was sacrifice enough. To be sure, several consortium members suffered staggering losses after the rescue, but the losses were not fatal.⁴⁶

4. U.S. Government Role Was Limited but Instrumental

Notwithstanding that U.S. government funds were not used in or committed to the LTCM bail-out, the importance of the government's role in facilitating the bail-out cannot be overstated. Although participation in the consortium was not legally compelled, the FRBNY brought the group together to do a deal and undoubtedly the FRBNY would hold member firms accountable if they failed to reach an agreement.⁴⁷

44. The Goldman–Buffett-led group estimated the cost of an LTCM recapitalization to be four billion dollars. Siconolfi et al, *supra* note 25. The similarity of the two valuations may suggest that both the Goldman–Buffett group and the consortium were planning to wind down LTCM and the only difference in the valuations was reflected by the fact that Goldman–Buffett was proposing to buy ninety-five percent of LTCM (for a total firm valuation of \$4.21 billion) while not retaining management, whereas the consortium was bidding for ninety percent of LTCM (for a total valuation of four billion dollars) and intended to supervise current management in the wind-down. Goldman's involvement in both groups may bring into question the independence of the two valuations. Interestingly, Goldman's financial contribution would be the same to either effort—\$300 million. In hindsight, Buffett's involvement in the LTCM matter may have been exaggerated. Other than a tepid, hour-long commitment to help bankroll Goldman's liquidation of LTCM's positions, Buffett seems not to have made a meaningful contribution to the process, other than perhaps by providing fodder to the critics of the FRB's involvement in the process. I found no convincing evidence that the FRB's involvement in coordinating the rescue discouraged any alternative recapitalization efforts. And in fairness to Uncle Warren, Wall Street called him, he didn't call it.

45. *See supra* note 28.

46. LOWENSTEIN, *supra* note 12, at 221–22.

47. *See, e.g., id.* at 230 (“[T]he banks would not have come together without the enormous power and influence of the Fed behind them, and without a joint effort, Long-Term surely would have collapsed.”).

II. FAST-FORWARD TO 2007: THE CALAMITY BEGINS

Below, the article seeks to provide a brief summary of the key events of the Financial Crisis by way of background, which the Article uses to frame a more useful forensic transactional analysis of the Financial Crisis, which serves as context for the parameters of the private liquidity consortium that is at the crux of this Article.

A. *Bear Stearns' High-Grade Funds Collapse*

The summer of 2007 marked a watershed in the Financial Crisis and, in hindsight, may have signaled the end of an era for the U.S. investment banking industry. In June 2007, two hedge funds operated by Bear Stearns edged toward insolvency.⁴⁸ The two funds (High Grade Structured Credit Strategies Fund and the more highly leveraged High Grade Structured Credit Strategies Enhanced Leverage Fund) invested in complex securities comprised of bonds backed by subprime mortgages.⁴⁹ The funds used leverage to enhance returns, but as the value of the securities in which the funds invested plummeted, their use of leverage exacerbated the losses the funds suffered.⁵⁰ As the funds neared insolvency, firms that lent to them threatened to liquidate collateral that the funds had used to secure the loans.⁵¹ Under pressure from the funds' lenders, Bear reluctantly pro-

48. Bear operated under a holding company structure. Bear Stearns Co., Quarterly Report (Form 10-Q) 10 (May 31, 2007) [hereinafter *Bear Stearns Quarterly Report*]. The Bear Companies Inc., the holding company, operated principally through its broker-dealer and international bank subsidiaries, which included Bear, Stearns & Co. Inc., Bear Securities Corp., Bear International Limited, and Bear Bank plc. *Id.* The Company was regulated by the SEC as a consolidated supervised entity (CSE), under which it was subject to group-wide supervision and examination by the SEC. *Id.* at 45. Provided that Bear held tentative net capital in excess of \$1 billion and net capital in excess of \$500 million, the SEC permitted Bear to calculate its net capital charges for market risk and derivatives-related credit risk based on mathematical models. *Id.* As of May 31, 2007, Bear had net capital of \$3.17 billion, far in excess of the minimum required to qualify for the CSE program. *Id.* Bear's gross leverage (i.e., total assets divided by stockholders' equity including preferred and trust preferred equity) at the time was 31.2 and Bear had total assets of \$423.3 billion. *Id.* at 87-88.

49. Kate Kelly et al., *Two Big Funds at Bear Stearns Face Shutdown*, WALL ST. J. (June 20, 2007), <http://online.wsj.com/article/SB118230204193441422.html>.

50. The two Bear funds invested in illiquid securities (i.e., securities that are not actively traded) backed by subprime mortgages (e.g., home loans extended to borrowers with poor credit histories). Illiquid securities often are difficult to value and sometimes are valued using pricing models. Such models can vary widely by firm and, therefore, may result in wide disparities among firms about the value of a particular security. The crisis was brought to a head when firms that lent to the Bear funds threatened to seize the collateral and sell it to satisfy the loans. The threat of large amounts of illiquid securities dumped onto the market put downward pressure on the prices of those securities. See Kelly et al., *supra* note 49.

51. Julie Creswell & Vikas Bajaj, *\$3.2 Billion Move By Bear Stearns to Rescue Fund*, N.Y. Times (June 23, 2007), <http://www.nytimes.com/2007/06/23/business/23bond.html?pagewanted=all> [hereinafter *Creswell & Bajaj: \$3.2 Billion*]; Vikas Bajaj & Julie Creswell, *Bear Stearns Staves*

vided a \$3.2 billion credit line to one of the funds in an attempt to stabilize it, which increased Bear's own financial exposure to the funds.⁵² The move marked the largest bail-out of a hedge fund since LTCM.⁵³

By mid-July 2007, the net value of assets in the most highly leveraged of the two Bear funds was zero; the other fund was nine percent of what it was in March 2007. In late July, Bear proceeded to unwind both funds.⁵⁴ The collapse of the two funds, which once had \$20 billion in assets under management, reportedly cost investors more than \$1 billion and worsened a developing credit crisis.⁵⁵ The collapse also damaged Bear's reputation as a prudent risk manager. An August 2007 investor conference call intended to calm investors and the ouster of the high-level Bear executive who oversaw the failed hedge funds only made matters worse.⁵⁶

off Collapse of 2 Hedge Funds, N.Y. Times (June 21, 2007), <http://www.nytimes.com/2007/06/21/business/21bonds.html?pagewanted=all> [hereinafter Bajaj & Creswell: Bear Stearns] (indicating that while JP Morgan, Goldman Sachs, and Bank of America reached agreements with Bear to preclude collateral liquidations, Merrill Lynch proceeded to auction the collateral it had seized and Deutsche Bank appeared to do so as well). Bear took flack for its initial reluctance to bail out the funds, contending that the money in the funds belonged to large institutions, wealthy individuals, and lenders who knew the risks before they invested. See Kate Kelly, *Lost Opportunities Haunt Final Days of Bear Stearns*, WALL ST. J. (May 27, 2008), <http://online.wsj.com/article/SB121184521826521301.html> [hereinafter Kelly: The Fall of Bear Stearns, Part I]. This article was the first of three regarding the fall of Bear that appeared in the *Wall Street Journal* from May 27, 2008, to May 29, 2008. See Kate Kelly, *The Fall of Bear Stearns: Fear, Rumors Touched Off Fatal Run on Bear Stearns*, WALL ST. J. (May 28, 2008), <http://online.wsj.com/article/SB121193290927324603.html> [hereinafter Kelly: The Fall of Bear Stearns, Part II]; Kate Kelly, *Bear Stearns Nearing Collapse Twice in Frenzied Last Days*, WALL ST. J. (May 29, 2008), <http://online.wsj.com/article/SB121202057232127889.html> [hereinafter Kelly: The Fall of Bear Stearns, Part III].

52. Kate Kelly & Serena Ng, *Lifeline: Bear Stearns Bails Out Fund with Big Loan*, WALL ST. J. (June 23, 2007), <http://online.wsj.com/article/SB118252387194844899.html>.

53. Creswell & Bajaj: \$3.2 Billion, *supra* note 51.

54. Kate Kelly, *Bear Seizes Most of Fund's Collateral*, WALL ST. J., July 27, 2007, at C5.

55. Kate Kelly et al., *Fed Races to Rescue Bear Stearns in Bid to Steady Financial System*, WALL ST. J., March 15, 2008, at A1 [hereinafter Kelly: Fed Races to Rescue]. See also Kate Kelly et al., *Wall Street, Bear Stearns Hit Again By Investors Fleeing Mortgage Sector*, WALL ST. J., Aug. 1, 2007, at A1 (indicating that Bear prevented investors from withdrawing money from another Bear-operated fund); Eric Martin, *U.S. Stocks Plunge On Higher Yields, Mortgage Bond Concern*, BLOOMBERG, June 20, 2007 (indicating that Merrill Lynch seized collateral from funds run by Bear, which recently controlled more than \$20 billion and had \$9 billion in loans), <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=a6stFLJZg4.U>.

56. Kelly: The Fall of Bear Stearns, Part I, *supra* note 51. Responding to what it saw as an opportunity to buy a piece of Bear at an attractive price, leveraged buyout firm Kohlberg Kravis Roberts & Co. (KKR) made an overture to Bear but no deal materialized, due in part to Bear's concern that a deal with KKR might offend Bear clients that competed with KKR. *Id.* Section 619(a)(1) of Dodd-Frank, with important limitations, restricts a "banking entity" from engaging in proprietary trading or acquiring or retaining any equity, partnership, or other ownership interest in, or sponsoring a hedge fund or a private equity fund. Dodd-Frank Wall Street Reform

By March 2008, as the credit crisis worsened, confidence in Bear faded. On March 10, 2008, a bundle of home loans that Bear had packaged and sold received a poor credit rating from a large rating agency. The downgrade triggered rumors about Bear's financial condition.⁵⁷ On March 11, 2008, the FRB launched a huge credit facility

and Consumer Protection Act, Pub. L. No. 111-203, § 619(a)(1), 124 Stat. 1376, 1620 (codified at 12 U.S.C. § 1851 (2010)). These provisions are referred to as the "Volcker Rule," after former Federal Reserve Board Chairman, Paul Volcker, who advocated the limitations. Bob Davis, *New Life for 'the Volcker Rule,'* WALL ST. J., May 1, 2010, at A3. Section 619(a)(2) of Dodd-Frank, which applies to nonbank financial companies supervised by the Federal Reserve Board, imposes additional capital requirements for and additional quantitative limits on proprietary trading or taking an equity or other interest in a hedge fund or private equity fund. *Id.* § 619(a)(2) (codified at 12 U.S.C. § 1851). Although the hedge fund provisions of the Volcker Rule appear designed to address the type of arrangements between Bear Stearns and its affiliates' hedge funds, Bear Stearns would not likely have met the definition of "banking entity" in § 619(h)(1) of the Act and therefore would not have been prohibited from owning affiliated hedge funds. *Id.* § 619(h)(1) (codified at 12 U.S.C. § 1851(h)(1)). Moreover, in light of a number of exceptions to the general hedge fund ownership provisions, it is not clear to what extent, if any, § 619 of Dodd-Frank would have restricted Bear Stearns' ownership of the affiliated funds. On the other hand, in the future, the Volcker Rule could restrict banks from entering into the types of arrangements that resulted in the LTCM rescue.

57. Rob Curran, *Ratings Downgrades Spur Action in Bear Puts,* WALL ST. J., Mar. 11, 2008, at C7. To understand the liquidity crunch that Bear faced, it is important to understand the way in which Bear, like many other financial firms, funded its operations. Bear's short-term cash sources consisted principally of collateralized borrowings, including repurchase agreements (repos), sell/buy arrangements, securities lending arrangements, and customer short balances. Bear Stearns Quarterly Report, *supra* note 48, at 89. Bear viewed these sources as more stable than short-term unsecured borrowings, which subjected the firm to "roll-over" risk because the providers of credit are not obligated to refinance the instruments at maturity. *Id.* Repos also enjoy special treatment under the U.S. Bankruptcy Code (i.e., they can't be clawed back by the trustee after a filing), which, some have argued, could have sped Bear's demise. See David A. Skeel, Jr. & Thomas H. Jackson, *Transaction Consistency and the New Finance In Bankruptcy*, 112 COLUM. L. REV. 152, 162-64 (2011). Short-term, unsecured funding sources included commercial paper, medium-term notes and bank borrowings, which typically had maturities ranging from overnight to one year. Bear Stearns Quarterly Report, *supra* note 48, at 89. To manage roll-over risk, Bear maintained a liquidity pool. *Id.* Bear also used equity and long-term debt as longer-term sources of unsecured financing. *Id.* Bear also attested to an alternative funding strategy, which was intended to enable the firm to weather an "event-driven liquidity crisis." *Id.* at 89-90. The alternative funding strategy was designed to allow Bear to maintain sufficient "cash capital" (i.e., equity plus long-term debt maturing in more than 12 months) and funding sources to enable Bear to refinance short-term, unsecured borrowings with fully secured borrowings. *Id.* The twelve-month time frame assumed that Bear would not or could not liquidate assets and could not issue unsecured debt, including commercial paper. Bear Stearns Quarterly Report, *supra* note 48, at 89-90. Bear maintained collateral for secured borrowing in various subsidiaries, both regulated and unregulated, not in the parent. *Id.* at 91. It noted the potential that regulators might prevent the flow of funds or securities from a regulated subsidiary to the parent or to an unregulated subsidiary. *Id.* In recognition of the potential that collateral might be "trapped" within a regulated subsidiary, the parent company maintained a minimum of \$5 billion of immediately accessible liquidity. *Id.* This so-called Parent Company Liquidity Pool measured \$11.3 billion at the end of June 2007. *Id.* Its "net cash capital," (i.e., cash capital in excess of that portion of assets that cannot be funded on a secured basis) was \$2.9 billion, but averaged just \$913 million over the previous seven months of fiscal year 2007, well below the firm's own target

to allow investment banks to obtain loans from the government collateralized by a much broader array of assets than had previously been the case.⁵⁸ On the heels of the news of the downgrade and the new credit facility, Bear's stock price plummeted, falling to \$57 from \$172 in January of 2007.⁵⁹ Some large investment banks stopped accepting trades that would expose them to Bear and some money funds reduced their holdings of short-term debt that Bear issued.⁶⁰ Hedge funds that used Bear to clear their trades and to provide financing drained cash from their accounts with Bear.⁶¹ Securities firms that had been willing to accept collateral from Bear now demanded cash.⁶²

of \$2 billion. Bear Stearns Quarterly Report, *supra* note 48, at 92. The company also maintained various committed credit facilities that would allow the parent and certain subsidiaries to borrow on a secured or unsecured basis, depending on the facility. *Id.*

58. Tomoeh Murakami Tse & Neil Irwin, *Stocks Surge as Fed Offers a Boost*, WASH. POST (Mar. 12, 2008), http://www.washingtonpost.com/wp-dyn/content/article/2008/03/11/AR2008031100893.html?nav=rss_print/asection.

59. KATE KELLY, STREET FIGHTERS: THE LAST 72 HOURS OF BEAR STEARNS, THE TOUGHEST FIRM ON WALL STREET 9, 12, 113 (2009) [hereinafter KELLY, STREET FIGHTERS].

60. *Turmoil in U.S. Credit Markets: Examining the Recent Actions of Federal Financial Regulators: Hearing before the S. Comm. on Banking, Hous. and Urban Affairs, 110th Cong.* 114 (2008) [hereinafter *Hearing: Turmoil in U.S. Credit Markets*] (statement of Timothy F. Geithner, President and Chief Executive Officer, Federal Reserve Bank of New York).

61. Kelly: Fed Races to Rescue, *supra* note 55. In one week, hedge funds and other prime-brokerage customers had withdrawn \$13.9 billion from Bear, leaving the firm with only about three billion dollars in cash. KELLY, STREET FIGHTERS, *supra* note 59, at 45–46. In early March 2008, the cost of credit default swaps, insurance against the possibility of Bear defaulting on its debt, spiked, as did so-called novation requests, requests by investors (e.g., hedge funds) to be bought out of securities contracts they had entered into with Bear. *See* Kelly: The Fall of Bear Stearns, Part II, *supra* note 51.

