

BY BRUCE GROHSGAL

Case in Brief Against “Chapter 14”

One narrative of the financial crisis of 2008 is that the U.S. needed to bail out Bear Stearns and AIG and the financial sector in general, and that the bankruptcy of Lehman Brothers deepened the calamity because neither the Bankruptcy Code nor the laws regulating financial companies safeguarded the financial system. Congress’s response was not to amend the Bankruptcy Code. But the outcry over those bailouts led to the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act.¹

The primary purposes of title II of the Dodd-Frank Act include mitigating systemic risk and minimizing moral hazard. U.S. financial regulators have the power under title II to put a large, failing financial institution into a liquidating Federal Deposit Insurance Corp. (FDIC) receivership and to hold accountable those responsible for its downfall.² The Dodd-Frank Act also expressly prohibits both a taxpayer-funded bailout and the Federal Reserve’s lending to a failing or failed bank,³ and the enrolled bill’s very title includes the purpose of protecting “the American taxpayer by ending bailouts.”⁴

The Dodd-Frank Act has drawn fire nonetheless as encouraging — rather than preventing — bailouts. Detractors are urging the repeal of title II of the Dodd-Frank Act and amending the Bankruptcy Code to include a new “chapter 14” in its place. The first chapter 14 proposals came from the Hoover Institution at Stanford University,⁵ and more recently a chapter 14 bill was introduced in the Senate, the stated purpose of which, not surprisingly, is “[t]o save taxpayer money and end bailouts of financial institutions by providing for a process to allow financial institutions to go bankrupt.”⁶

This article summarizes the Dodd-Frank Act’s orderly resolution regime, then addresses the core

proposals for a new chapter 14. It concludes that the proposed chapter 14 does not mitigate systemic risk, minimize moral hazard or improve on the Dodd-Frank Act’s prohibitions against bailouts, which are the primary purposes of title II of the Dodd-Frank Act.⁷

Orderly Resolution under the Dodd-Frank Act

Resolution under title II of the Dodd-Frank Act is a last — not a first — resort. Title I of the Dodd-Frank Act requires each large financial company to file with the regulators a “living will” that provides for its orderly resolution *under the Bankruptcy Code*.⁸ Any resolution plan that does not do so must be revised until it accomplishes that goal.⁹ The regulators may even order that a large financial company be broken up so that each of the surviving companies is capable of being resolved under the Code.¹⁰

Title II of the Dodd-Frank Act may only be used 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”¹¹ so that creditors and shareholders bear the losses; responsible management is not retained; responsible parties, including management, directors and third parties, “bear losses consistent with their responsibility,” including actions for damages and “recoupment of compensation and other gains not compatible with such responsibility;”¹² and the FDIC as receiver protects the U.S.’s financial stability.¹³ An FDIC receivership may be imposed under title II only after the following criteria are met:¹⁴

7 The full range of chapter 14 proposals is beyond the scope of this article. The best suggestions include repealing or shrinking the safe harbors for repo financing and certain derivatives such as credit default swaps, including the provisions in both the Bankruptcy Code and the Dodd-Frank Act that protect pre-petition margin calls on such instruments from avoidance, a repeal that is notably absent from the proposed Taxpayer Protection and Responsible Resolution Act. Prof. David A. Skeel, Jr. (University of Pennsylvania School of Law; Philadelphia) has argued that “if the special treatment of derivatives were reversed, the Dodd-Frank resolution regime would rarely, if ever, be necessary.” David Skeel, *The New Financial Deal: Understanding the Dodd-Frank Act and Its (Unintended) Consequences*, 163 (John Wiley & Sons, 2011). None of these chapter 14 proposals address the absence in the Bankruptcy Code and case law of any authority for a bankruptcy judge to take actions for the purpose of mitigating systemic risk or minimizing moral hazard, which, along with the anti-bailout provisions of both title II of the Dodd-Frank Act and the proposed chapter 14, are the primary focus of this article.

8 12 U.S.C. § 5365(a)(1) and (d)(1). Financial companies supervised by the Board of Governors of the Federal Reserve, and bank holding companies with total consolidated assets equal to or greater than \$50 billion, must file advance plans that provide for their orderly resolution under the Bankruptcy Code. *See id.*

9 *Id.*, § 5365(d)(4).

10 *Id.*, § 5365(d)(5).

