

## An End to Too Big to Let Fail?

### The Dodd–Frank Act’s Orderly Liquidation Authority

*Thomas J. Fitzpatrick IV and James B. Thomson*

One of the changes introduced by the sweeping new financial market legislation of the Dodd–Frank Act is the provision of a formal process for liquidating large financial firms—something that would have been useful in 2008, when troubles at Lehman Brothers, AIG, and Merrill Lynch threatened to damage the entire U.S. financial system. While it may not be the end of the too-big-to-fail problem, the orderly liquidation authority is an important new tool in the regulatory toolkit. It will enable regulators to safely close and wind up the affairs of those distressed financial firms whose failure could destabilize the financial system.

*“...the U.S. government lacked any workable means to address the potential disorderly failure of a large, systemically important firm in a way that protected the economy and taxpayers from severe collateral damage.”*

—Federal Reserve Chairman Ben S. Bernanke, April 2007

Many observers point to the summer of 2007 as the starting date for the financial crisis that would bring down most of the U.S. investment banking industry, force the U.S. Treasury to take Fannie Mae and Freddie Mac into conservatorship, and prompt the federal government to infuse capital into the largest banks and nonbank financial firms in the country. If the summer of 2007 marked the beginning of the crisis, then Lehman Brothers filing for protection from its creditors under Chapter 11 of the bankruptcy code in September 2008 marked the end of the beginning. Lehman Brothers’ bankruptcy petition, coupled with the announcement of a taxpayer rescue of AIG and the deathbed acquisition of Merrill Lynch by Bank of America, sent shockwaves through the financial system. The Federal Reserve and the U.S. Treasury moved quickly to contain the damage.

In some sense it does not matter whether the shock to the financial system was due to the failure of Lehman Brothers or to uncertainty about whether the government would support large, distressed financial firms, often referred to as the too-big-to-fail problem. Whatever its cause, the

market turbulence in the days immediately after Lehman’s failure confirmed the fears of policymakers that bankruptcy was unlikely to produce an orderly resolution of a large nonbank financial firm, at least not during a period of financial market stress. Therefore, it is not surprising that Title II of the Dodd–Frank Wall Street Reform and Consumer Protection Act adds orderly resolution powers to the supervisory toolkit.

Some observers have hailed Title II of Dodd–Frank as the end of the too-big-to-fail problem as we know it. A number of reports have suggested that Title II replaces bankruptcy as the default method for resolving the insolvency of large nonbank financial firms, especially those identified as systemically important. However, these are both misconceptions about the orderly liquidation authority in Dodd–Frank. In this *Economic Commentary* we provide an overview of Title II of the Dodd–Frank Act and clarify its implications for financial market supervisory policy going forward.

#### **Financial Institution Failures Are Different**

The insolvency of most firms is handled through the judicial process of bankruptcy. Depending on the type of bankruptcy petition filed—Chapter 11 (reorganization) or Chapter 7 (liquidation)—the bankruptcy process can involve negotiations between creditor committees and between creditor committees and the management of the firm. Decisions of the bankruptcy court are subject to judicial review and can be appealed in federal court.



Through much of its history, the United States has treated the failures of banking companies differently than the failures of other businesses. During the late 1800s, 50 years before the Federal Reserve was founded, national banks that were either closed forcibly or were voluntarily shuttering their operations went through an administrative receivership process managed by the Office of the Comptroller of the Currency, a subagency of the U.S. Treasury.

Two factors had encouraged the creation of a bank-specific resolution regime at the time. First, it was important to the goal of a uniform currency. Banking legislation of the day sought to provide a uniform national currency by ensuring that the bank notes issued by national banks could be used as widely as possible. A critical component of such an approach was a process of seamlessly redeeming and retiring the notes of failed banks. Second, there were no provisions for bankruptcy in the federal code at the time. In fact, a permanent federal bankruptcy code would not be enacted until nearly the end of the nineteenth century.

Years later, on the heels of massive bank failures, the Banking Act of 1933 established a system of federal deposit guarantees and created a new federal entity, the Federal Deposit Insurance Corporation (FDIC). The FDIC would be charged with insuring the accounts of depositors at banks and would (for national banks and most state-chartered banks) operate and administer the receivership of failed banks (this responsibility was expanded in the late 1980s to include all FDIC-insured depository institutions).

The recent financial crisis gave legislators a number of new challenges to deal with. One was what to do with the so-called shadow banking system. The shadow, or parallel, banking system refers to nondepository financial firms that resemble banks in terms of their activities and their reliance on short-term funding, but which are not banks since they don't fund themselves with deposits. The similarity of these large nondepository financial firms to traditional banks has led some to question whether bank-like resolution regimes should be extended to include them. Calls for a "shadow solvency resolution" regime for systemically important nondepository companies reached a crescendo during the financial crisis, as financial system supervisors worked feverishly to prevent the disorderly failure of a number of these firms and to contain the negative spillovers associated with the reorganization of Lehman Brothers. Title II of the Dodd-Frank Act established just such a resolution authority.

### **Orderly Liquidation Authority: How It Works**

As the financial reform legislation marched forward in both houses of Congress, one of the most debated parts of the legislation was Title II. The debated issues ranged from who would operate the receivership function to which firms or types of firms would be subject to the authority, and how it would be funded. Ultimately, Congress established a process for implementing the authority and gave the responsibility for operating the receivership to the FDIC. In addition, Congress decided that Title II resolutions would not be funded by means of an ex ante resolution fund.