62. Bear's primary regulator, the SEC, stated that neither the regulatory program under which Bear was subject nor the Basel Committee on Banking Supervision (Basel II), which develops international capital standards for banks, considered the possibility that secured financing (e.g., repos) that was backed by high-quality collateral could become completely unavailable. SEC, OFFICE OF INSPECTOR GENERAL, SEMIANNUAL REPORT TO CONGRESS, APRIL 1, 2008 – SEP. 30, 2008, at 21–22 (2008), <http://www.sec-oig.gov/Reports/Semiannual/2008/seminov08.pdf>. And yet, for Bear Stearns, it had. The day the SEC Inspector General's Report was released, then-SEC Chairman, Christopher Cox, announced that the SEC was ending the CSE program. In doing so, he stated:

The last six months have made it abundantly clear that voluntary regulation does not work. When Congress passed the Gramm-Leach-Bliley Act [of 1999, Pub. L. 106-102, 113 Stat. 1338, which repealed provisions of the Glass-Steagall Act of 1933 that had restricted commercial banks, investment banks, and insurance companies from combining within a single entity], it created a significant regulatory gap by failing to give to the SEC or any agency the authority to regulate large investment bank holding companies, like Goldman Sachs, Morgan Stanley, Merrill Lynch, Lehman Brothers, and Bear Stearns.

Press Release, SEC, Chairman Cox Announces End of Consolidated Supervised Entities Program (Sept. 26, 2008), <http://www.sec.gov/news/press/2008/2008-230.htm>. *See also* Report of Anton R. Valukas, Examiner at 1484–85, *In re Lehman Brothers Holding Inc.*, (No. 08-13555 (JMP)) (S.D.N.Y. Mar. 11, 2010) [hereinafter Valukas Report] (noting that neither the SEC nor any other agency was given statutory authority to regulate systemically important large invest-

As Bear's cash position shriveled, the firm contacted JP Morgan, its clearing bank, to seek a \$25 billion line of credit.⁶³ JP Morgan agreed to consider making the loan and began assembling a team to explore it.

Bear also hired investment bank Lazard to explore a "gamut" of alternatives to save the firm.⁶⁴ Additionally, Bear retained bankruptcy attorneys to begin exploring the possibility of a bankruptcy filing. With nearly five hundred subsidiaries, such a filing promised to be a monumental task.⁶⁵ Lazard contacted potential investors that might have an interest in lending to or taking an equity stake in Bear. They included Christopher Flowers, the billionaire founder of J.C. Flowers & Co., a private investment firm that specializes in financial industry acquisitions.⁶⁶ Flowers had approached Bear the previous fall about a possible investment, but Bear rejected the overture, suspi-

ment bank holding companies, a gap which the SEC intended to fill in 2004 with the creation of the CSE program). Although the CSE program was technically voluntary, a firm that withdrew from the program would be subject to regulation by the European Union, which major investment banks viewed as less preferable. *Id.* at 1484–85 nn.5732 & 5735–36. Some firms appear to have been better prepared for weathering the credit crisis than others.

63. KELLY, *STREET FIGHTERS*, *supra* note 59, at 42. It is unclear whether Bear ever tapped any of its committed credit facilities. While awaiting a response from JP Morgan, Bear executives also considered approaching Warren Buffett for financing. *Id.* at 43. Bear also considered a deal with Citadel Investment Group, but eventually rejected pursuing that avenue because, among other reasons, Bear was reluctant to allow Citadel to look at Bear's books for fear that Citadel would use the information to bet against Bear. *Id.* at 130.

64. *See* Kelly: Fed Races to Rescue, *supra* note 55.

65. KELLY, *STREET FIGHTERS*, *supra* note 59, at 43–45.

66. *See id.* at 40. In 2006, *Forbes* named Mr. Flowers, a former Goldman Sachs partner, one of the Top 400 richest Americans. Mr. Flowers' firm invested in financial firms that included the failed Long-Term Credit Bank of Japan, which Flowers and a consortium bought from the Japanese government in 2000 and renamed Shinsei Bank. *400 Richest Americans*, *FORBES* (Sept. 21, 2006), http://www.forbes.com/lists/2006/54/biz_06rich400_J-Christopher-Flowers_6MBS.html. [Note to self: avoid investing in firms with names beginning in "Long-Term."] Japanese regulators criticized Shinsei, the first Japanese bank bought by foreigners, for its reluctance to lend to risky borrowers. Jason Singer & Phred Dvorak, *Shinsei Bank Pressured to Keep Shaky*, *WALL ST. J.*, Sept. 26, 2001, at C1 (noting ironically that "[t]he back-and-forth between Shinsei and the [Japanese regulators] underscores the gap between regulation in Japan and countries such as the U.S. and the United Kingdom, where authorities rarely manage the setting of a bank's lending policies."). *See* Sapsford, *supra* note 39. *But see* Atsuko Fukase, *International Finance*, *WALL ST. J.*, Apr. 15, 2010, at C2 (indicating that Shinsei suffered net losses after the Financial Crisis due to investments in U.S. mortgage sector and domestic real estate financing). Although a frequent adviser during the financial crisis, more recently Mr. Flower's investment decisions have drawn negative scrutiny. *See, e.g.*, William D. Cohan, *Checkmate for a Wall Street Wizard?*, *FORTUNE* (Aug. 31, 2009), http://money.cnn.com/2009/08/31/magazines/fortune/chris_flowers.fortune/index.htm. More recently, he has been credited (if you want to call it that) with recruiting former Goldman colleague, Jon Corzine, to head MF Global, the joint broker-dealer/futures commission merchant that failed in October of 2011. *See* Aaron Lucchetti & Mike Spector, *The Unraveling of MF Global*, *WALL ST. J.* (Dec. 31, 2011), <http://online.wsj.com/article/SB10001424052970203686204577117114075444418.html>.

cious of Flowers' intentions.⁶⁷ Lazard believed that Flowers was an attractive suitor for Bear for two reasons: (1) Flowers could put a deal together quickly and (2) the imprimatur of a respected private investor might instill confidence in Bear's lenders and clients.⁶⁸

After speaking to Bear about its need for emergency funding, JP Morgan notified the FRB of Bear's request. Separately, the SEC and Bear also notified the FRB that Bear had lost far more of its liquidity than Bear had originally believed.⁶⁹ Bear was nearly bankrupt.⁷⁰

On March 13 and 14, 2008, the FRB, the Treasury Department and the SEC discussed possible approaches to obtain a short-term cash infusion for Bear to allow more time for an industry solution to the problem. One alternative that they considered hours before the market opened on Friday, March 14, 2008, was to bring together other securities firms which could contribute to a fund to allow Bear to open that morning. They rejected this alternative because other firms were in self-preservation mode and such an ad hoc arrangement could not be put together under such a short time frame.⁷¹

B. *FRB Throws Bear a Life Line through JP Morgan*

The regulators concluded that allowing Bear to fail was too risky in light of the broader market turmoil.⁷² Regulators were particularly concerned about the impact that a Bear bankruptcy would have on

67. KELLY, *STREET FIGHTERS*, *supra* note 59, at 41. Instead, Bear's management pursued what they believed was a much more attractive option, a joint venture with the Chinese investment bank, Citic Securities Co., which would make an immediate investment of one billion dollars in Bear in exchange for a similar amount to be invested by Bear in the Chinese firm over time. In addition to the immediate cash infusion, Bear was confident that the deal would enhance Bear's presence in Asia. The announcement of the deal with the Chinese in October of 2007 did little to restore confidence in Bear. Nevertheless, so confident was Bear management in the merits of the Citic deal that in early 2008 it nixed two other potential deals with the Japanese—one with Sumitomo, the other with Nomura Holdings, Inc. Bear also rejected overtures from Fortress Investment Group. *Id.* at 111–12. Additional deals between Bear and Allianz SE's Pacific Investment Management Co. failed to materialize. Kelly: *The Fall of Bear Stearns*, Part I, *supra* note 51. Chinese regulatory approval of the Citic deal was slow and Citic itself backed out after the JP Morgan buyout was announced. Rick Carew, *Credit Crisis: The Response: Citic Ditches Tie-up Plans After Bear Deal*, *WALL ST. J.*, Mar. 19, 2008, at C2.

68. KELLY, *STREET FIGHTERS*, *supra* note 59, at 41.

69. See Kelly: *Fed Races to Rescue*, *supra* note 55. See also *Hearing: Turmoil in U.S. Credit Markets*, *supra* note 60, at 114 (statement of Timothy F. Geithner) (“[R]umors of Bear's failing financial health caused its balance of unencumbered liquidity on March 13[, 2008] to decline sharply to levels that were not adequate to cover maturing obligations and funds that could be withdrawn freely.”). See also Kelly: *The Fall of Bear Stearns*, Part II, *supra* note 51 (“Lenders such as Fidelity Investments were refusing to replenish the financing Bear Stearns needed to open the next morning.”).

70. *Hearing: Turmoil in U.S. Credit Markets*, *supra* note 60, at 106 (statement of Geithner).

71. KELLY, *STREET FIGHTERS*, *supra* note 59, at 67–68.

72. *Hearing: Turmoil in U.S. Credit Markets*, *supra* note 60, at 114–15 (statement of Geithner).

the tri-party repo market, a \$2 trillion market through which investment banks obtain short-term funding from institutional investors and others with large cash reserves.⁷³ Therefore, the FRB arranged for JP Morgan to provide a loan to Bear.⁷⁴ The duration of the loan was for

73. KELLY, STREET FIGHTERS, *supra* note 59, at 66. A brief discussion of the size, complexity, and global scope of the tri-party repo market may help illustrate why regulators were uniquely concerned about this market as Bear teetered on the brink of bankruptcy. Although economically similar to a secured loan, a repurchase agreement or “repo,” is technically a sale of securities coupled with an agreement to repurchase the securities at a later date at a specified price slightly higher than the original purchase price. See FED. RESERVE BANK OF NEW YORK, TRI-PARTY REPO INFRASTRUCTURE REFORM 5 (2010) [hereinafter FRBNY REPO WHITE PAPER], http://www.newyorkfed.org/banking/nyfrb_triparty_whitepaper.pdf. The tri-party repo market provides a means for certain types of firms with abundant cash reserves (*e.g.*, money market mutual funds, large banks, and corporate treasurers) to loan it, for short periods of time, to large securities firms and securities affiliates of banks, which use the cash to finance their securities inventories. The tri-party label refers to the fact that the transaction between the cash “lender” and “borrower” settles through one of two clearing banks: Bank of New York Mellon or J.P. Morgan Chase. Tri-party repos are collateralized primarily by U.S. Treasuries and mortgage-backed securities and debentures issued by Fannie Mae, Federal Home Loan Mortgage Corporation, or the Government National Mortgage Association, but other asset classes, such as corporate and municipal bonds and equity securities on deposit at the Depository Trust & Clearing Corporation (DTCC) are also used. *Id.* at 8 nn.6–7. Clearing bank collateral management systems enable dealers to use their assets maintained throughout the world to collateralize their repo transactions. See Letter from Gerald L. Hassell, President, Bank of N.Y., to Jennifer J. Johnson, Sec’y, Fed. Reserve Bd. & Jonathan G. Katz, Sec’y, SEC (Aug. 9, 2002) (regarding the Interagency White Paper on Structural Change in the Settlement of Government Securities), <http://www.sec.gov/rules/concept/s71502/hassell1.htm>. The value of the collateral posted exceeds the amount of cash loaned. This “haircut” or “margin” provides the lender with a buffer against short-term variations in the value of the securities. FRBNY REPO WHITE PAPER, *supra* note 73, at 5. The higher the perceived risk of the collateral, the greater the haircut. Even though a security is held as collateral in a repo, a dealer may still sell the security to a buyer in a separate transaction. Clearing banks assume an extreme amount of intraday exposure because, each morning every repo transaction (even those that are not yet maturing), is “unwound” (or, perhaps more descriptively, “disassembled”). In the unwinding process, the clearing bank releases collateral securities to the dealer to permit the dealer to delivery those securities to buyers. The unwinding creates an overdraft in the dealer’s account at the clearing bank, which remains in place until the dealer posts replacement collateral securities, which are then locked into the cash lender’s account at the end of the day when the repo transaction is “rewound” (or reassembled). In 2010, the value of securities financed through the tri-party repo market averaged \$1.7 trillion, down from a peak of \$2.8 trillion in 2008. FRBNY REPO WHITE PAPER, *supra* note 73, at 6. At its peak, individual dealers routinely financed \$100 billion in securities through the tri-party repo market, with one firm (regulators aren’t saying which one) financing more than \$400 billion. PAYMENTS RISK COMM., REPORT OF THE TASK FORCE ON TRI-PARTY REPO INFRASTRUCTURE 3, 6, 14 (2010).

74. *Hearing: Turmoil in U.S. Credit Markets*, *supra* note 60, at 115–16 (statement of Geithner). FRBNY extend the loan to JP Morgan through the discount window through the FRB’s authority under section 13(3) of the Federal Reserve Act, 12 U.S.C. § 343. *Id.* at 11–13. Section 13(3) authorized the FRB, in “unusual and exigent circumstances” to authorize any Federal Reserve Bank “to discount for any individual, partnership, or corporation, notes, drafts, and bills of exchange when such notes, drafts, and bills of exchange are indorsed or otherwise secured to the satisfaction of the Federal Reserve Bank.” 12 U.S.C. § 343 (2006). Before making the loan, the Act required the Federal Reserve Bank to obtain evidence that such individual, partnership, or

twenty-eight days. The amount was limited only by the amount of collateral Bear could provide. The FRB, not JP Morgan, would bear the risk of repayment of the non-recourse loan, the first such financing arrangement by the U.S. government for an entity other than a bank since the Great Depression.⁷⁵ The goal of the short-term loan was to enable Bear to open on Friday, March 14, 2008, to buy time to allow Bear and regulators to explore options with other financial institutions that would allow Bear to avoid bankruptcy or, should no such alternative be available, to allow regulators to contain the risks to the markets that a bankruptcy would cause.⁷⁶

C. *Bear Continues to Sink*

Rather than diminish counterparty and investor anxiety about Bear, the loan only increased it. Upon news of the loan, credit rating agencies downgraded Bear.⁷⁷ Throughout the day on Friday, hedge funds and other Bear customers continued to wire staggering amounts of cash from their accounts with Bear as the firm's stock continued to fall.⁷⁸ After the markets closed, Treasury Secretary Henry Paulson Jr. advised Bear's Chief Executive Officer, Alan Schwartz, that, notwithstanding the twenty-eight day maturity of the loan from JP Morgan,

corporation was "unable to secure adequate credit accommodations from other banking institutions." 12 U.S.C. § 343(3)(A) (2010). Dodd-Frank clarified and expanded the FRB's authority to lend to non-bank companies. *See, e.g.*, 12 U.S.C. § 343(B) (2010). Contemporaneous with the loan to Bear, the FRB also announced the establishment of a Term Lending Facility, which allowed primary dealers to pledge a wider range of collateral to borrow Treasury securities. *Hearing: Turmoil in U.S. Credit Markets, supra* note 60, at 117 (statement of Geithner).

75. KELLY, STREET FIGHTERS, *supra* note 59, at 68. The Bear bailout drew unflattering comparisons with Northern Rock PLC, which the Bank of England bailed out in September 2007 after depositors lost confidence in the bank. *See Kelly: Fed Races to Rescue, supra* note 55. To stave off a run on Northern Rock, the Bank of England extended an emergency line of credit, which appeared only to exacerbate depositors' concerns about the bank. Ultimately, the U.K. nationalized the bank. The scenario was also compared to the 1984 bailout of Continental Illinois National Bank & Trust Co., which the FDIC backstopped with \$4.5 billion after depositors drained billions from the struggling bank, leading Bear's counsel to conclude that a financial institution can sustain a massive liquidity run only with Government intervention. *See KELLY, STREET FIGHTERS, supra* note 59, at 134–35. For his part, Federal Reserve Chairman, Ben Bernanke, thought the Bear crisis reminiscent of that faced by Credit-Anstalt, a large Austrian bank that went bankrupt in 1931 after acquiring several smaller, weaker banks. The Austrian central bank had guaranteed Credit-Anstalt's customer deposits, but the move only denigrated Austria's currency and spread panic to other European countries, contributing to the decline of Europe's banking system and the commencement of the Great Depression. *Id.* at 65. *See also* Ambrose Evans-Pritchard, *Forget the Wolf Pack—the Ongoing Euro Crisis Was Caused by EMU*, TELEGRAPH (May 16, 2010), http://www.telegraph.co.uk/finance/comment/ambroseevans_pritchard/7730964/Forget-the-wolf-pack-the-ongoing-euro-crisis-was-caused-by-EMU.html.

76. *Hearing: Turmoil in U.S. Credit Markets, supra* note 60, at 116 (statement of Geithner).

