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TOO BIG AND UNABLE TO FAIL

Stephen J. Lubben[+] *& Arthur E. Wilmarth, Jr.*[*]

Financial regulation after the Dodd-Frank Act has produced a blizzard of acronyms, many of which revolve around the "too big to fail" (TBTF) problem. OLA, OLF, SPOE, and TLAC are new regulatory tools that seek to build a new regime for resolving failures of systemically important financial institutions (SIFIs). The explicit goal of this new regime is to enable a SIFI to fail, just like United Airlines or Blockbuster Video, without requiring a government bailout. In this article, we express significant doubts about the new regime's ability to work as advertised. The "single point of entry" (SPOE) resolution strategy, which focuses all resolution efforts on a SIFI's parent holding company, is a strategy devised for a very stylized, even hypothetical sort of failure that does not threaten the stability of the financial system. It is unlikely to work as intended during a future global crisis that involves multiple failing SIFIs operating thousands of subsidiaries across dozens of national boundaries. The Federal Reserve's "total loss-absorbing capacity" (TLAC) proposal is closely tied to SPOE. It would require parent holding companies of SIFIs to issue large amounts of debt securities that can be written off or converted into equity in a resolution proceeding. In our view, TLAC debt will create a new, more opaque way to impose the costs of financial distress in SIFIs on ordinary citizens, because most TLAC debtholders are likely to be retail investors in brokerage accounts, mutual funds, and pension funds.

The most fundamental shortcoming of SPOE and TLAC, as currently proposed, is that both policies would entrench our perverse system for regulating SIFIs. Our current regulatory system enables SIFIs and their Wall Street creditors to reap massive benefits from the TBTF subsidy while imposing the costs of that subsidy on ordinary citizens. We recognize that a new and improved version of Dodd-Frank is unlikely to emerge from Congress in the near term. However, regulators should use their existing powers to shrink the TBTF subsidy by forcing SIFIs and their Wall Street creditors to internalize at least some of the costs of the enormous risks they create. The final part of our paper proposes reforms that would help to achieve that goal.

INTRODUCTION

The heart of 2010's Dodd-Frank Act is the hope of ending too big to fail. Since the most important American financial institutions remain very large, Dodd-Frank's long-term success necessarily turns on the ability of those

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financial institutions to fail. Failing without disrupting the broader economy, and thus requiring taxpayer assistance, is the key objective.[1]

To further this central aim, the Federal Reserve Board recently proposed a new "total loss-absorbing capacity" (TLAC) requirement. According to the Fed, the proposed new TLAC requirement "will bolster financial stability by improving the ability of banks covered by the rule to withstand financial stress and failure without imposing losses on taxpayers."[2]

The Fed's TLAC proposal is closely tied to a proposed strategy for handling financial institution failure – or "resolution," in the industry argot – known as "single point of entry." Single point of entry, predictably referred to as SPOE, goes hand in hand with TLAC. SPOE cannot work without TLAC, and there is no reason to impose TLAC on financial institutions without SPOE.

In this paper we argue that TLAC is just a new, more opaque way to impose the cost of financial distress in oversized financial institutions on ordinary citizens. Moreover, SPOE is a resolution tool designed for a very stylized, even hypothetical sort of failure. We agree with other commentators that SPOE's strategy for resolving the failure of large, systemically important financial institutions (SIFIs) depends on a number of unrealistic assumptions and, therefore, is unlikely to work in actual practice.[3]

Title II of Dodd-Frank establishes the Orderly Liquidation Authority (OLA), which empowers the Secretary of the Treasury to appoint the Federal Deposit Insurance Corporation as receiver for failed SIFIs.[4] Title II requires the FDIC to liquidate failed SIFIs and to impose any resulting losses on their

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[1] See Dodd-Frank Wall Street Reform and Consumer Protection Act (preamble), 124 Stat. 1376 (2010) (stating that Dodd-Frank is intended "to end 'too big to fail,' [and] to protect the American taxpayer by ending bailouts").

[2] https://www.federalreserve.gov/newsevents/press/bcreg/20151030a.htm

[3] *See., e.g.,* Paul L. Lee, *Bankruptcy Alternatives to Title II of the Dodd-Frank Act-Part I*, 132 Banking L.J. 437, 464-74 (2015); Paul H. Kupiec & Peter J. Wallison, *Can the 'Single Point of Entry' Strategy Be Used to Recapitalize a Failing Bank?* (Nov. 4, 2014), available at http://ssrn.com/abstract=2519229.