11 *Id.*, § 5384(a).

12 *Id.* “Financial company” is defined in 11 U.S.C. § 5381(a)(11).

13 *Id.*, § 5384(a).

14 *Id.*, §§ 5381(a)(8) and 5383(b).



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1 Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L., H.R. 4173, 111th Cong. (2010) (hereinafter, the “Dodd-Frank Act”) (“To promote the financial stability of the United States by improving accountability and transparency in the financial system, to end ‘too big to fail,’ to protect the American taxpayer by ending bailouts, to protect consumers from abusive financial services practices, and for other purposes.”). President Obama, on final passage of the Dodd-Frank Act on July 15, 2010, stated that “[b]ecause of this reform, the American people will never again be asked to foot the bill for Wall Street’s mistakes. There will be no more taxpayer-funded bailouts, period.” *See* Jesse Lee, “President Obama on Final Passage of Wall Street Reform: An End to Bailouts, a Beginning for Accountability,” available at www.whitehouse.gov/blog/2010/07/15/president-obama-final-passage-wall-street-reform-end-bailouts-a-beginning-accountabi.

2 12 U.S.C. §§ 5383 and 5384.

3 12 U.S.C. § 5394; H.R. 4173 § 1101 (amending Federal Reserve Act § 13 (codified as amended at 12 U.S.C. § 343)).

4 *See* Dodd-Frank Act (providing precatory that the purpose of the act is, *inter alia*, “to protect the American taxpayer by ending bailouts”).

5 For a fuller description of the Hoover Institution’s proposals, *see* the general publications posted by its Working Group on Economic Policy Resolution Project, available at www.hoover.org/taskforces/economic-policy/resolution-project/publications.

6 Taxpayer Protection and Responsible Resolution Act, S. 1861, 113 Cong. (2013).

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(a) the recommendation by the regulators, who must have evaluated why a private sector alternative or a bankruptcy case is not appropriate;¹⁵ and

(b) the designation by the Secretary of the Treasury (having consulted with the President), who must have determined, among other things, that the financial company is in default or in danger of default, its failure would have serious adverse effects on the financial stability of the U.S., no viable private sector alternative is available, and the receivership would mitigate the adverse effects of the default.¹⁶

Once a title II resolution proceeding begins, it trumps any previously or subsequently commenced bankruptcy proceeding.¹⁷

Chapter 14 Proposals

The Hoover Institution and S. 1861 propose to replace title II of the Dodd-Frank Act with a new chapter of the Bankruptcy Code, chapter 14, under which the primary regulator or the Federal Reserve could commence an involuntary bankruptcy case if a financial company is not paying its debts or is otherwise insolvent.¹⁸ Chapter 14 would include the following features.

Purposes Do Not Include Preventing Systemic Risk or Reducing Moral Hazard

The Bankruptcy Code’s present goals of reorganization and maximizing distributions to creditors would not be changed, and neither the Hoover Institution proposal nor S. 1861 would empower bankruptcy judges to make decisions with the aim of mitigating systemic risk or minimizing moral hazard, which are the purposes of title II of the Dodd-Frank Act.

FDIC and Federal Reserve Involvement in Case

The Hoover Institution proposes that on the regulators’ motion, the court could appoint the FDIC as trustee with an authority to reorganize or liquidate the company and file motions “in parallel with the trustee or debtor in possession, for the use, sale or lease of property” under § 363 of the Bankruptcy Code.¹⁹ Each of the debtor’s primary regulators, the debtor itself, and its unsecured creditors’ committee would have the authority to propose a plan as soon as the order for relief is entered in the debtor’s bankruptcy case.²⁰ S. 1861 provides that the Fed can be heard on matters that are relevant to its regulation of the debtor or the financial stability of the U.S., and that the FDIC can be heard with respect to any transfer of the debtor’s assets to a bridge company pursuant to § 363.²¹

Regulators’ Post-Petition Lending for Payments to Critical Creditors Permitted, but in Some Instances Subordinated

The Hoover Institution’s proposal would permit financing by a regulator or other debtor-in-possession (DIP) lender to pay critical creditors early in the case “for liquidity or other systemic reasons.” However, if these payments exceed the distributions that these creditors would ultimately be entitled to receive in the case, to that extent, the DIP lender’s claim would be subordinated to the claims of other creditors to the extent of such excess.²²