77. *Id.*

78. KELLY, STREET FIGHTERS, *supra* note 59, at 83–102.

Bear would need to have a deal in place to address the firm's capital deficit by Sunday night.⁷⁹

Flowers and JP Morgan, which was also weighing an investment in Bear, conducted due diligence under harried conditions that weekend.⁸⁰ On Saturday, March 15, 2008, JP Morgan notified Bear that it was considering a bid of between \$8 and \$12 per share for the firm, a fraction of what Bear's management believed the firm was worth.⁸¹ JP Morgan was clear at the time, however, that it would still need to further review Bear's assets before it could make a final offer.⁸²

Later that day, Flowers tentatively offered to buy ninety percent of Bear for \$3 billion or \$28 per share. The deal was contingent, however, on Flowers lining up a consortium of lenders willing to provide \$20 billion to finance Bear's continuing operations. Flowers proposed segregating some of Bear's troubled mortgage-related assets into a new security in the hopes of attracting investors who might be interested in distressed debt. The proposal also was predicated on Flowers' ability to borrow from the FRB's discount window, a move that Bear management had been advocating, unsuccessfully, for months.⁸³

79. Kelly: The Fall of Bear Stearns, Part III, *supra* note 51. Paulson and FRBNY President Geithner were concerned that Schwartz was laboring under the misconception that the loan from the FRB allowed Bear a month to seek the highest offer for the firm. From Paulson's and Geithner's perspective, it was imperative that Bear find a suitor immediately or face imminent bankruptcy. KELLY, STREET FIGHTERS, *supra* note 59, at 101–02.

80. Citadel, which had expressed interest in acquiring Bear, was ruled out because it was perceived as too small to close such a large deal quickly and because of lingering suspicions that the firm had been shorting Bear's stock. Bank of New York Mellon and Royal Bank of Canada each expressed interest in acquiring some portion of Bear, but neither was comfortable committing to an investment in the shaky Bear under such a short time frame. Lazard also probed interest from sovereign wealth funds (*i.e.*, investment pools controlled by foreign governments) and Santander, a large Spanish bank. For his part, Flowers contacted General Electric's GE Capital Division, the TD Bank Financial Group in Toronto, Goldman Sachs, Harvard University's endowment, and, last but not least, Warren Buffett. Other than G.E. and Goldman Sachs, which expressed some interest, the others balked. Some felt that they would not have sufficient time for due diligence. Buffett opted out, having been jaded by the industry after his bet on Salomon Brothers in 1987. He was also concerned about the optics of acquiring the once-fabled firm for a song. KELLY, STREET FIGHTERS, *supra* note 59, at 167–70, 175. Although Lazard viewed Flowers as a legitimate suitor, Paulson, who was a former Goldman Sachs colleague of Flowers' founding partner, was skeptical about a deal with Flowers because it did not have the backing of a large bank or consortium of banks. *Id.* at 129–31.

81. *Id.* at 171.

82. *Id.* at 173.

83. *Id.* at 174–76. Flowers had not lined up complete financing for the deal but apparently had a commitment from GE's Capital Division to invest several billion dollars in a secured investment. See KELLY, STREET FIGHTERS, *supra* note 59 at 167, 174. Flowers also suggested that Bear management invite Goldman Sachs to the table, which they reluctantly agreed to do. *Id.* at 174–75. Goldman arrived at Bear's offices on Sunday, March 16, 2008, under a cloud of suspicion and uncertainty over what Goldman's role was to be in the process. Flowers anticipated that Goldman might have an interest in buying Bear's prime brokerage business. Flowers later

On Sunday morning, March 16, 2008, JP Morgan withdrew its tentative offer because it believed that the inadequate due diligence period made the deal too risky.⁸⁴ JP Morgan was particularly concerned about Bear's \$30 billion mortgage portfolio. While Flowers' contingent offer was still pending, without committed financing, Flowers apparently was not viewed as a serious contender in the process.⁸⁵

With no deal on the table, the FRB and Treasury concluded that an infusion of government capital, through JP Morgan, was likely the only alternative to bankruptcy for Bear.⁸⁶ The agencies decided that they could provide financing against collateral posted by Bear, but were not willing to sign off on such a deal unless it was clear that Bear's shareholders would not get a windfall if JP Morgan took over the firm with the help of government financing.⁸⁷ With government backing, JP Morgan appeared willing to make an offer of between \$3 and \$5 per share for Bear. Treasury officials, however, thought a nominal price between \$1 and \$2 per share was more in keeping with the policy against providing a windfall to Bear's shareholders.⁸⁸ On Sunday evening, JP Morgan returned to the table, this time with a reduced offer of \$4 per share, contingent upon the FRB's assumption of \$30 billion of Bear losses.⁸⁹ Hours later JP Morgan revised the offer down to \$2 per share. JP Morgan also agreed to guarantee Bear's obligations until the deal closed. Bear's disgusted board, believing that \$2 was likely the best they would be able to do under the circumstances, approved the deal.⁹⁰ Once the fifth largest investment

contended that discussions were quickly aborted when Goldman refused to sign a nondisclosure agreement because Goldman had already started to poach Bear's employees. Whatever Goldman's role, it never committed capital to any proposal to acquire Bear or any of its assets. Bear, possibly through Flowers, also contacted Morgan Stanley to determine whether it might have an interest in acquiring Bear's prime brokerage unit but, after a cursory assessment, Morgan Stanley dropped out of the process. *Id.* at 205–06.

84. *Hearing: Turmoil in U.S. Credit Markets*, *supra* note 60, at 118 (statement of Geithner).

85. KELLY, STREET FIGHTERS, *supra* note 59, at 173, 202, 209. While Flowers may not have been viewed as a viable contender in the process, Bear's management viewed his firm's participation as valuable because it created the appearance, if not the actuality, of a two-party bidding process.

86. *Hearing: Turmoil in U.S. Credit Markets*, *supra* note 60, at 118–19 (statement of Geithner). The Agencies did not believe they had the authority to acquire an equity interest in either Bear or JP Morgan, nor were they prepared to guarantee Bear's "very substantial obligations. And the only feasible option for buying time would have required open ended financing by the Fed to Bear into an accelerating withdrawal by Bear's customers and counterparties." *Id.* at 118.

87. KELLY, STREET FIGHTERS, *supra* note 59, at 198. See also Peter Robison, *Dimon Rejected Rescuing Bear Until Geithner Promised Funding*, BLOOMBERG (Apr. 4, 2008), <http://www.bloomber.com/apps/news?pid=21070001&sid=aDNaFtVZV4ws>.

88. KELLY, STREET FIGHTERS, *supra* note 59, at 204–05.

89. Kelly, *The Fall of Bear Stearns*, Part III, *supra* note 51.

90. KELLY, STREET FIGHTERS, *supra* note 59, at 208, 210.

bank with a market value of \$25 billion, the JP Morgan offer valued the firm at \$243 million.⁹¹

The \$2 offer was met with open revolt by Bear's shareholders who threatened to scuttle the deal and take their chances in bankruptcy. Moreover, due to what may have been some careless drafting, JP Morgan perhaps would have still been on the hook for guaranteeing Bear's obligation, even if the deal was rejected by Bear's shareholders.⁹² To diminish the outrage expressed by Bear's shareholders after the announcement of the original terms of the deal, the purchase price was eventually raised to \$10 per share for a forty percent stake in the company (placing Bear's value at \$1.2 billion).⁹³

D. *A Trip to Maiden Lane: JP Morgan Receives Government Financing To Acquire Bear*

The FRB facilitated JP Morgan's acquisition of Bear through a \$29 billion non-recourse loan that it made to a newly created limited liability company (LLC) called "Maiden Lane," of which the FRBNY is the sole and managing member.⁹⁴ JP Morgan also extended a \$1 billion note, subordinated to the FRBNY note, to Maiden Lane. With the proceeds of these loans, Maiden Lane purchased assets from Bear Stearns which, according to Bear, were worth \$30 billion.⁹⁵ At the time the FRBNY established Maiden Lane, some expressed the belief that the FRB was merely buying Bear's riskiest assets, which would have otherwise appeared on JP Morgan's books. JP Morgan's CEO denied this accusation, stating that although a confidentiality agreement constrained what he could say about the assets, the assets consist "entirely of loans that are current and domestic securities rated invest-

91. Although the perception of a windfall to Bear's shareholders was a primary concern of the government, there apparently was no such concern with respect to JP Morgan's shareholders. After the original deal was announced, JP Morgan's stock rose ten percent in a down market, increasing the bank's capitalization by more than twelve billion dollars. Steven M. Davidoff, *JP Morgan's \$12 Billion Bailout*, NY TIMES (Mar. 18, 2008), <http://dealbook.nytimes.com/2008/03/18/jpmorgans-12-billion-bailout/>. A fuller understanding of the risk that JP Morgan was assuming in guaranteeing Bear's obligations—even if the deal did not close—might have tempered investor enthusiasm. See *infra* note 98 and accompanying text.

92. Ashby Jones, *Did Deal Overexpose J.P. Morgan?*, WALL ST. J. (Mar. 25, 2008), <http://online.wsj.com/article/SB120640936857461199.html>.

93. See KELLY, STREET FIGHTERS, *supra* note 59, at 226.

94. In New York, the FRBNY building is bordered on one side by Liberty Street and on another by Maiden Lane.

95. Blackrock Financial Management Inc. manages Maiden Lane's portfolio for the FRBNY. MAIDEN LANE LLC, CONSOLIDATED FINANCIAL STATEMENTS FOR THE PERIOD MARCH 14, 2008 TO DECEMBER 31, 2008, AND INDEPENDENT AUDITOR'S REPORT 24 (2009), <http://www.newyorkfed.org/aboutthefed/annual/annual08/MaidenLaneinstmt2009.pdf>.

ment grade. We kept the riskier and more complex securities in the Bear Stearns portfolio for our own account.”⁹⁶

E. *JP Morgan Guarantees Bear's Obligations Before Deal Closes*

JP Morgan agreed to guarantee certain of Bear's obligations for a certain period of time to provide stability to the markets before the Bear deal closed.⁹⁷ The scope and timing of the guarantee, however, was itself a source of uncertainty. Under the original guaranty agreement, JP Morgan agreed to “unconditionally” guarantee “the due and punctual payment” of all of Bear's “covered liabilities” for the period beginning March 16, 2008, until either the deal closed or when the deal failed, whichever came first. The guarantee applied to all transactions on Bear's books as of the signing of the deal in principle and any transactions entered into while the guarantee was in place. The only way for the parties to scuttle the deal under the agreement in a manner that would terminate JP Morgan's guarantee was for Bear's board to oppose the deal. In the absence of board opposition, JP Morgan's obligations would continue, even if Bear's shareholders voted the deal down. The firms viewed the coverage period as lasting at least a year and perhaps longer.⁹⁸

The original guaranty agreement was quickly revised when the price for Bear was raised from \$2 to \$10 per share. Under the amended guaranty agreement, JP Morgan “unconditionally guaranties the due and punctual payment of all Covered Liabilities of” forty Bear affiliates, adding nineteen additional subsidiaries to the original agreement.⁹⁹ The agreement did not cover obligations of Bear-sponsored special purpose entities or structured investment vehicles (i.e. SIVs).¹⁰⁰

96. *Hearing: Turmoil in U.S. Credit Markets*, *supra* note 60, at 73 (testimony of James Dimon, Chairman and Chief Executive Officer, JP Morgan Chase).

97. *Id.* at 118–21 (statement of Geithner).

98. Jones, *supra* note 92. See also *Hearing: Turmoil in U.S. Credit Markets*, *supra* note 60, at 120 (statement of Geithner) (“[S]everal infirmities became evident in the agreement between JPMorgan and Bear during the week of March 17th that needed to be cured.”).

99. Bear reportedly had nearly 500 subsidiaries. See KELLY, *STREET FIGHTERS*, *supra* note 59, at 43–45. Therefore, the guaranty would have covered only a fraction of these. It is unclear what criteria were used to determine which subsidiaries would be included in the guaranty and which would not.

100. JPMORGAN CHASE, *KEY TERMS OF JPMORGAN CHASE AMENDED AND RESTATED GUARANTY AGREEMENT* (2008), http://www.jpmorgan.com/cm/cs?pagename=JPM/DirectDoc&urlname=bsc_merger_guaranty.pdf&track=no. Compare *Hearing: Turmoil in U.S. Credit Markets*, *supra* note 60, at 119 (statement of Geithner) (indicating that government financing made it possible for JP Morgan to “step in immediately to guarantee all of Bear's short-term obligations.”).

The guaranty covered three transactions: (1) all short and long-term loans; (2) all contracts associated with Bear's trading businesses; and (3) all obligations to deliver cash, securities or other property held by Bear to customers under custody arrangements. Coverage excluded, among other things, (1) Bear's bond debt and other debt securities issued by Bear; (2) employee and trade-vendor claims; (3) claims for violations of law; and (4) claims for non-contractual breach of duty.

The amended guaranty covered liabilities that arose before the firms signed the Acquisition Agreement. The amount guaranteed was not capped. The guaranty would terminate if Bear's board recommended a competing proposal, but only if the proposal were accompanied by an equivalent guaranty to take effect simultaneously with the termination of JP Morgan's guaranty so that there was no gap between the guaranties. The competing guaranty would have to be given by "a financial institution with capital, liquidity and financial resources sufficient to enable Bear to conduct business in the ordinary course."¹⁰¹

F. *Take-Aways From Bailout-Buyout of Bear*

1. Gradual Deterioration of Bear Allowed Time for Alternatives, Most of Which Bear Rejected

Unlike LTCM, which found itself in a crisis state very quickly, warning signs of Bear's impending demise occurred over several months. From the time of the failure of Bear's hedge funds, Bear had ample warning that its reputation as a prudent risk manager was compromised. Numerous market participants warned Bear that it needed to raise more capital. Bear had numerous suitors that would have bolstered its financial condition and possibly warded off the bailout/buyout.¹⁰²

2. Bear's Competitors Were Also Suffering

Unlike the LTCM situation, where most of the largest brokers and banks with the financial wherewithal to make a contribution were financially strong, the difficult market conditions at the time of Bear's demise had also weakened Bear's largest competitors and counterparties. The firms were in self-preservation mode and reluctant to take on the added risk of Bear's positions.

101. JPMORGAN CHASE, *supra* note 100, ¶ 11.

102. See Kelly, *The Fall of Bear Stearns*, Part I, *supra* note 51.

3. FRB Loan Viewed As Sign of Bear's Weakness

Two key factors affect how the markets will perceive a third-party investment in a firm: (1) the amount of the investment; and (2) the source of the investment. In LTCM, the amount was relatively small compared to LTCM's exposure, but the source—private industry consortium—sent a message to the markets: the largest and best-capitalized firms have a vested interest in ensuring that LTCM continues to trade, at least until its positions can be unwound in an orderly fashion. Because the industry support for preserving LTCM's portfolio was so broad-based, it was less likely that any one firm or group of firms would make a “bear run” against LTCM's positions (i.e., bet against LTCM's positions).

On the other hand, the FRB loan to Bear sent a much different message. In facilitating a loan to Bear, the FRB was admitting that it was Bear's last resort. Many firms had gained some knowledge of Bear's positions, but none was willing to take a chance on Bear. Moreover, the fact that the FRB-facilitated loan was limited only by the collateral that Bear could provide also sent a message of desperation. Rather than capping the loan at a certain fixed amount, the FRB loan suggested that Bear's potential risk was very high and perhaps unknowable. In reality, the message that Bear was out of private alternatives may have been overstated. Flowers was still interested in Bear if he could secure financing, but was unable to line it up under the short time frame. JP Morgan may also have been genuinely interested in Bear as an investment (as opposed to an obligation imposed on the bank by the FRB), but with the FRB showing its hand and apparently no other firm willing or able to take the risk, JP Morgan was able to drive a hard bargain for Bear. And, with the help of the government, JP Morgan likely received a windfall in the process. Nevertheless, in a market with imperfect information, perception can become reality. Bear was perceived to be on its last legs and that became its reality.

4. Credit Rating Agencies' Eleventh Hour Downgrades Helped Force FRB's Hand

Many have faulted the credit rating agencies' for rating mortgage-based derivative securities in a way that may not have accurately reflected the risk that those securities posed and thereby contributing to the Financial Crisis.¹⁰³ Less has been written about the credit rating

103. See, e.g., Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 931, 124 Stat. 1376, 1872 (codified at 15 U.S.C. § 78o-7 (2010)):

agencies' role in heightening an already turbulent time by downgrading securities that Bear had packaged for resale and eventually Bear itself after the FRB extended credit to Bear. The downgrade of Bear is particularly noteworthy, not because of the guidance that the rating agencies provided about Bear, but because of the fact that the downgrades themselves triggered covenants in the debt agreements, which authorized firms that lent to Bear to call the loans immediately.¹⁰⁴ Triggering the debt covenants tightened the noose around Bear and may have forced the FRB's hands in pressuring Bear to reach a deal immediately rather than weigh any competing offers that may have materialized over the twenty-eight day loan period. Although the downgrades of Bear did not provide any new information to the public, they made a bad situation even worse.