Congress decided that firms subject to Title II resolution would be determined through a multistep process. First, it must be determined whether a company is a "covered financial company" under the Dodd-Frank Act. Covered financial companies include all firms that derive 85 percent of their revenues from activities that are financial in nature, as well as any financial company designated as systemically important by the Financial Stability Oversight Council. The Act requires the FDIC to define what makes an activity financial in nature, though the Act specifies that revenues derived from the ownership or control of depository institutions be included as part of the definition. Expressly excluded from the definition of a covered financial company are all depository institutions, government sponsored enterprises, and any government entity.

Once it is determined that a firm is a covered financial company, the next step in subjecting it to a Title II resolution involves the agreement of oversight agencies to proceed. Namely, two-thirds of the Board of Governors of the Federal Reserve System, along with two-thirds of either the FDIC Board, the SEC (for securities broker-dealers), or the Federal Insurance Office (for insurance companies), must write a recommendation detailing why the authority should be used. Upon receiving the written recommendation, the Secretary of the Treasury, in consultation with the President, must decide whether four conditions are met: The firm must be either in default or in danger of default; its failure under the Bankruptcy Code would have serious financial stability effects; a Title II resolution would avoid or mitigate these effects; and there is no viable private sector alternative to the use of the resolution authority.

The Act provides for a limited judicial review of the classification of the firm as a covered financial institution that is in default or in danger of default. Judicial review utilizes an "arbitrary and capricious" standard—typical when reviewing decisions of administrative agencies—which essentially prevents the judiciary from overruling those determinations unless there was no reasonable basis for them.

The FDIC must be named receiver of any firm placed into a Title II receivership. Its powers under the orderly liquidation authority mirror those it already has for depository institution receiverships, including the equivalent of bridge bank authority (the ability to create and operate a temporary firm into which some or all of the assets and liabilities of the failed firm can be passed) and the limited judicial review of its actions. Creditor protections in orderly resolution are limited to the requirement that unsecured creditors can receive no less in a Title II resolution than they would have received under a Chapter 7 bankruptcy proceeding.

Despite this requirement, the FDIC has two powers under its resolution authority that vary in important ways from bankruptcy law. First, it is allowed to treat unsecured creditors of the same class differently if doing so is consistent with an orderly resolution of the firm. Second, for qualified financial contracts (QFCs)—basically, derivative contracts and repurchase agreements (repos)—the FDIC gets a one-day automatic stay, meaning counterparties on the QFCs must wait before taking the collateral backing their claim. Note that most QFCs are currently exempt from automatic stay provisions in bankruptcy. The FDIC can then consider all the claims, QFCs, and property securing the QFCs that are associated with a single counterparty and pass them to another company (including its bridge institution) or keep them in the failed institution. The passing of a QFC to another institution would not constitute a default under the orderly resolution authority of the Dodd–Frank Act.

Unlike traditional FDIC resolution, there is no *ex ante* resolution fund the FDIC can draw on to fund a Title II resolution. Initially, the receivership can be funded by borrowing from the U.S. Treasury, but the loan must be repaid within 60 months. At the end of the day, the cost of the resolution is to be funded from the sale of unencumbered receivership assets and through assessments on other large financial institutions. To the extent that a creditor receives preferential treatment during the receivership (such as a higher payout on their claim than similarly situated creditors, or even more senior creditors), the FDIC can assess them for an amount up to what they received in excess of similar creditors of the failed company.

The Dodd–Frank Act has a number of provisions aimed specifically at the management of any firm placed into the orderly liquidation process. It states at the outset that the purpose of the orderly liquidation is, in part, to ensure that the management responsible for the condition of a liquidated company is not retained and personally bears losses consistent with their responsibility. As such, an action required of the FDIC once it is acting as a receiver is removing the firm’s management and any members of the firm’s board of directors who are determined by the FDIC to be responsible for the condition of the company. The Act does not provide guidance on the determination of responsibility.

Furthermore, the FDIC may pursue legal action against directors and officers for anything from gross negligence—essentially behavior that falls far short of what the ordinary reasonable person would have done in similar circumstances—to intentional misconduct. It may also recoup compensation paid in the past two years to senior executives and directors who are “substantially responsible” for the failed condition of a liquidated firm. Finally, the Federal Reserve’s Board of Governors and the FDIC are given the power to prohibit senior executives or directors from participating in a financial company’s affairs when the executive or director violates written orders or agreements, breaches his or her fiduciary duty to the corporation, or engages in any unsafe or unsound practice in connection with the company.

### Orderly Liquidation Authority Going Forward

The orderly liquidation authority is meant to be an exceptional power and not the default procedure for winding up the affairs of large distressed nondepository financial firms. The implicit expectation in the Dodd–Frank Act is that the majority of troubled nondepository financial firms will continue to be resolved in bankruptcy. Yet it recognizes that some nondepository financial firm failures are different from others because of their potential to significantly destabilize the financial system. Thus, the Act provides an important new tool in the regulatory toolkit that allows financial system supervisors to close and resolve such firms appropriately.

With the availability of the liquidation authority, regulators may be able to improve the “time-consistency” of regulators’ responses to troubled and failing financial firms. In the past, the only way to prevent the instability that might result from a large firm being resolved through bankruptcy was to keep it afloat or smooth its resolution with an infusion of funds. The new resolution authority creates a viable option to providing funds to failing firms and should send markets a clear signal of how such firms will be resolved. The provision of such authority by Congress does not, itself, end too-big-to-fail. Consistent and appropriate use of the authority, however, is an important step toward addressing the too-big-to-fail problem.

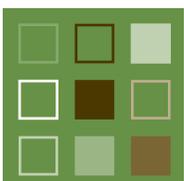


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