The Case Against Chapter 14

Proposed chapter 14’s central flaw is that it does nothing to reconcile the Dodd-Frank Act’s purposes of mitigating systemic risk and minimizing moral hazard with the Bankruptcy Code’s starkly contrasting aims of reorganizing troubled companies, “preserving going concerns and maximizing property available to satisfy creditors.”²³

Systemic Risk

Chapter 14 would give a bankruptcy judge no authority to make decisions for the purpose of mitigating systemic risk, and that objective cannot be reconciled with the Bankruptcy Code’s goals of reorganizing, preserving going concerns and maximizing distributions.²⁴ For example, how does a judge decide whether to approve a sale by the debtor of its business to the highest bidder, on a motion that is filed by the debtor and supported by the debtor’s secured and unsecured creditors (who will receive a higher distribution through the high bid), over the objection or competing sale motion filed by the regulators, which favor a lower bid from a buyer that is financially and operationally stronger and will be better able to shore up the acquired business and reduce systemic risk? Similarly, how does the bankruptcy judge determine whether to confirm a reorganization plan proposed by the debtor or its creditors (or both) that maximizes distributions to creditors, and equity but results in a weaker company, over a plan proposed by regulators that buttresses the bank’s capital structure for the longer term at the expense of plan distributions to creditors and equity?

This bankruptcy judge’s dilemma is only deepened by chapter 14 proposals that would enhance regulators’ powers and standing to be heard in a bankruptcy case, which include authorizing the court to appoint the FDIC as chapter 11 trustee and permitting regulators to file competing sale motions and plans. S. 1861 also amplifies the discordance. The bill would authorize transfers of a failed company’s assets to a bridge company, subject to both § 363, which requires maximizing the debtor’s estate,²⁵ and an additional determination

15 *Id.*, §§ 5381(a)(8) and 5383(a)(1)(A).

16 *Id.*, § 5383(b).

17 Dodd-Frank Act, § 204(a).

18 Kenneth E. Scott, “A Guide to the Resolution of Failed Financial Institutions: Dodd-Frank Title II and Proposed Chapter 14,” p. 6, available at <http://media.hoover.org/sites/default/files/documents/guide-to-resolution-project-20120302.pdf>.

19 Scott, “A Guide,” p. 8; Thomas H. Jackson, “Bankruptcy Code Chapter 14: A Proposal,” p. 17; 11 U.S.C. § 363.

20 Jackson, “Bankruptcy Code Chapter 14: A Proposal,” p. 22.

21 S. 1861 §§ 1404 and 1406.

22 Jackson, “Bankruptcy Code Chapter 14: A Proposal,” pp. 21–22.

23 See, e.g., *Bank of Am. Nat’l Trust & Sav. Ass’n. v. 203 N. LaSalle St. P’ship*, 526 U.S. 434, 453 (1999); 7 *Collier on Bankruptcy* ¶ 1129.01 (Alan N. Resnick and Henry J. Sommer eds., 16th ed.).

24 The Bankruptcy Code reconciles the potential conflict between the policies of reorganization and maximization of distributions to creditors by the best interests of creditors rule, which requires that a creditor must receive under a reorganization plan at least as much as it would receive in a chapter 7 liquidation. 11 U.S.C. § 1129(a)(7)(A).

25 See, e.g., *In re Chrysler LLC*, 405 B.R. 84, 96 (Bankr. S.D.N.Y. 2009).

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that the transfer is “necessary to prevent imminent substantial harm to [the] financial stability of the United States.”²⁶ These enhancements provide no basis for a bankruptcy judge to resolve these conflicting goals or make predictable rulings.

Moral Hazard

Chapter 14 would not limit excessive risk-taking by individuals and does not otherwise minimize “moral hazard,” which is simply nothing more than the likelihood that one will not be held accountable for self-serving, risky actions that ultimately damage only others. The Dodd-Frank Act’s provisions minimizing moral hazard stand in sharp contrast to the deference given under both state corporate law and the Bankruptcy Code to the business judgment of a company’s board and managers, both before and (only to a slightly lesser extent) after a bankruptcy filing, and to the Code’s redemptive regime. Chapter 14 proposals (1) do not alter the respect that must be given in a bankruptcy proceeding to management’s pre-petition business judgment under state fiduciary law; and (2) do not provide for clawbacks of bonuses, stock options and other compensation paid to executives and traders, or otherwise hold managers accountable for actions taken by them that benefited them personally and the company in the short term, but ultimately caused the enterprise’s downfall. Replacing title II of the Dodd-Frank Act with a proposed chapter 14 would remove the accountability that title II provides.