5. Takeover of Bear Introduced Good Bank/Bad Bank Paradigm and the Concept of a Preclosure Guarantee

a. Good Bank/Bad Bank Paradigm

JP Morgan determined that it could not, with limited time for due diligence, take on all of Bear's exposures, separate and apart from any financing help the FRB might provide. Moreover, from its perspective, the FRB viewed its authority under Section 13(3) of the Federal Reserve Act as limited to lending against collateral. The Maiden Lane transaction was a way to accommodate both the FRB and JP Morgan. JP Morgan was able to identify a discreet pool of assets—Bear's \$30 billion real estate portfolio—that was either too risky for JP Morgan to underwrite or the risks of which were not sufficiently known for JP Morgan to take on prudently, depending on your perspective.¹⁰⁵ Although Blackrock, which the FRB retained as an ad-

In the recent financial crisis, the ratings on structured financial products have proven to be inaccurate. This inaccuracy contributed significantly to the mismanagement of risks by financial institutions and investors, which in turn adversely impacted the health of the economy in the United States and around the world. Such inaccuracy necessitates increased accountability on the part of credit rating agencies.

104. See KELLY, STREET FIGHTERS, *supra* note 59, at 100.

105. In testimony following the takeover, JP Morgan's CEO, Jamie Dimon, adamantly denied that JP Morgan was shifting Bear's riskiest assets to the FRB. *Hearing: Turmoil in U.S. Credit Markets*, *supra* note 60, at (testimony of James Dimon, Chairman and Chief Executive Officer, JP Morgan Chase) 154, 157. Dimon stated,

[T]his transaction is not without risk for JP Morgan. We are acquiring some \$360 billion of Bear Stearns assets and liabilities. The notion that Bear Stearns' riskiest assets have been placed in the \$30 billion Fed facility is simply not true The assets taken by the Fed [to collateralize Maiden Lane LLC] consist entirely of loans that are current and domestic securities rated investment grade. We kept the riskier and more complex securities in the Bear Stearns portfolio for our own account.

viser, oversaw the process of selecting the assets that went into Maiden Lane, little information is available about what criteria JP Morgan used to select the assets. It is known however, that they were “loans that [were] current and domestic securities rated investment grade”¹⁰⁶ and that Bear marked them to market when they were sold to Maiden Lane. This created a new paradigm that was not present in the LTCM rescue but would be predominate in the Lehman context: Walling off risky assets.

b. Preclosure Guaranty

The Bear acquisition also introduced the concept of the acquiring firm guaranteeing the obligations of the distressed firm before the deal closes and potentially for a period after the deal is scuttled by a shareholder vote by the troubled firm. Like the other terms of the deal, the JP Morgan guaranty was hurriedly drafted and apparently at the behest of the government as another means of restoring some semblance of calm to the counterparties of the distressed firm and to the markets as a whole.

Four points of the JP Morgan guaranty are worth highlighting. First, the guaranty did not apply to all of Bear’s obligations and affiliates. Rather, it applied only to a particular pool of covered obligations and to an expressed list of subsidiaries. For these obligations and entities, JP Morgan’s liability was uncapped. For those not included, there was only an expectation on the part of JP Morgan that Bear would meet its own obligations.¹⁰⁷ Second, the guaranty agreement did not define the criteria for selecting the covered subsidiaries and obligations. Instead, the guaranty agreement was designed to ensure that the acquired firm’s day-to-day operations and funding arrangements could proceed in the ordinary course rather than to ensure that all obligations or entities were protected. Third, only obligations on the distressed firm’s balance sheet were protected by the guaranty agreement. Off-balance sheet positions (e.g., those in SIVs)

Id. Nevertheless, in August 2010, more than two years after the FRBNY took over the assets, the residential and commercial loans in the portfolio were worth about five billion dollars, compared to \$9.6 billion in March 2008. Serena Ng et al., *Foreclosed on—By the U.S.*, WALL ST. J. (Aug. 4, 2010), <http://online.wsj.com/article/SB10001424052748704499604575407584128526218.html>. It is unclear how much of that loss of value is related to a continued devaluation of the real estate market or a reflection of Bear’s overly optimistic marking to market of the assets before they were sold to the FRB.

106. *Hearing: Turmoil in U.S. Credit Markets*, *supra* note 60, at 157 (testimony of Dimon).

107. With respect to non-covered entities or obligations, JP Morgan stated, “JP Morgan Chase fully expects that Bear will honor all of its obligations, whether or not guaranteed. The guaranty is additional credit support to reassure customers and counterparties.” JPMORGAN CHASE, *supra* note 100, ¶ 9.

were not. Fourth, the guaranty did not preclude a competing firm from bidding on the distressed firm, but the competing firm would have to offer a similar guaranty and have the resources to meet reasonably the terms of the guaranty. Presumably, this precondition would have precluded many private equity firms from bidding on Bear without the backing of a large bank or insurance company willing to underwrite Bear's obligations before the deal closed.

III. TOO BIG TO FAIL NO MORE: LEHMAN BROTHERS, GSEs, AND THE DAM BREAKS

"We have access to Fed funds. We can't fail now." — Richard Fuld, Lehman CEO, Summer 2008.¹⁰⁸

A. *Wary Eyes Turn to Lehman as the Firm Scrambles for Funding*

Before the ink had dried on the JP Morgan takeover of Bear, wary eyes turned to Lehman Brothers, the next smallest of the standalone investment banks.¹⁰⁹ Rumors began circulating that Bear's demise had been precipitated by a consortium of hedge funds and other traders that had purchased credit default swaps, the value of which would increase as Bear faltered.¹¹⁰ Regardless of the accuracy of the rumors, they created an air of apprehension among the remaining investment banks, perhaps none more so than Lehman. After the fall of Bear, two large banks had already stopped trading with Lehman.¹¹¹

Despite a favorable earnings report that gave Lehman a temporary respite from the selling that permeated the market after the Bear announcement, investors became increasingly skeptical of Lehman's ac-

108. Susanne Craig et al., *The Weekend that Wall Street Died*, WALL ST. J. (Dec. 29, 2008), <http://online.wsj.com/article/SB123051066413538349.html>. After JP Morgan's takeover of Bear, the FRB also announced that it would allow investment banks to borrow directly from the Government. KELLY, STREET FIGHTERS, *supra* note 59, at 211.

109. Valukas Report, *supra* note 62, at 1491 n.5769 and accompanying text (noting Lehman's business model was viewed as similar to Bear's in that Lehman used high leverage, low capitalization, and had a high concentration of illiquid assets like subprime and Alt-A mortgages). As with Bear, the SEC was the primary regulator of Lehman under the CSE program. Bear Stearns Quarterly Report, *supra* note 48, at 45. Nevertheless, the heads of Treasury, the FRB, which also oversaw Lehman, and the FRBNY, which was a lender to Lehman under the FRB's discount window, all had direct communications with Lehman's CEO during this period. After the takeover of Bear, the SEC and FRBNY began on-site monitoring of Lehman's financial condition. Valukas Report, *supra* note 62, at 1482 nn.5728–30.

110. Kelly: The Fall of Bear Stearns, Part II, *supra* note 51; Kate Kelly, SEC Will Scour Bear Trading Data, WALL ST. J., May 28, 2008, at A1.

111. ANDREW R. SORKIN, TOO BIG TO FAIL: THE INSIDE STORY OF HOW WALL STREET AND WASHINGTON FOUGHT TO SAVE THE FINANCIAL SYSTEM — AND THEMSELVES 15 (2009).

counting.¹¹² The Treasury Department was also worried about Lehman's valuations and its failure to raise capital, which many larger banks had done.¹¹³ Treasury feared that Lehman might already be insolvent.¹¹⁴ Treasury Secretary Paulson prodded Lehman to raise capital or arrange for either an investment or sale by a third party.¹¹⁵ Lehman agreed that that would be advisable and, of course, considered approaching Buffett. Lehman's Fuld did not know Buffett well, so he requested that Paulson call Buffett to soften him up.¹¹⁶ Fuld then called Buffett himself to feel him out about investing in Lehman. Buffett was noncommittal but promised to consider it and gave Fuld some off-the-cuff numbers that Buffett might be willing to agree to if a deal looked promising. Paulson followed up Fuld's call to Buffett with his own tepid pitch for a Buffett investment in Lehman to restore market confidence. Buffett reviewed Lehman's financial statements but found numerous issues that concerned him. When Fuld called back to discuss Buffett's off-the-cuff numbers, the two realized that they had not had a meeting of the minds on what the numbers meant. To Fuld's chagrin, Buffett was asking for a far better return than Fuld had originally understood. Fuld believed the terms were unworkable and the talks ended.¹¹⁷ As with the Goldman-Buffett offer for LTCM's assets, there was a disconnect between Buffett and the bankers that prevented the parties from further exploration of a deal.

Although Lehman did not secure financing from Buffett, it raised \$4 billion by selling convertible securities to a group of investment funds,¹¹⁸ but the added capital did little to calm the markets or regulators. The Treasury Department became increasingly concerned about Lehman's viability and contacted Barclays to determine whether the

112. See *id.* at 35. See also Alejandro Lazo & David Cho, *Financial Stocks Lead Wall Street Turnabout*, WASH. POST (Mar. 19, 2008), <http://www.washingtonpost.com/wp-dyn/content/article/2008/03/18/AR2008031802972.html> ("'I still don't believe any of these numbers because I still don't think there is proper accounting for the liabilities they have on their books,' said Peter Schiff, president and chief global strategist of Euro Pacific Capital. 'People are going to find out that all these profits they made were phony.'"). Accounting rules relating to repos permitted Lehman to reduce its reported debt by \$38.6 billion in the fourth quarter of 2007 and \$49.1 billion and \$50.38 billion, respectively, in the first two quarters of 2008, which distorted Lehman's true financial condition. See Skeel, Jr. & Jackson, *supra* note 57, at 13-14.

113. In the summer of 2008, Lehman had exploratory discussions with a number of strategic partners, including the Korean Development Bank (KDB), MetLife and the Investment Corp. of Dubai. During this period, Lehman rejected a proposal from the KDB and term sheets from MetLife and the ICD. Valukas Report, *supra* note 62, at 619 nn.2189-90 and accompanying text.

114. SORKIN, *supra* note 111, at 51.

115. Valukas Report, *supra* note 62, at n.5769.

116. SORKIN, *supra* note 111, at 54-55.

117. *Id.* at 56-57.

118. *Id.* at 55-57.

U.K. bank would be interested in acquiring Lehman. Barclays explained that it was in preliminary talks to acquire UBS but might have an interest in acquiring Lehman under the right conditions.¹¹⁹ While Treasury lined up potential suitors for Lehman, Lehman's CEO worked diligently to stick his foot in his mouth by conceding to a financial commentator that Lehman was taking on more leverage (Lehman's leverage exceeded thirty to one¹²⁰) even though his peers were deleveraging.¹²¹

As Lehman's condition became increasingly dire, it sought funding from a range of potential suitors, including AIG, GE, and the state-owned KDB, which a former Lehman banker headed. Only the KDB showed anything more than a passing interest.¹²² Meanwhile, pressure mounted for senior management changes and Lehman's chief operating officer and chief financial officer resigned.¹²³ In a show of desperation, Lehman pitched multiple suitors, including Morgan Stanley and Bank of America. None were interested.¹²⁴ Lehman even broached the idea of becoming a commercial bank, but the FRB opposed the idea for fear that the effort would alert an already wary public to Lehman's desperation.¹²⁵

In a last ditch effort, Lehman hired investment bank Lazard to explore alternative funding sources for Lehman, but Lazard's pessimism toward Lehman's condition put off Lehman's CEO.¹²⁶ With apparently no other alternative for saving Lehman, the Treasury Department orchestrated a meeting between Lehman and Bank of America to try to bring the two together in a merger. Bank of America again rejected an acquisition.¹²⁷ The KDB remained as the only possible salvation for Lehman, but the KDB conditioned any offer on Lehman unloading its struggling real estate holdings, a sacrifice that Lehman's CEO was unwilling to make.¹²⁸ The prospect of a Lehman bank-

119. *Id.* at 93–95.

120. *Id.* at 81.

121. SORKIN, *supra* note 111, at 99. Lehman's prospects were further depressed when a respected hedge fund manager accused Lehman of failing to mark its illiquid assets to market daily as required by a new accounting interpretation. *Id.* at 103–04.

122. *Id.* at 109, 113, 186.

123. *Id.* at 132.

124. *Id.* at 192, 198.

125. SORKIN, *supra* note 111, at 193–94. See also Valukas Report, *supra* note 62, at 1498 n.5802 and accompanying text (indicating that FRBNY's Geithner viewed the bank holding company idea for Lehman as "gimmicky").

126. SORKIN, *supra* note 111, at 205.

127. *Id.*

128. *Id.* at 213–14.

ruptcy filing loomed large as regulators began to identify the systemic risks that such a prospect raised.

To prepare for the potential fallout from a Lehman bankruptcy filing, regulators identified four specific areas of Lehman's business that might stress the global financial system: (1) Lehman's repo book; (2) its derivatives book; (3) its broker-dealer operations; and (4) its illiquid assets, including Lehman's real estate holdings and private equity investments.¹²⁹ Given Lehman's large holdings in the U.K., a Lehman liquidation promised to be a messy international affair.

B. *GSE Interlude: The Implied Government Guarantee Goes Live As the Treasury Mounts a Hostile Takeover*

As pressing as Lehman was for regulators in the spring of 2008, a more pressing matter pushed itself to the fore. Fannie Mae and Freddie Mac—two government sponsored enterprises (GSEs) that were at the heart of the cratering U.S. housing market—teetered on the brink of bankruptcy.¹³⁰ The Treasury Department retained Morgan Stanley to advise the U.S. on the condition of the GSEs. Morgan Stanley determined that the GSEs would need a \$50 billion capital infusion just to get their capital to 2.5% of assets—still well below the skimpy four percent required for banks.¹³¹ To head off what was certain to be a thorny political battle over the treatment of the GSEs, which had powerful and vocal supporters and opponents,¹³² Treasury Secretary Paulson decided effectively to launch a hostile takeover of the GSEs under a grant of authority Congress had given the Administration just months before. In the takeover, deemed a conservatorship, the government acquired warrants which, if exercised, allowed the government to acquire, for a nominal sum, nearly eighty percent of the common shares of each of the publicly traded GSEs. The government also received senior preferred shares that pay an annual dividend of ten percent. In return, the government committed to invest up to

129. *Id.* at 217.

130. Congress chartered Fannie Mae and Freddie Mac in 1938 and 1970, respectively, to help ensure a reliable and affordable supply of mortgage funds throughout the country. FED. HOUS. FIN. AGENCY, GOVERNMENT SPONSORED ENTERPRISES, <http://www.fhfa.gov/Default.aspx?Page=33> (last visited Mar. 24, 2012).

131. SORKIN, *supra* note 111, at 222.

132. See, e.g., Eric Dash, *Fannie Mae's Offer to Help Ease Credit Squeeze is Rejected, As Critics Complain of Opportunism*, N.Y. TIMES (Aug. 11, 2007), <http://www.nytimes.com/2007/08/11/business/11fannie.html>.

\$200 billion in capital to stabilize the two GSEs, fifty times the amount that the LTCM consortium committed to stabilize LTCM.¹³³

C. *Take-Away from Treasury's Hostile Takeover of the GSEs*

It is difficult to imagine a scenario under which the private sector could have mobilized funding of the magnitude required to stabilize the GSEs under such an emergency time frame. To put the commitment that the government made in taking over the GSEs in context, it may be useful to examine private company initial public offerings and loan transactions. In 2010, the Agriculture Bank of China's initial public offering raised a record \$22.1 billion or approximately eleven percent of the \$200 billion that the government committed in taking over the GSEs.¹³⁴ The largest syndicated loan ever was \$55 billion lined up for BHP Billiton to use in buying Rio Tinto PLC.¹³⁵ Although the GSEs were privately traded financial institutions prior to the takeover, their government charter and implied government guarantee, which turned into a de facto guarantee, places them outside the scope of this article. An orderly resolution of the GSEs, which continues today, seems properly within the public rather than the private realm. Looking ahead, however, Congress and the President have several alternatives for dealing with the GSEs, some of which could bring the functions the GSEs perform back within the scope of this Article. Therefore, it is useful to discuss briefly possible options for the GSE going forward. One alternative would be for Congress to roll the functions of the GSEs into an existing government entity. This alternative seems unlikely under the post-Financial-Crisis political environment where smaller government and fewer public incentives for home-ownership seem favored.

Another alternative would be for Congress to liquidate the GSEs and their portfolios, leaving their functions to the private sector. It is unlikely that most commercial banks would be willing or able to carry a significant percentage of residential home loans they originate on their books. Therefore, it would not be inconceivable that the com-

133. James R. Hagerty et al., *U.S. Seizes Mortgage Giants*, WALL ST. J. (Sept. 8, 2008), <http://online.wsj.com/article/SB122079276849707821.html>. See also SORKIN, *supra* note 111, at 229. Under the agreements, Treasury would acquire one billion dollars of preferred shares in each company without providing immediate cash in exchange for the commitment to provide as much as \$200 billion to the companies. *Id.* Management control over the companies was given to the Federal Housing Finance Authority, the GSEs' regulator. *Id.*

134. See Sharon Terlep et al., *GMs IPO May Raise Record Amount*, WALL ST. J. (Nov. 17, 2010), <http://online.wsj.com/article/SB10001424052748704312504575619004098993666.html>.

135. David Benoit, *The Changing Telecom Landscape: J.P. Morgan Loan Shows Confidence in Market*, WALL ST. J., Mar. 22, 2011, at B5.

mercial banks would again rely on off-balance-sheet vehicles, such as SIVs to off-load the capital risk of those loans to investors. Given the reputation that SIVs gained during the Financial Crisis, most notably with respect to Citibank, however,¹³⁶ this alternative seems problematic for—if not enticing to—banks facing newly tightened capital standards. The attractiveness for SIV-issued debt to institutional investors burned badly during the Financial Crisis remains an open question.

A third alternative would be a new special purpose bank charter. The charter could be limited to buying loans from member financial institutions (e.g., banks, thrifts, and credit unions), repackaging them as mortgage-backed securities, and selling them to institutional investors, as the GSEs do today. The special purpose bank could serve as a utility of sorts for the member financial institutions that originate the loans. The charter could require the members to ensure that the special purpose bank remained “well-capitalized” under a Basel III or other recognized standard for systemically important financial institutions, such as those that might be established by the Financial Stability Oversight Council under the Dodd–Frank Act.¹³⁷ If the bank’s capital level fell below the mandated level, the charter could require the bank to seek additional capital from its member financial institutions. The charter could require the bank to operate as a not-for-profit organization, which would mitigate the perception that the bank was competing with its member financial institutions, much in the same way that a securities clearing agency does in netting and guaranteeing its members’ settled trades.¹³⁸

D. *Back to Lehman: Counterparties and Clients Pulled Capital as List of Potential Suitors Dwindled*

The takeover of the GSEs only increased the pressures on Lehman as JP Morgan informed Lehman that it was pulling \$5 billion in collateral.¹³⁹ Lehman informed JP Morgan that it could not come up with

136. See e.g., Andy Kessler, *The End of Citi’s Financial Supermarket*, WALL ST. J. (Jan. 16, 2009), <http://online.wsj.com/article/SB123207111431688593.html>.

137. See Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 113, 124 Stat. 1376, 1398–1402 (codified at 12 U.S.C. § 5323 (2010)). See also Advance Notice of Proposed Rulemaking Regarding Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies, 12 C.F.R. XIII (2010).

138. See Securities Exchange Act of 1934, Pub. L. No. 73-291, §17A, 48 Stat. 881, 897 (codified at 15 U.S.C. § 78q-1 (2010)). For a detailed analysis of potential successors to the GSE model see Michael E. Murphy, *Fannie Mae and Freddie Mac: Legal Implications of a Successor Cooperative*, 10 DEPAUL BUS. & COM. L.J. 171 (2012).

139. At the time, Lehman owed JP Morgan approximately twenty billion dollars. In addition to demanding a five billion dollar payment, JP Morgan also froze seventeen billion dollars of Lehman’s cash and securities. Skeel, Jr. & Jackson, *supra* note 57, at 14.

the cash, and JP Morgan recommended that Lehman seek an LTCM-type rescue from the government.¹⁴⁰ Sensing that the end was near for Lehman, Goldman contacted the Treasury Department to volunteer to take some of Lehman's assets off its hands if the price were right.¹⁴¹ The Treasury advised Lehman to cooperate with Goldman. The Treasury also encouraged Bank of America, which had previously abandoned discussions about acquiring Lehman, to reconsider an acquisition. The Treasury offered to negotiate directly with Bank of America.¹⁴² Bank of America retained Chris Flowers to do due diligence on Bank of America's behalf and viewed Flowers as a possible acquirer of Lehman's most distressed assets.¹⁴³

1. Lehman Proposes Walling Off Good Bank from Bad

As hedge funds continued to pull funds out of the sinking Lehman, Lehman proposed a good bank–bad bank structure similar to the one that was used in the JP Morgan takeover of Bear Stearns as a way to salvage the firm.¹⁴⁴ Some in the industry acknowledged that such an approach might work, but the proposal raised concerns about how much capital would be needed to fund the “bad” bank. Regulators quickly concluded that Lehman's plan was doomed.¹⁴⁵

2. As Lehman Swoons, Barclays Steps Up to the Plate

By September of 2008, Barclays realized that Lehman was near the end of its rope and might be an attractive target at a distressed price. Barclays conveyed its interest in Lehman to the Treasury Department but insisted that any deal be negotiated directly with the U.S. government and be completed with U.S. financial assistance. Bank of America reached the same conclusion, telling regulators that the government would need to guarantee up to \$40 billion in Lehman's losses. U.S. regulators indicated that no such assistance would be

140. SORKIN, *supra* note 111, at 242–43.

141. *Id.*

142. *Id.* at 237, 245–46. FRB Chairman Bernanke also contacted Bank of America and reportedly agreed to help resolve certain capital issues Bank of America was having with the Federal Reserve Bank in Richmond regarding Bank of America's acquisition of Countrywide to facilitate a possible Bank of America acquisition of Lehman. *Id.* at 262.

143. *Id.* at 267.

144. As originally proposed, the Lehman good bank/bad bank was a way to “lift” distressed positions out of the firm, a concept that was discussed but ultimately rejected by the LTCM consortium. *See supra* notes 23–24 and accompanying text.

145. SORKIN, *supra* note 111, at 256.

available but left the door open to some type of assistance—possibly through a private LTCM-type consortium.¹⁴⁶

3. Barclays' Regulators Balk as a New Consortium Forms to Salvage Lehman, but U.S. Funding Is off the Table

Realizing that Barclays, a U.K. bank, might be close to bidding on Lehman, Secretary Paulson's counterpart in the U.K. advised Paulson that the U.K. government had serious reservations about such an acquisition. Seeing any deal for Lehman as unlikely, U.S. regulators summoned the largest banks and informed them that no U.S. government assistance would be forthcoming and that if an entity was to save Lehman, the firms would have to put together a rescue package as they had with LTCM.¹⁴⁷ Treasury officials also informed the banks that potential suitors were considering a deal for Lehman but that the consortium would need to be prepared to backstop such a deal by acquiring Lehman's toxic assets. In other words, the consortium was asked to acquire Lehman's "bad" bank in the event that another acquirer were willing to buy the good one.¹⁴⁸

While the consortium met to discuss ways to value Lehman's assets, Barclays, a possible suitor for Lehman's "good" bank learned that it could not acquire Lehman without a shareholder vote, which would take sixty to ninety days; a U.K. corporate governance requirement that could scuttle any potential deal. During that period, Barclays would have to guarantee Lehman's trade or otherwise Lehman's funding would dry up.¹⁴⁹ Barclays' sought potential partners that might be willing to guarantee Lehman's trades until a deal could be completed. One likely candidate was AIG. But, unbeknownst to Barclays, AIG was facing a dangerous liquidity crisis of its own.¹⁵⁰ That left, of course, Warren Buffett, who politely declined.¹⁵¹ Nevertheless, Bar-

146. *Id.* at 270–271, 279, 300. In addition to the moral hazard involved in such an arrangement, Government assistance for a Lehman buy-out also raised the possibility of political hazard given that President Bush's cousin was employed by Lehman, as was Secretary Paulson's brother. *Id.* at 284. Lehman alums also included an SEC commissioner who was the spouse of a former FRB vice chairman. Kara Scannell, *Former SEC Official Joins Davis Polk*, WALL ST. J., Sept. 22, 2008, at B7.

147. SORKIN, *supra* note 111, at 302.

148. *Id.* at 312. The unenviable position of the consortium members provoked Goldman's CEO to inquire rhetorically of Treasury: "How do I get in the other room." In other words, how do we get to acquire GoodCo while others backstop our losses." Although Treasury provided no answer, a likely answer was: Get there first.

149. Recall that JP Morgan also was required to guarantee Bear's trades even though it did not yet own the firm.

150. SORKIN, *supra* note 111, at 325.

151. *Id.*

clays drafted a deal for acquiring Lehman under which Barclays would invest \$3.5 billion for Lehman's "good" bank, which some referred to as GoodCo, and the consortium would use that capital to take over Lehman's troubled assets (i.e., BadCo). In addition to the \$3.5 billion from Lehman, the consortium would have to contribute approximately \$30 billion in additional capital to fund BadCo. Although the consortium was understandably displeased with the deal structure, they recognized that it might be the only alternative for saving Lehman and sparing themselves from the fallout that such a failure was sure to have on their respective businesses.¹⁵²

4. Consortium Ready to Buy BadCo but No Takers for GoodCo As U.S. Decides to Pull the Plug

Using the same risk avoidance incentive they applied with respect to the LTCM rescue, the consortium members tentatively agreed to raise the capital needed to take over Lehman's BadCo. While the consortium agreed to contribute enough capital to close the deal, Barclays' acquisition of GoodCo hit a regulatory snag ostensibly because the acquisition would violate a listing standard that applied to Barclays, as a publicly traded company. In the U.S., listing standards are rules adopted by the securities markets on which the listed company's shares are traded. The listing standard at issue in the Barclays instance, similar to those that apply to U.S.-listed firms, was a shareholder protection rule that required shareholder approval prior to an acquisition or guarantee of another firm's debt.¹⁵³ Had it wanted the deal to go through, the U.K. government no doubt could have formulated a waiver to the listing requirements, as U.S. regulators have done countless times for U.S.-listed firms. Nevertheless, the requirement proved a convenient excuse for slowing down a deal that undoubtedly made U.K. regulators nervous, particularly after they learned that Bank of America, the only other suitor for Lehman, had

152. *Id.* at 336–37.

153. Similar U.S. stock exchange rules were at issue with respect to JP Morgan's acquisition of Bear Stearns. Rules of the New York Stock Exchange, where Bear was listed, generally require shareholder approval before issuance of securities that are convertible into more than twenty percent of the outstanding shares of a listed company. The rules provide an exception, however, where the delay involved in obtaining shareholder approval would jeopardize the financial viability of the listed company. The Audit Committee of Bear's Board authorized Bear to rely on this exception in completing the JP Morgan acquisition. See Press Release, JPMorgan Chase & Co. & The Bear Stearns Companies Inc., Amended Agreement Between JPMorgan Chase and Bear Stearns (Mar. 24, 2008), <http://www.nysun.com/business/press-release-on-amended-agreement-between/73527/>.

ended negotiations.¹⁵⁴ Moreover, U.K. regulators and Barclays were particularly concerned about what appeared to be a precondition to a deal for Lehman that Barclays “guarantee” Lehman’s financial obligations in a manner similar to JP Morgan’s guarantee of Bear Stearns’ obligations.¹⁵⁵ Unlike the Bear Stearns transaction, however, the U.S. government was not prepared to backstop the Lehman deal, preferring an LTCM-type arrangement whereby the private consortium would capitalize Lehman’s BadCo. Given that the capital required to rescue Lehman’s BadCo was perhaps ten times greater than that for LTCM and that many of the consortium members were also struggling, it is perhaps no wonder that U.K. regulators objected to Barclays providing a potentially uncapped guarantee for the obligations of a U.S. company before the deal even closed.

With no buyer for Lehman’s GoodCo willing to provide a preclosure guarantee, the potential deal quickly unraveled, and U.S. regulators began pressuring Lehman to file for bankruptcy.¹⁵⁶ The shift in the government’s posture stunned the consortium, which apparently had already accomplished the hard part (i.e., agreeing to capitalize BadCo). In hindsight, it is baffling why U.S. regulators, when they realized that the U.K. would not sign off on a Barclays deal, did not simply adjust their mandate to the consortium to include GoodCo in the rescue plan. If the consortium itself were not willing or able to take on GoodCo, then presumably independent investors would have been willing to invest in Lehman’s most valuable assets without taking on any of its riskiest real estate holdings. Indeed, it was the very deal that the Korean Development Bank had sought before Lehman’s CEO killed the negotiations.¹⁵⁷ That left only the matter of the guarantee, which, although not an inconsequential matter, is certainly a quantifiable and insurable risk, particularly with the types of limitations that JP Morgan wrote into its amended agreement in acquiring Bear.¹⁵⁸ The consortium of banks that was willing to rescue Lehman’s GoodCo was undoubtedly in a much better position to understand the potential risks of guaranteeing Lehman’s assets until the deal closed than a single foreign firm such as Barclays would have been. Moreover, as unpalatable as it may have been to the U.S. government, extending Maiden Lane-type financing to the consortium (or preferably

154. Confusion over which U.S. regulator, Treasury or the SEC, was responsible for facilitating the issue with the U.K. only made matters worse. SORKIN, *supra* note 111, at 344–47.

155. Valukas Report, *supra* note 62, at 1526–27 n.5939.

156. Susanne Craig et al, *Ties that Long United Strongest Firms Unraveled as Lehman Sank Toward Failure*, WALL ST. J., Dec. 29 2008, at 1.

157. See *supra* note 128 and accompanying text.

158. See *supra* notes 99–101 and accompanying text.

a contingent thereof which consisted of the U.S. banks in the consortium) likely would have been more politically defensible than extending it to Barclays, a U.K. bank.

But alas, it was not meant to be. Under pressure from U.S. regulators, Lehman filed for bankruptcy.¹⁵⁹ Lehman's U.S. broker-dealer was permitted to continue trading out of its positions, but Lehman's affiliates in Europe and Asia were forced to cease operations immediately.¹⁶⁰ This action had a ripple effect for hedge funds that had collateral with those affiliates. Because Lehman had rehypothecated (i.e., reloaned) the hedge fund collateral, when the Lehman affiliates ceased operations it was a monumental task to determine who owned what assets. With the hedge fund collateral locked up, the hedge funds were forced to sell their most liquid assets at deflated prices and began withdrawing collateral from other banks.¹⁶¹ The resulting market swoon only exacerbated the liquidity crisis at AIG, which had a hole in its \$1 trillion balance sheet. In less tumultuous times, AIG, with its steady flow of premiums, likely could have weathered the storm with a private sector bridge loan until the commercial paper market stabilized. In the post-Lehman filing environment, however, where short-term financing was strained for even the strongest non-

159. On Sunday, September 14, 2008, "the SEC, with the support of the FRBNY and Treasury, all but directed Lehman to declare bankruptcy." Valukas Report, *supra* note 62, at 621 n.2202 and accompanying text. Lehman's holding company parent and a number of its U.S. affiliates filed for Chapter 11 bankruptcy on September 15, 2008. Lehman's U.K. broker-dealer filed for administration in the U.K. Lehman's U.S. broker-dealer operated until September 19, 2008, when it was placed into a liquidation under the Securities Investor Protection Act. FDIC, *The Orderly Liquidation of Lehman Brothers Holdings Inc. Under the Dodd-Frank Act*, 5 FDIC Q. 1, 3 n.16-17 (2011), available at http://www.fdic.gov/bank/analytical/quarterly/2011_vol5_2/lehman.pdf.

160. This fact may have been due more to the way in which Lehman was structured than to the regulations of European and Asian regulators. For example, the Lehman parent holding company out of New York entirely financed Lehman's European affiliate. All liquidity ran through the parent. Once Lehman's parent filed for bankruptcy, it stopped funding its European affiliate, which was taken into administration by U.K. regulators because of inadequate capitalization. *Id.* at 1355 nn.5987-91.