Bailouts

Section 214 of Dodd-Frank mandates that “[t]axpayers shall bear no losses,” prohibits the use of taxpayer funds to prevent the liquidation of a financial company, and requires that any funds expended in the title II proceeding be recovered from the sale of the company’s assets or paid by the financial sector through assessments to the Orderly Liquidation Fund.²⁷ Section 1101 of the Dodd-Frank Act also amended the emergency lending provisions of the Federal Reserve Act section 13(3) to prohibit the Fed from making loans to insolvent companies, and to require that any such lending be pursuant to programs and facilities with broad-based eligibility.²⁸

Chapter 14, as proposed by both the Hoover Institution and the Taxpayer Protection and Responsible Resolution Act, would repeal title II of the Dodd-Frank Act, including § 214, thus removing from the U.S. Code the one express prohibition against taxpayer (as opposed to Federal Reserve) bailouts²⁹ and would also relieve the financial sector of its obligation to fund the Orderly Liquidation Fund. Repeal of title II would *increase* the likelihood of taxpayer bailouts for failing banks. The proposed act would amend the Federal Reserve Act to prohibit any Federal Reserve Bank from lending to a financial company that is in a chapter 14 proceeding.³⁰ This change adds nothing to

Dodd-Frank Act § 1101, which already forbids lending by the Fed to insolvent companies, including those in a bankruptcy or in a title II proceeding of the Dodd-Frank Act.³¹ The Hoover Institution’s DIP lending rule would engender bailouts in another respect, by subordinating to the claims of other creditors (*i.e.*, forgiving repayment of) that portion of any government loan used to pay critical creditors early in the case, to the extent that with hindsight such payments are shown to have been excessive.

The Dodd-Frank Act receivership is a last — but crucial — resort.... Chapter 14 would unnecessarily strip the regulators of these powers, thereby increasing systemic risk, moral hazard and the likelihood of taxpayer bailouts.

Chapter 14 proponents have contended that the Dodd-Frank Act encourages bailouts because managers will be discouraged from planning for and filing a bankruptcy case knowing that a later-commenced title II proceeding of the Dodd-Frank Act will supersede their efforts, and that this failure to plan will make an emergency government rescue more probable. However, this argument is strained. At present, managers will more likely be motivated, to the contrary, to plan for and, if necessary, commence a case under the existing chapter 11 and seek prompt approval of a going-concern sale or a plan that is acceptable to the regulators, if only to avoid the more punitive title II receivership of the Dodd-Frank Act that is the regulators’ last resort, under which the managers are removed, and held accountable, and their pre-petition compensation subject to recoupment.

Conclusion

The Dodd-Frank Act already encourages a failing financial company to file for bankruptcy (which, in its present form, has proved to be an adequate (although imperfect) tool for the resolution of complex financial companies such as Lehman Brothers) instead of waiting for regulators to impose an FDIC receivership under title II of the Dodd-Frank Act. The Dodd-Frank Act receivership is a last — but crucial — resort. It authorizes financial regulators to commence a receivership to protect the financial system from systemic risk, hold accountable those responsible for a financial company’s failure and, if funds are needed to complete the liquidation, assess the financial sector (rather than taxpayers or the Fed) for contributions to the Orderly Liquidation Fund. Chapter 14 would unnecessarily strip the regulators of these powers, thereby increasing systemic risk, moral hazard and the likelihood of taxpayer bailouts. **abi**

31 H.R. 4173 § 1101 (amending Federal Reserve Act § 13 (codified as 12 U.S.C. § 343)).

26 S. 1861 § 1406.

27 12 U.S.C. § 5394.

28 12 U.S.C. § 5394; H.R. 4173 § 1101 (amending Federal Reserve Act § 13(3) (codified as amended at 12 U.S.C. § 343)).

29 This is no minor distinction. The Fed, as central bank does not tax, but creates at will most of the money that it requires to buy or lend against assets.

30 12 U.S.C. § 347b(b).