161. SORKIN, *supra* note 111, at 393-94. See also Jeffrey McCracken, *Lehman's Chaotic Bankruptcy Filing Destroyed Billions in Value*, WALL ST. J., Dec. 29, 2008, at A10. The bankruptcy filing by Lehman Holdings triggered a cascade of defaults at Lehman subsidiaries that held trading contracts, which created an "event of default" for Lehman's derivatives. The default resulted in the termination of over eighty percent of transactions with Lehman counterparties, including contracts in which Lehman was owed money. Losses from derivatives and related claims cost Lehman's unsecured creditors at least fifty billion dollars. Lehman's filing had an immediate adverse impact on its creditors, few more severe than Reserve Primary Fund, a sixty-two billion dollar money market fund that held \$785 million of Lehman's commercial paper. After Lehman's filing, investors fled the fund, redeeming forty billion dollars in two days. The Fund subsequently "broke the buck," repricing its shares at \$0.97 and causing hysteria among investors in the normally super safe investment. See FDIC *supra* note 159, at 3 nn.19-20.

financial firms (e.g., McDonald's), AIG was left with no options other than a GSE-type government takeover or a bankruptcy filing. After quick but careful consideration, AIG's board determined that twenty percent of something (the share that the government would leave to shareholders after the takeover) was better than one hundred percent of nothing (the share the Board feared would be left after a bankruptcy filing), and AIG was off to Maiden Lane.¹⁶²

In the end, Bank of America swallowed Merrill Lynch for what in hindsight appeared to be a generous premium, leaving only Goldman and Morgan Stanley as free-standing investment banks, both of which chose to subject themselves to regulation as bank holding companies to gain the ability of permanent access to the FRB's discount window and financing in the form of federally insured customer deposits, an idea that Geithner dismissed as "gimmicky."¹⁶³ Of course, Warren Buffett was one of the few winners who finally found a financial firm he felt comfortable investing in—Goldman Sachs—at a bargain price that not even Buffett could resist. Along the way, both Morgan and Goldman sought desperation funding from the likes of the Chinese Investment Corp. and the Industrial and Commercial Bank of China, among others.¹⁶⁴

E. *Take-Aways from Lehman's Bankruptcy*

1. Lehman Could Have Been Saved

There were a number of reasons why Lehman went bankrupt. Market conditions, managerial missteps, and political opposition to another bail-out certainly top the list. Another may have had to do with the fact that U.S. government officials genuinely did not believe they had the legal authority to recapitalize Lehman as they had helped to do with Bear. Chairman Bernanke told the Lehman bankruptcy examiner: "I speak for myself, and I think I can speak for others, that at

162. AIG actually took two trips to Maiden Lane. In addition to the eighty-five billion dollar credit facility that the FRBNY extended directly to AIG, the Government also lent \$37.8 billion to a special purpose vehicle to bail out AIG's securities lending business (Maiden Lane II) and \$24.3 billion to bail out AIG's unregulated over-the-counter derivatives business (Maiden Lane III). AIG also borrowed fourteen billion dollars from the FRB's Commercial Paper Funding Facility, a separate facility that the Government set up to stabilize the nation's commercial paper market. For all of 2008, AIG lost ninety-nine billion dollars, sixty-two billion dollars in the fourth quarter alone. See *American International Group: Examining What Went Wrong, Government Intervention, and Implications for Future Regulation, Hearing before the S. Comm. on Banking, Hous., and Urban Affairs, 111th Cong.* 44–49 (2009) (statement of Donald L. Kohn, Vice Chairman, Board of Governors of the Federal Reserve System). With so much traffic, it is surprising that Maiden Lane was not renamed "Floozy Court."

163. See *supra* note 125.

164. SORKIN, *supra* note 111, at 445, 456.

no time did we say ‘We could save Lehman but we won’t.’ Our concern was about the financial system, and we knew the implications for the greater financial system would be catastrophic, and it was.”¹⁶⁵ Chairman Bernanke did not believe that the FRB had the legal authority to bail out Lehman because he did not believe that the FRBNY could lend to Lehman because Lehman had no collateral to secure such a loan.¹⁶⁶ Treasury Secretary Paulson concurred.¹⁶⁷

The reasons for Lehman’s failure did not necessarily preclude a private sector rescue of the firm. Unlike the GSEs and AIG, which had dug such large holes that it would have been nearly impossible to raise the capital needed to save them privately under crisis timing, the private sector could have rescued Lehman. In committing to capitalize BadCo with \$33 billion, the consortium was already most of the way there. Raising the remaining \$3.5 billion to include Lehman’s GoodCo in the deal was doable, either within the consortium membership or through a side deal with a hedge fund or a sovereign wealth fund. The main sticking point for Barclays and its U.K. regulators appeared to be an insistence on the part of U.S. regulators that Barclays guaranty Lehman’s obligations much in the same way that JP Morgan guaranteed Bear’s. Whereas the U.S. government was willing to provide \$30 billion to finance the Bear acquisition, it was, at least openly, unwilling to provide such financing to Barclays. U.S. regulators may have considered and rejected an all-consortium deal for Lehman, with or without Maiden Lane financing, but I could find no public record of such deliberations.

165. Valukas Report, *supra* note 62, at 1504 n.5838. Although Chairman Bernanke himself was concerned that the impact of Lehman’s failure would be severe, others thought it would be less so. *See id.* at 1504 nn.5839–41 and accompanying text (Chairman Bernanke recalled there being a “range of views” on the likely severity of the impact of Lehman’s collapse. Some believed it would be “a minor disruption” (*i.e.*, 1-15 on a scale of 1-100) and others, including Chairman Bernanke, believed it would be in the 90-95 range. The actual effect turned out to be “maybe 140 . . . worse than almost anybody expected.”).

166. *Id.* at 1503 nn.5831–33. In July 2008, staff at the FRBNY developed a “Maiden Lane type vehicle” for Lehman, similar to the one used to rescue Bear. Under the proposal, FRBNY would create a special purpose vehicle to take sixty billion dollars in illiquid assets off of Lehman’s books. The FRBNY would backstop the assets by five billion dollars in Lehman equity. The FRBNY ultimately decided not to extend the Maiden Lane vehicle to Lehman. *See id.* at 1500 nn.5814–5821. In hindsight, however, FRBNY President Geithner concurred with Chairman Bernanke and Secretary Paulson that there was nothing that the FRBNY could have done at the time to save Lehman. *Id.* at 1502 n.5822.

167. *Id.* at 1506 n.5849. Paulson distinguished Lehman from Bear because, unlike Bear which had a “willing” buyer in JP Morgan, Lehman did not. Given that JP Morgan was unwilling to invest in Bear until the FRB committed to provide thirty billion dollars in financing and remove Bear’s risky real estate portfolio from Bear’s balance sheet Paulson’s comparison between Bear and Lehman begs the question of what it means to be a “willing” buyer. *See supra* notes 87–89 and accompanying text.

2. Lehman's Liquidation Should Have Been Managed Better

Lehman's failure sent a clear message to the markets and to financial firms that they could not rely on the government to bail them out. In that regard, the failure may have achieved short-term public policy benefits.¹⁶⁸ These benefits alone, however, do not appear to justify the great wealth destruction that occurred due to the way in which the bankruptcy was carried out. By one estimate, as much as \$75 billion of Lehman's value was destroyed by the unplanned and chaotic bankruptcy filing.¹⁶⁹ Losses suffered by entities with no connection to Lehman was likely far greater. An executive of the advisory firm that managed Lehman's estate stated, "While I have no position on whether or not the federal government should have provided further assistance to Lehman, once the decision was made not to provide further assistance, an orderly wind-down plan should have been pursued. It [the chaotic liquidation] was an unconscionable waste of value."¹⁷⁰

While reasonable people may disagree over whether Lehman should have been allowed to fail, few would argue that the process by which that failure occurred was necessary or productive. Much of the blame for the ugliness of the process (and the resulting costs) likely can be attributed to the fact that regulators responsible for making the ultimate call about Lehman's future had few attractive alternatives for addressing the problem. One regulatory agency noted that at the time of Lehman's failure "there was no common or adequate statutory scheme for the orderly liquidation of a financial company whose failure could adversely affect the financial stability of the United States."¹⁷¹ In Title II of the Dodd-Frank Act, Congress enacted such a scheme. While this statutory scheme and the agency rules promulgated under it will surely go a long way to provide regulators with the needed tools to address future instances of financial firm failures, the scheme does not preclude the need for a formalized alternative private-sector approach. Indeed, certain provisions of the statutory scheme could make such a private-sector approach all the more ap-

168. Assertions that Lehman's failure struck a blow against moral hazard are undercut by the fact that prior to the bankruptcy filing the NYFRB lent Lehman over forty-six billion dollars in an effort to prop up the firm. In the subsequent sale of Lehman to Barclays, the NYFRB was paid back in full, much to the chagrin of other creditors who stand to recoup "dimes on the dollar." Jeffrey McCracken & Mike Spector, *Lehman's Legacy: Fed Draws Court's Eyes in Lehman Bankruptcy*, WALL ST. J., Oct. 2, 2009, at C1.

169. See McCracken, *supra* note 161.

170. *Id.*

171. Orderly Liquidation Authority Provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act, 76 Fed. Reg. 4207, 4207-08 (Jan. 25, 2011) (to be codified at 12 C.F.R. pt. 380).

pealing. For this reason, it is worthwhile to consider the formulation of a regulatory structure to facilitate private sector rescues of distressed, systemically important non-bank financial firms.

IV. DODD-FRANK ACT ORDERLY LIQUIDATION FRAMEWORK

A thorough analysis of the Dodd-Frank orderly liquidation provisions is beyond the scope of this article.¹⁷² Nevertheless, it is important to understand the basic structure of the framework as well as certain limitations in it that may warrant the development of the type of private sector alternative that this article advocates.

Prior to enactment of Dodd-Frank, “there was no common or adequate statutory scheme for the orderly liquidation of a financial company whose failure could adversely affect the financial stability of the United States.”¹⁷³ Instead, there were several different liquidation frameworks that applied, depending on the type of institution that was to be liquidated: First, insured depository institutions were subject to an FDIC-administered receivership under the Federal Deposit Insurance Act. Second, insurance companies were subject to insolvency proceedings under state law. Third, registered broker-dealers were subject to the U.S. Bankruptcy Code and proceedings under the Securities Investor Protection Act. Finally, other companies (including parent holding companies of any of the above) were “eligible to be a debtor under the U.S. Bankruptcy Code.”¹⁷⁴

These disparate insolvency regimes were found to be “inadequate to effectively address the actual or potential failure of a financial company that could adversely affect economic conditions or financial stability in the United States.”¹⁷⁵ Rather than attempt to consolidate or harmonize the diverse and many regimes, Dodd-Frank added another

172. DAVID A. SKEEL, *THE NEW FINANCIAL DEAL: UNDERSTANDING THE DODD-FRANK ACT AND ITS (UNINTENDED) CONSEQUENCES* (2011). Put mildly, Professor Skeel, who advised Congressional staff on the drafting of Dodd-Frank, is not a fan of the new law. He contends that the new law “enshrines a system of ad hoc interventions by regulators that are divorced from basic rule-of-law constraints.” *Id.* at 9. He is particularly critical of the orderly liquidation provisions. Professor Skeel implies that the Dodd-Frank threshold for taking over a struggling bank is too low and that once the institution is in government hands the FDIC can pick and choose which creditors will get paid in full and which will be left with the dregs. *Id.* at 152. Although he finds “the overall pattern of the legislation is disturbing” he believes that “a handful of its contributions [the new framework for clearing derivatives and trading them on exchanges and the new Consumer Financial Protection Bureau] could genuinely improve the regulatory landscape.” *Id.* at 14.

173. Orderly Liquidation Authority Provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act, 76 Fed. Reg. at 4208.

174. *Id.*

175. *Id.*

in Title II of the Act. The new liquidation authority is intended to provide the FDIC with the same type of powers it already possesses with respect to commercial banks.¹⁷⁶

Many of the provisions remain controversial and their application will no doubt be politically sensitive. However, the process is as follows: (1) predetermination by regulators of which financial institutions are systemically important;¹⁷⁷ (2) recommendation by the FRB and the FDIC that the Treasury Secretary appoint the FDIC as receiver for a systemically important financial institution that is in default or in danger of default (the recommendation must be made with the SEC (for a broker-dealer or an entity whose largest U.S. subsidiary is a broker-dealer) or the Director of the new Federal Insurance Office (for an insurance company or an entity whose largest U.S. subsidiary is an insurance company));¹⁷⁸ (3) determination by the Treasury Secretary (in consultation with the President), based on certain findings, that the financial company should be placed into receivership.¹⁷⁹

176. See Skeel, Jr. & Jackson, *supra* note 57, at 45.

177. The “systemically important” determination is to be made jointly by the agency heads that make up the newly created “Financial Stability Oversight Council.” Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, §§ 111, 804, 124 Stat. 1376, 1392, 1807 (codified at 12 U.S.C. § 5321 and 12 U.S.C. § 5463 (2010)).

178. *Id.* § 203 (codified at 12 U.S.C. § 5383).

179. *Id.* § 203(b). There are several findings that must form the basis of the determination: (1) the company is in default or in danger of default; (2) the failure of the company and its resolution under other applicable federal or state law would have “serious adverse effects on financial stability” in the United States; (3) no viable private sector alternative is available to prevent the default; (4) effects on the interests of the company’s creditors, counterparties and shareholders, and other market participants is “appropriate” given the impact that any action taken under these provisions of Dodd–Frank would have on financial stability in the United States; (5) any action taken pursuant to the FDIC’s appointment as receiver (Dodd–Frank § 204) would avoid or mitigate such adverse effects (taking into consideration the effectiveness of the action in mitigating potential adverse effects on the financial system, the costs of the general fund to the Treasury and the potential to increase excessive risk taking by creditors, counterparties and shareholders of the company (*i.e.*, moral hazard)); (6) a federal regulatory agency has ordered the company to convert all of its convertible debt instruments that are subject to the regulatory order; and (7) the company must meet the Dodd–Frank definition of a “financial company” under Dodd–Frank § 201. *Id.* §§ 203–204 (codified at 12 U.S.C. §§ 5383, 5384). Subparagraph (6) apparently relates to a provision in Dodd–Frank § 165(c) that authorizes the FRB to issue regulations that require nonbank financial companies that the FRB supervises and certain bank holding companies to maintain a certain amount of contingent capital that is convertible to equity in times of financial stress. *Id.* § 203. Under Dodd–Frank, a “financial company” is a (i) bank holding company, (ii) a nonbank financial company supervised by the FRB, (iii) any company that is “predominantly engaged in” activities that the FRB has determined are financial in nature or incidental thereto (other than (i) or (ii)); (iv) any subsidiary of (i) through (iii) that the FRB determines is predominantly engaged in activities that are financial in nature or incidental thereto (other than an insured depository institution or an insurance company) (Farm Credit Systems are excluded from the definition). Dodd–Frank Act, § 201(a)(11) (codified at 12 U.S.C. § 5381).

After determining that a financial company satisfies the criteria for receivership, the Secretary must notify the FDIC and the financial company.¹⁸⁰ The company's board of directors may consent or acquiesce to the appointment of the FDIC as receiver.¹⁸¹ If the board consents or acquiesces, the Secretary may make the appointment without going to court. If the board does not, then the Secretary must petition the U.S. District Court for the D.C. Circuit for an order authorizing the appointment.¹⁸² The court reviews whether the Secretary's decision was arbitrary and capricious in two of his determinations: first, whether the financial company was "in default or in danger of default;"¹⁸³ second, whether the company satisfied Dodd–Frank's definition of "financial company."¹⁸⁴ If the court determines that the Secretary's determination with respect to these two findings was not arbitrary and capricious, then it will authorize the Secretary to appoint the FDIC as receiver.¹⁸⁵

The FDIC's authority as receiver under Dodd–Frank is provided in section 204, which highlights that it is the purpose of the orderly liquidation provisions to "provide the necessary authority to liquidate failing financial companies that pose a significant risk to the financial stability of the United States in a manner that mitigates such risk and minimizes moral hazard."¹⁸⁶ To the extent that fair treatment of creditors or customers of the failing firm are to be considered in carrying out the liquidation authority, they are clearly subordinate under Dodd–Frank to the twin goals of mitigating financial stability risk and minimizing moral hazard. To that end, Congress is clear that the FDIC must exercise its authority for three reasons: (1) shareholders and creditors will bear the financial company's losses; (2) management responsible for the failure of the financial company will not be retained; and (3) the FDIC (and other applicable agencies) will take all steps "necessary and appropriate" to assure that all parties responsible for the failing firm's condition will bear the losses.¹⁸⁷ Such action

180. *Id.* § 202(a)(1)(A)(i).

181. Board members are not liable to the financial company's shareholders or creditors for acquiescing or consenting in good faith to the appointment of the FDIC as receiver. *Id.* § 207 (codified at 12 U.S.C. § 5387).

182. *Id.* § 202(a)(1)(A)(i) (codified at 12 U.S.C. § 5381).

183. *Id.* § 203(c)(4) (codified at 12 U.S.C. § 5383).

184. *See* Dodd–Frank Act § 202(a)(1)(A)(iii).

185. *Id.* § 202(a)(1)(A)(iv)(II). If the court does not rule within twenty-four hours of receiving the Secretary's petition, then the petition shall be granted "by operation of law." *Id.* § 202(a)(1)(A)(v).

186. *Id.* § 204(a) codified at 12 U.S.C. § 5384).

187. *Id.* § 204(a)(1)-(3).

may include restitution, actions for damages and recoupment of compensation.

Dodd–Frank leaves scant room for innocent bystanders and victims of circumstances. Heads will roll if a company is in default, or if it risks default and is important enough to pose a significant risk to the financial stability of the United States. Additionally, Dodd–Frank and the FDIC’s interpretation of it are clear that Dodd–Frank permits the FDIC to pay certain creditors of a receivership more than similarly situated creditors if the FDIC deems such action is necessary to (1) maximize the value of (or minimize the loss from the sale of) assets; and (2) initiate and continue operations of the receivership and any bridge financial company.¹⁸⁸ To be sure, the FDIC has provided assurance that only a “limited group” of creditors would be entitled to additional payments under Dodd–Frank’s “strict standards,” that certain categories of creditors would never be entitled to such additional payments (e.g., creditors holding certain unsecured senior debt with a term more than 360 days), and that, at a minimum, creditors under the Dodd–Frank liquidation provisions will receive no less than the creditor would have received under Chapter 7 of the Bankruptcy Code.¹⁸⁹ Nevertheless, the FDIC concedes that the orderly liquidation authority under Dodd–Frank would be a remedy of last resort to be used only after other remedies are unable to stave off failure. The FDIC anticipates that the mere knowledge of the consequences of a Title II resolution would encourage a struggling firm to find an acquirer or

188. See Dodd–Frank Act §§ 210(b)(4), (d)(4) (h)(5)(E) (codified at 12 U.S.C. § 5390); see also Orderly Liquidation Authority Provisions of the Dodd–Frank Wall Street Reform and Consumer Protection Act, 76 Fed. Reg. 4207, 4211 (Jan. 25, 2011) (to be codified at 12 C.F.R. pt. 380). Dodd–Frank authorizes the FDIC to transfer certain contracts of the failing firm (e.g., securities contracts, repos, and swaps) to a new entity such as a bridge financial company to avoid termination of those contracts. FDIC, *supra* note 159, at 6 nn.30–31 and accompanying text. According to the FDIC, “[t]he bridge financial company is a completely new entity that will not be saddled with the shareholders, debt, senior executives or bad assets and operations that led to the failure of the covered financial company.” Orderly Liquidation Authority Provisions of the Dodd–Frank Wall Street Reform and Consumer Protection Act, 76 Fed. Reg. at 4209. The authority to charter a bridge financial company, authority similar to that which the FDIC has under the FDIA with respect to insured depository institutions, is reminiscent of the GoodCo/BadCo structure that the private consortium considered as a way to wall off Lehman’s good assets from its bad.

189. Orderly Liquidation Authority Provisions of the Dodd–Frank Wall Street Reform and Consumer Protection Act, 76 Fed. Reg. at 4211. The FDIC’s guidance about how it will likely interpret the Dodd–Frank liquidation priorities appears intended to address lingering concerns that those provisions may be applied in a manner that unfairly favors short-term creditors over long-term creditors of the failing financial firm in the name of promoting financial stability. See, e.g., SKEEL, *supra* note 172, at 11 (“If regulators do take over a large financial institution under their resolution authority, they can evade the bankruptcy-like provisions by simply agreeing to pay favored creditors in full under the FDIC’s *carte blanche* to cherry-pick among creditors”).

partner prior to a failure.¹⁹⁰ Indeed, Dodd–Frank requires the Secretary to determine whether such private sector alternatives are available before deciding whether the FDIC should be appointed as receiver.¹⁹¹ One such possible alternative is proposed below.¹⁹²

V. REGULATORY FRAMEWORK TO FACILITATE PRIVATE SECTOR
RESCUES OF DISTRESSED NON-BANK FINANCIAL FIRMS—
A LIQUIDITY CONSORTIUM APPROACH

The LTCM rescue and the Financial Crisis of 2007–2008 clearly show that, from time-to-time, there will be a need to access, on an emergency basis, a substantial amount of capital to avert far greater capital destruction and the resulting loss of investor confidence. The capital might be necessary to facilitate an orderly winddown of the firm in a manner that is most efficient in terms of minimizing wealth destruction or the capital may enable the struggling firm to be rehabilitated, either as a whole or in parts. Regulatory means are in place under the FDIA to address a failing bank or other insured depository institution.¹⁹³ Moreover, under Dodd–Frank, an untested mechanism is in place to isolate the impact of a failure of a systemically important non-bank, which emphasizes loss absorption by creditors and shareholders of that entity.¹⁹⁴ Such a structure was politically feasible at the time Congress enacted the law, but it is at best a last ditch approach for unwinding a troubled firm that has no other viable alternative for saving itself. Now that the crisis that gave rise to Dodd–Frank has dissipated, critics of the Act generally, and of the liquidation provisions specifically, have gained momentum. Unlike the FDIA provisions for liquidating insured depository institutions, which provide the popular safeguard of guaranteeing customer deposits, the benefits of the Dodd–Frank provisions are much more tenuous from the perspective of an average citizen, thereby making the Dodd–Frank provisions more susceptible of efforts to roll them back. Even if critics of Dodd–Frank are unsuccessful in repealing or significantly diluting the liquidation provisions of the Act, Dodd–Frank will continue to be an

190. See Sheila C. Blair, *We Must Resolve to End Too Big to Fail*, 5 FDIC Q. 25, 31 (2011); FDIC *supra* note 159, at 19.

191. Dodd–Frank Act § 203(b)(3) (codified at 12 U.S.C. § 5383).

192. Dodd–Frank does not define the term “private sector alternative.” Given that the liquidity consortium framework proposed below could include some Government incentives, to avoid uncertainty, it would be necessary to clarify that any private liquidity consortium formed pursuant to the proposed regulation would qualify as a private sector alternative for purposes of Dodd–Frank.

193. Dodd Frank Act § 363 (codified at 12 U.S.C. § 1811 (2010)).

194. *Id.* § 204(a)(1) (codified at 12 U.S.C. § 5384 (2010)).

imperfect means for addressing the likely future occurrence of the failure of a systemically important financial firm. Therefore, it is worthwhile to discuss alternative approaches to addressing such an impending failure.

Despite the Lehman experience, ad hoc consortia will likely continue to play an important role in financial firm rescues. As the LTCM experience highlights, private sector consortia are capable of assembling, in a short time frame, the means to raise sufficient capital to facilitate the orderly winddown of a large, struggling financial firm. Arguably, such a framework was well on its way toward facilitating an orderly winddown of Lehman and could have completed the task had U.S. regulators been willing to help backstop the transaction. The sticking point—the insistence on a preclosure guarantee of certain of Lehman’s obligations—had it been vetted and sized in advance, might have proven far less daunting to potential liquidity providers such as hedge funds and sovereign wealth funds, than it appeared to Barclays and its U.K. regulators.¹⁹⁵

Ultimately, the guarantee was nothing more than a short-term insurance policy to comfort Lehman’s counterparties and creditors to assure them that the sky would not fall from the time a consortium inked a deal until the deal closed. By way of comparison, after an initial drafting hiccup with respect to the drafting of the JP Morgan–Bear Stearns guarantee, the guarantee itself appeared to cause little concern for JP Morgan’s shareholders who viewed the bank as landing a sweetheart deal.¹⁹⁶ If U.S. regulators were concerned about a potential Lehman consortium taking on the additional risk of a guar-

195. Margaret Coker & Liz Rappaport, *Libya’s Goldman Dalliance Ends in Losses, Acrimony*, WALL S. J. (May 31, 2011), <http://online.wsj.com/article/SB10001424052702304066504576347190532098376.html>. Of course, investments from sovereign wealth funds raise their own unique set of concerns. A study of sovereign wealth fund investment patterns highlighted some of these concerns. BERNARDO BORTOLOTTI ET AL., SOVEREIGN WEALTH FUND INVESTMENT PATTERNS AND PERFORMANCE 1–62 (2009). The study examined thirty-three funds that control assets of over two trillion dollars. Fourteen of the funds were created after 2004. Most of this growth was fueled by petroleum-related trade surpluses earned by state-owned enterprises primarily based in non-Western, non-democratic countries. Their investments were typically large, risky, cross-border, and often were concentrated in such politically sensitive areas as banking, energy, and telecommunications. American companies attracted about half of all investments from sovereign wealth funds and about one third of the total value (\$58.3 billion of \$181.6 billion invested). Much of this investment was focused on U.S. financial companies. Although sovereign wealth fund investors tend to be long-term investors, they are typically poor at monitoring management and may even exacerbate conflicts between management and minority shareholders by freeing management from effective oversight, often because of the perception of the sovereign funds meddling in foreign operations. A recent high-profile case underscores the thorny issues that such investments raise. Coker & Rappaport, *supra* note 195.

196. See Davidoff, *supra* note 91.

antee, it would not have been difficult to imagine a separate side deal between the consortium and other liquidity providers, a few of whom had already done the due diligence on Lehman, taking on the guarantee in the form of a swap. Such a framework could have worked effectively to preserve Lehman and avoid much of the fall-out from its liquidation.

Nevertheless, ad hoc consortia, particularly those facilitated through emergency government action, have a number of drawbacks. For example, any government involvement in facilitating the consortium will create the appearance that the government is bailing out the struggling firm. Even in the case of LTCM, where, in relation to the Financial Crisis, the U.S. government's involvement was minimal, the public and some in Congress still viewed the rescue of LTCM as somehow involving a government bail out. While the perception of a government bail out was concerning in its own right, when done on an ad hoc basis, the action raised the question of whether the government was picking winners and losers. If Bear Stearns should be saved, then why shouldn't Lehman? Ultimately, this concern may have been the driving force in the government's unwillingness to backstop a Lehman deal. Unfortunately, the fallout rippled far beyond Lehman's stakeholders.

Moreover, an ad hoc approach will inevitably risk a free rider problem, illustrated in the LTCM context by Bear Stearns' non-participation. Finally, an ad hoc approach, by definition, allows no formalized means for accessing potential liquidity, such as capital from hedge funds, the offers of which during the Financial Crisis often raised suspicion from distressed firms which feared (sometimes justifiably) that the hedge fund was merely bottom-fishing or seeking information upon which it could build a short position to drive the target firm's stock lower.¹⁹⁷

Ultimately, an important lesson of the Financial Crisis seems to be that, where a systemically important institution is involved, a purely hands-off approach by the government is neither workable nor wise. Because it is in the public interest that such entities be unwound in an orderly manner, then, by necessity, there will be some government involvement. What is less certain is whether that involvement must reach the scale of that envisioned by Dodd-Frank, or whether, as proposed below, there is a middle ground between a hands-off ad hoc approach and an all out Dodd-Frank liquidation.

197. See *supra* note 67 and accompanying text.

A. *How a Liquidity Consortium Might Work*

The liquidity consortium approach envisioned in this article would be a bundle of rights and responsibilities that would apply to private firms that might be willing and able to participate in a liquidity consortium assembled for the purpose of recapitalizing or facilitating the winding down of a struggling, non-bank financial firm. For simplicity, this bundle of rights and responsibilities is referred to as Regulation LC (or Reg. LC) for liquidity consortium.

Reg. LC would establish, among other requirements, eligibility criteria for consortium members. Membership could be two-tiered, one set of criteria for LC “sponsors” and another for members that are not sponsors. The base membership requirement could recognize firms based on financial sophistication. A number of existing economic sophistication standards could be adapted for this purpose.¹⁹⁸

At least one member of the consortium would be required to meet the stricter standards of a LC “sponsor.” The sponsor would be the party legally responsible for meeting the requirements of the LC designation. In other words, the sponsor would be the regulator “hook” on the consortium. Banks, broker-dealers, and other regulated financial institutions that met the financial sophistication requirements would be the most obvious candidates to serve as consortium sponsors. Hedge funds, other private equity firms, and non-U.S. financial institutions (including sovereign wealth funds) could qualify as LC members so long as they met the financial sophistication requirements. They could not, however, serve as sponsors.

The LC process could be invoked by the sponsor filing a notice with the Treasury Department (or other appropriate regulatory agency) notifying the government that an LC had been formed with respect to a particular target firm. The filing would identify the target firm, whether it was publicly traded, whether it was regulated and, if so, by whom. The filing would identify all members of the consortium and represent that all members met whatever criteria that were established to be such a member. The filing could also include an explanation of why a liquidity consortium was appropriate for this firm (e.g.,

198. See Securities Act of 1933, 17 C.F.R. § 230.144A(a)(1) (2011); Securities Exchange Act of 1934, 17 C.F.R. § 240.15(a)(6)(A)(4) (2011). For example, firms that wished to be consortium members might be required to meet the same sophistication standards as those required of “major U.S. institutional investors” or “qualified institutional buyers” as those terms are defined under the U.S. securities laws. See Securities Exchange Act of 1934, 17 C.F.R. § 240.15a-6(a)(4) (indicating that entities that have or have under management total assets in excess of \$100 million); Securities Act of 1933, 17 C.F.R. § 230.144A(a)(1) (indicating that entities that own and invest at least \$100 million in securities of unaffiliated issuers).

the company is in default or in danger of default). The notice could also include an explanation of why a liquidity consortium approach would be preferable to a Bankruptcy Code filing or a Dodd–Frank liquidation.

The sponsor could also be required to represent that it had segregated a certain amount of “good faith” capital to ensure that it had sufficient “skin in the game” to facilitate a recapitalization or winding down of the distressed firm.¹⁹⁹ If a preclosure guarantee were deemed necessary, the sponsor could also represent that it was prepared to make the necessary guarantee if the consortium and the struggling firm reached an agreement, the details of which could be worked out with the appropriate regulator or regulators.

B. *Proposed Incentives To Encourage Industry Participation in a Liquidity Consortium*

While the existence of a formalized liquidity consortium framework could, in and of itself, be beneficial by providing some certainty to a necessarily messy liquidation process, its effectiveness could be greatly enhanced by adding certain incentives to encourage industry participation and acceptance.

By way of illustration, the filing of the Liquidity Consortium notice discussed above could trigger the following benefits to industry participants. Filing the LC notice could entitle LC members to (1) a suspension of short selling rules for target company shares, which many of the struggling firms blamed for the speed of their demise;²⁰⁰ (2) a moratorium on rating agency downgrades, which can trigger collateral calls;²⁰¹ (3) exemptions from antitrust laws for consortium members; (4) special tax treatment for any resulting deal done through the auspices of the LC structure; (5) right of first refusal should a competing bidder surface; and (6) access to public financing under certain limited circumstances and with respect to certain struggling entities. For part (6), public financing could include LC sponsor access to the FRB’s discount window during the period from the announcement of a deal

199. The filing of an LC notice (and good faith deposit or segregation) should not preclude consortium members from betting against the target firm, so long as filing the LC notice were not done merely with the intent of gathering information to undermine the struggling firm.

200. See, e.g., Patrick Fitzgerald & Mike Spector, *Lehman: Och-Ziff Helped Spread Rumors*, WALL ST. J. (Aug. 13, 2010), <http://online.wsj.com/article/SB10001424052748704407804575425470563638134.html>.

201. Rating agency downgrades can require a firm to tie up billions of dollars in additional capital and trigger counterparty termination payment obligations. See, e.g., Bret Philbin, *Morgan Stanley Notes a Cost of a Moody’s Cut*, WALL ST. J. (Feb. 28, 2012), <http://online.wsj.com/article/SB10001424052970204520204577249862876265478.html>.

until the deal closes, a period during which, if the sponsor agreed to a preclosure guaranty, the sponsor would be on the hook for the struggling firm's trades, and, in light of the MF Global failure, perhaps its compliance with customer fund segregation requirements.²⁰²

Any government involvement in the rescue of a struggling firm would, of course, raise the specter of a bail-out. For that reason, any liquidity consortium model would need to carefully prescribe and target potential government involvement in the liquidation or dissolution of a firm. In this regard, under the proposal, the government's role could be limited to (1) dictating disclosure requirements for LC sponsors; (2) administering transaction-specific regulatory safe harbors (e.g., antitrust exemption, short selling suspension, and credit rating suspensions); and (3) authorizing credit extensions in limited circumstances. Part 3's limited circumstances could obtain (a) where failure of target in the context of existing market conditions would likely result in systemic risk; (b) where the LC sponsor seeking the credit extension was already authorized to access the Discount Window; and (c) where the credit extension was contingent upon a determination consistent with FRB Regulation A²⁰³ that such credit was necessary to facilitate the orderly resolution of the serious financial difficulty of the struggling firm. Risk of loss would ultimately be borne by the liquidity consortium and underwritten by the LC sponsor.

C. *Benefits of a Liquidity Consortium Approach*

The liquidity consortium approach provides a number of possible benefits: establishing prequalified sources of capital; promoting regulatory accountability by delimiting regulatory involvement; preserving capital and jobs by providing breathing room for the distressed firm to facilitate a deal or wind down in an orderly manner; preventing a crisis from worsening by providing a mechanism for attracting private sources of liquidity; and postponing and potentially avoiding the uncertain and potentially draconian alternative of a resolution under the Dodd–Frank orderly liquidation provisions. The filing of an LC notice could serve as an informal stay of the Dodd–Frank liquidation process, particularly if the regulators recognized the LC framework under Dodd–Frank as a “private sector alternative.”²⁰⁴

202. For a discussion of MF Global, *see infra* Part F.

203. Availability and Terms of Credit, 12 C.F.R. § 201.4(b).

204. *See supra* notes 191–93 and accompanying text.

D. *What Likely Message Would Participation of a Liquidity Consortium Send to the Markets?*

While Reg. LC could allow the sponsors to file the LC notice without disclosure to the public (at least for a limited time), it is unrealistic to assume that the markets would not be alerted to the fact that a consortium was forming. Therefore, it is important to consider the potential message that the formation of such a consortium would send to the markets regarding the struggling firm. Recall that the initial government financing for Bear only expedited the firm's decline, whereas news of a potential investment from Buffett buoyed Goldman Sachs.

The message that the formation of an LC would send depends on the perceived motivation of the members. Is the consortium a surrogate for a government-funded bail-out, similar to JP Morgan's takeover of Bear, or a market-driven assessment of the distressed firm? The message would also be impacted by the perceived reasons for the LC formation. For example, is the failure of the firm a systemic threat? Is it a strategic fit for an LC member? Is it a good investment opportunity for a savvy investor? Ultimately, the circumstances would dictate the message. A potential factor that might suggest that the message would tend to be more positive than negative, all things being equal, is that the filing of an LC notice could suggest to the markets that the more uncertain process of a Dodd-Frank liquidation would be delayed and potentially avoided.

E. *Should a "Hostile" LC Filing Be Permitted?*

Instances could occur where a struggling firm (or its management) believed that it could get a better deal in bankruptcy or by holding out for a possible government bail-out. The GSEs, Lehman, and AIG all considered these alternatives. All decided to do as the government advised. In the future, other firms might not. The Dodd-Frank liquidation provisions give the government more formal authority to force a firm into liquidation, but they only apply to large firms that pose a financial stability risk. Moreover, they do not preclude a preemptive bankruptcy filing. This possibility raises the issue of whether a consortium, creditors, or other stake holders should be permitted to make a "hostile" liquidity consortium filing (i.e., seek to recapitalize or wind down a struggling firm without the firm management's consent or acquiescence). Depending on the circumstances, such a filing might be warranted depending on the financial condition of the target and the impact that its failure might have on the stake holders and on the

markets. Therefore, the LC model should not preclude formation of a liquidity consortium where firm management does not consent.

F. *Didn't MF Global's Failure Prove that Lehman Was Just a Fluke?*

Fast forward to 2011. The dust had barely settled on the Financial Crisis when yet another financial firm—MF Global—found itself highly leveraged and on the wrong side of questionable investments in European sovereign debt while some of the European countries that issued the debt faced a financial crisis of epic proportions.²⁰⁵ In June of 2011, the Financial Industry Regulatory Authority (FINRA) informed MF Global that the SEC's Net Capital Rule required that the firm post additional capital to cover the risk to the firm from certain repos MF Global had entered into that were collateralized by the debt of certain European countries.²⁰⁶ MF Global disputed FINRA's inter-

205. Jon Corzine, MF Global's CEO at the time of its demise, would likely take exception both to the above characterization of MF Global's sovereign debt investments as "shaky" and to the assertion that MF Global was "highly leveraged" under his watch. See *Hearing to Examine the MF Global Bankruptcy, Before the H. Comm. on Agric., 112th Cong.* 67 [hereinafter *Hearing to Examine MF Global Bankruptcy*] (statement of Hon. Jon S. Corzine, Former Chief Executive Officer, MF Global Inc.) (2011) ("During my tenure [MF Global's leverage] was consistently around 30"). Three of the five European countries whose debt MF Global held (Italy, Spain and Belgium) were rated at least AA when MF Global invested, although the debt of the other two countries, Ireland and Portugal, was "lower rated." *Id.* at 68. He also apparently took solace in the fact that the debt might have been backed by the European Financial Stability Facility. See Aaron Lucchetti, *MF Global Told to Boost Capital*, WALL ST. J. (Oct. 17, 2011), <http://online.wsj.com/article/SB10001424052970203658804576635361082548304.html>. Considering that both Lehman and Bear had thirty times leverage shortly before they collapsed, it may be fair to surmise that 30 times leverage is sufficient (although not necessarily certain) to bankrupt a firm. See *supra* notes 48 & 120 and accompanying text. At fifty-to-one leverage or greater LTCM was just showing off. See *supra* note 17. Moreover, relying on a rating agency to support the creditworthiness of a particular issuer—even one of the caliber of say, Portugal, seems so 1990s. Moreover, unlike the type of overnight and other short-term repos (often collateralized by U.S. Treasury securities) that many firms entered into during the Financial Crisis and continue to enter into today to finance their daily operations, the repos that MF Global was required to take a capital charge against were a special type of repo called repos to maturity (RTMs) with maturity dates that extended out to June 2012 for the Irish and Portuguese debt and to December 2012 for the Italy, Spain, and Belgium debt. *Hearing to Examine MF Global Bankruptcy, supra* note 205, at 68–69.

206. *The Collapse of MF Global, Hearing Before the Subcomm. on Oversight and Investigations of the H. Comm. on Fin. Servs., 112th Cong.* [hereinafter *Hearing: The Collapse of MF Global*] (testimony of Richard G. Ketchum, Chairman and Chief Executive Officer, FINRA) (2011). MF Global was registered with the SEC as a broker-dealer and with the Commodity Futures Trading Commission (CFTC) as a futures commission merchant (FCM). In addition to being a member of FINRA, MF Global was also a member of the Chicago Board Options Exchange, Inc. (CBOE) and the Chicago Mercantile Exchange (CME), which was the designated self-regulatory organization (DSRO) for MF Global's futures business. *Id.* at 3 (testimony of Terrence A. Duffy, Executive Chairman, CME Group, Inc.). As such, MF Global was subject to the rules of each of these self-regulatory organizations. The SEC had designated CBOE as the

pretation of the SEC's rule, but ultimately lost that battle with its regulators and was required to post \$150 million in additional capital. Soon after the matter became public, investors began to dump MF Global's stock. MF Global made a last ditch effort to raise funding to save the firm by seeking a buyer and by selling off some of the sovereign bonds that contributed to its demise.²⁰⁷ The effort failed, and MF Global filed for Chapter 11 bankruptcy on October 31, 2011, after a last minute deal for an asset sale to another broker-dealer fell apart under suspicions that MF Global had misused customer funds.²⁰⁸ MF Global's collapse was the eighth-largest corporate bankruptcy in U.S. history and the largest securities firm to fail since Lehman.²⁰⁹ From a systemic standpoint, however, MF Global's failure seems to have had

firm's Designated Examining Authority (DEA) for purposes of compliance with the SEC's financial responsibility rules, which include the SEC's uniform net capital rule, Rule 15c3-1, Securities Exchange Act of 1934, 17 CFR § 240.15c3-1, and its customer protection rule, Rule 15c3-3, Securities Exchange Act of 1934, 17 CFR § 240.15c3-3. The net capital rule, which focuses on liquidity, is designed to protect a broker-dealer's customers, counterparties, and creditors by ensuring that broker-dealers have sufficient liquid resources to satisfy promptly claims against the firm. *See Hearing to Examine MF Global Bankruptcy, supra* note 205, at 122–25 (testimony of William J. Brodsky, Chairman and Chief Executive Officer, CBOE Holdings, Inc. Chicago Board Options Exchange Inc.). There appears to have been some uncertainty with respect to FINRA's interpretation of the net capital rule as it related to MF Global's repos, but the matter was ultimately settled in FINRA's favor by the SEC staff member who administers the rule. *Id.* at 123 (“[a]lthough there may have been some room for debate about whether [the repos that gave rise to the capital charge] were properly left off of [MF Global's] balance sheet, CBOE nonetheless agreed with FINRA and the SEC that it was appropriate to apply a net capital charge to these positions given the significant market and credit risk posed by them.”). *See also Hearing: The Collapse of MF Global, supra* note 206, at 3–4 (testimony of Richard G. Ketchum) (“[w]hile the SEC has issued guidance clarifying that RTMs collateralized by U.S. Treasury debt do not require capital to be reserved, there is no such relief for RTMs collateralized by debt of non-U.S. governments.”); *Hearing to Examine MF Global Bankruptcy, supra* note 205, at 70 (Testimony of Jon Corzine) (“MF Global was apprised by FINRA that FINRA would not change its position. I thereafter made a telephone call to [an SEC Associate Director] who told me, in substance, that there was no further appeal and that MF Global had to comply with FINRA's direction.”). Mr. Corzine was not the first to highlight the apparent lack of clarity in the net capital rule. In fact, one erstwhile SEC staff attorney was even rewarded for doing so. *See* Press Release, SEC, Chairman Levitt Announces Winner of Gobbledygook Contest (Jan. 21, 1998), <http://www.sec.gov/news/press/pressarchive/1998/98-8.txt>.

207. Aaron Lucchetti et al., *MF Global Fights to Live Until Sale*, WALL ST. J. (Oct. 29, 2011), <http://online.wsj.com/article/SB10001424052970203687504577003733625453536.html>.

208. *See* Mike Spector et al., *MF Global Collapses as Books Questioned*, WALL ST. J. (Nov. 1, 2011), <http://online.wsj.com/article/SB10001424052970204528204577009473406903312.html>. *See also* Lucchetti & Spector, *supra* note 66; Aaron Lucchetti & Jacob Bunge, *MF Global Weighs Its Sale*, WALL ST. J. (Oct. 27, 2011), <http://online.wsj.com/article/SB10001424052970203687504576654992676019306.html>. As of February 2012, over \$1.6 billion of MF Global customer funds were still unaccounted for (\$900 million) or locked up in a non-U.S. affiliate of the firm (\$700 million). *See* Jacob Bunge, *Missing at MF: \$1.6 billion*, WALL ST. J. (Feb. 11, 2012), <http://online.wsj.com/article/SB10001424052970203646004577215400103051944.html>.

209. Mike Spector et al., *supra* note 208.

no lasting material impact.²¹⁰ There will no doubt be seemingly endless debate about the significance of MF Global's failure in a post Dodd–Frank Act world. Some will undoubtedly argue that what appears at this point to be a relatively orderly liquidation of a highly leveraged securities firm is evidence that the Dodd–Frank Act was an unnecessary overreaction by Congress and regulators to Lehman's collapse and that the Bankruptcy Code is an adequate means for handling liquidations of even the largest financial firms.²¹¹ Others may argue that, despite MF Global's concentration of risk, the firm was not "interconnected enough to bring down the rest of the world."²¹² No matter what lessons ultimately are taken from MF Global's failure, it serves as a reminder that some financial firms will continue to struggle and some will fail with little warning and that the current regulatory frameworks for addressing such a failure are not without risks to the system and to the customers and other stakeholders of failing firms.

Therefore, it is important to consider proposals, such as the private liquidity consortium framework proposed in this article, to supplement the current frameworks, to help ensure that the failure of a large, uninsured financial firm does not impose an undue strain on the financial system or those who rely on it. In this regard, it is interesting

210. Although the Financial Stability Oversight Council discussed the possible implications of MF Global's failure, it took no formal immediate action on the matter. See FIN. STABILITY OVERSIGHT COUNCIL, *Minutes* (Oct. 31, 2011), <http://www.treasury.gov/initiatives/Documents/5a2%20DRAFT%20Minutes%20of%20the%20FSOC%2010%2031%202011.pdf>. The immediate reaction (or lack thereof) of markets and regulators to MF Global's failure does not suggest, however, that MF Global's apparent misuse of customer funds will not result in criminal or civil sanctions against MF Global employees or in additional safeguards to prevent such abuses in the future. See, e.g., Tim Geithner, Treasury Secretary, Remarks By Treasury Secretary Tim Geithner on the State of Financial Reform (Feb. 2, 2012), <http://www.treasury.gov/press-center/press-releases/Pages/tg1408.aspx> ("The failure of customer account segregation rules to protect the customers of MF Global illustrates that we have some work to do ahead. Recently, the CFTC finalized rules to improve protections for certain customer funds. The Council, working with the SEC and the CFTC, will undertake a broad review of what other changes are necessary to strengthen these protections further.") See also Jacob Bunge, *CBOE Regulation Head Departs During Inquiry*, WALL ST. J. (MAR. 20, 2012), <http://online.wsj.com/article/SB10001424052702304724404577293532643623196.html>; Jacob Bunge, *CME Group Discloses Subpoenas in MF Global Probes*, WALL ST. J. (Feb. 28, 2012), <http://blogs.wsj.com/deals/2012/02/28/cme-group-discloses-subpoenas-in-mf-global-probes/>.

211. See generally, e.g., SKEEL, *supra* note 172 (stating that the Bankruptcy Code with certain improvements would be fairer alternative to the Dodd–Frank liquidation provisions).

212. See, e.g., Catherine Dunn, *MF Global: Just the Right Size to Fail?*, CORPORATE COUNSEL (Nov. 2, 2011), <http://www.law.com/jsp/cc/PubArticleFriendlyCC.jsp?id=1202521560153#>. Some may even cite the several-week delay between MF Global's disclosure in its SEC filings that it was required to take a capital charge for its European debt repos and the market's negative reaction to that disclosure to open up another line of assault on the efficient market hypothesis. See Lucchetti & Spector, *supra* note 66 ("MF Global disclosed some details in regulatory filings about FINRA's concerns in early September. The disclosure got little attention until it was reported in the Wall Street Journal in mid-October.").

to speculate how the plight of MF Global (and that of its customers) might have changed had those firms that expressed an interest in acquiring MF Global or its assets had a formalized, regulatorily approved mechanism for doing so. For example, would Interactive Brokers been less inclined to walk away from a deal to acquire MF Global's assets and more willing to guarantee the return of MF Global's customer funds in the context of a liquidity consortium framework? If so, could the Chapter 11 process have been avoided or at least expedited?

V. CONCLUSION

The Financial Crisis highlighted weaknesses in the regulatory structure with respect to financial firms whose default could have an adverse impact on U.S. market stability. The Lehman bankruptcy underscored how an uncertain bankruptcy process can result in damage to market stability and can lead to the unnecessary destruction of wealth. And yet, during the Financial Crisis no adequate alternative means was in place for winding down or recapitalizing such a firm. Congress took an important step toward closing this gap in adopting the orderly liquidation provisions of Dodd–Frank. To accommodate the many concerns that such a liquidation raises, however, Congress included certain provisions in Dodd–Frank that have raised additional legitimate concerns among stakeholders in firms that could be subject to those provisions. Whether these concerns will lead to improvements in Dodd–Frank remains unclear. What is clear, however, is that the Dodd–Frank liquidation provisions do not obviate the need for a viable, private sector alternative to a government-led liquidation. If anything, uncertainty over how the Dodd–Frank liquidation provisions would be applied and lingering doubts about the efficacy of the Bankruptcy Code, even among some of its supporters, makes the need for a formalized, private sector solution all the more pressing. The LTCM crisis illustrated that private liquidity consortia can be an effective means for recapitalizing and winding down struggling firms whose liquidation could adversely impact U.S. financial market stability. A formalized structure for facilitating and incentivizing the formation of such consortia, such as that proposed herein, while not a perfect solution, warrants further consideration.