[4] Dodd-Frank § 203. *See* Stephen J. Lubben, *A New Understanding of the Bankruptcy Clause*, 64 Case W. Res. L. Rev. 319, 409 (2013).

shareholders and creditors.[5] Section 214(a) of Dodd-Frank declares: "All financial companies put into receivership under [Title II] shall be liquidated. No taxpayer funds shall be used to prevent the liquidation of any financial company under [Title II]."[6]

The FDIC recognized Title II's liquidation-only mandate in its early rulemakings under Dodd-Frank.[7] However, megabanks quickly realized that a liquidation-only approach for resolving failed SIFIs would pose a major threat to the survival of their TBTF subsidy and would also threaten to impose losses on Wall Street creditors, including holders of commercial paper, derivatives, and securities repurchase agreements (repos). Accordingly, in 2011 megabanks and other Wall Street interests proposed a very different approach for resolving failed SIFIs. This new approach, called "recapitalization-within-resolution," created a roadmap for resolving failed megabanks by using chapter 11-style reorganizations instead of liquidations. Wall Street's reorganization plan helped to provide the conceptual foundation for the SPOE resolution strategy.[8]

The SPOE strategy would place only the parent holding company of a failed megabank into an OLA receivership and would impose losses only on the holding company's shareholders and debtholders. Under SPOE, the operating subsidiaries of a failed SIFI (including depository banks, securities broker-dealers, swap dealers, and insurance companies) would remain in business, and all of the creditors of those subsidiaries (including Wall Street creditors) would be fully protected.

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[5] *Id.* §§ 204(a)(1), 206(2), (3), 214(a).

[6] *Id.* § 214(a).

[7] *See* Arthur E. Wilmarth, Jr., *The Financial Industry's Plan for Resolving Failed Megabanks Will Ensure Future Bailouts for Wall Street*, 50 Georgia Law Review 43, 51-53 (2015) (describing the FDIC's rulemakings under Title II in 2010 and 2011), available at http://ssrn.com/abstract=2648572.

[8] *Id.* at 53-54 (describing the development of Wall Street's "recapitalization-within-resolution" plan for resolving failed SIFIs). Although the FDIC played an important role in developing the SPOE concept, the FDIC has not yet formally endorsed SPOE as its preferred strategy for resolving failed SIFIs under Title II of Dodd-Frank. See *infra* notes 34-39, 48-49 and accompanying text.

The Fed's proposed TLAC requirement would apply to eight U.S. megabanks, which are currently designated as global systemically important banks (G-SIBs), as well as U.S. intermediate holding companies owned by foreign G-SIBs.[9] These, of course, are the very same institutions that are most likely to be subject to OLA.

The Fed's TLAC proposal is expressly designed to establish SPOE as the preferred strategy for resolving failed U.S. megabanks. The Fed's proposal would require the parent holding company of each SIFI to maintain a minimum level of Tier 1 shareholders' equity and TLAC debt. If the parent holding company is placed in an OLA receivership, the company's shareholders' equity and TLAC debt would be used to help recapitalize the SIFI's operating subsidiaries.

Adding TLAC debt to the capital structure would also facilitate the use of SPOE in other contexts, including cases filed under the Bankruptcy Code. We think it is notable that many of the so-called "chapter 14" proposals, which would add a new, financial institution focused chapter to the current Bankruptcy Code, are designed to facilitate a process that looks very much like SPOE.

As we show below, most TLAC debtholders would probably be retail investors in brokerage accounts, mutual funds and pension funds, because federal regulators would strongly discourage financial institutions from purchasing TLAC debt. Additionally, the SPOE approach would open up the possibility that non-bankrupt operating subsidiaries of a financial holding company – the very subsidiaries that are most apt to cause actual problems – would be eligible for either direct financial support from Fed or indirect assistance, funneled through the holding company, in the form of a taxpayer-financed bridge loan from the Treasury Department. Thus,

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[9] Board of Governors of Federal Reserve System, Notice of proposed rulemaking: "Total Loss-Absorbing Capacity, Long-Term Debt, and Clean Holding Company Requirements for Systemically Important U.S. Bank Holding Companies and Intermediate Holding Companies of Systemically Important Foreign Banking Organizations," 80 Federal Register 74,926 (2015) [hereinafter Fed TLAC Proposal]. The eight U.S. banking organizations currently designated as G-SIBs are Bank of America, Bank of New York Mellon, Citigroup, Goldman Sachs, JPMorgan Chase, Morgan Stanley, State Street, and Wells Fargo.

SPOE and TLAC would impose the costs of resolving failed megabanks on ordinary citizens, either as investors or taxpayers, while giving 100% protection to Wall Street creditors.

As we also argue, it is highly questionable whether SPOE and TLAC will produce their promised benefits. It is far from clear whether the parent holding company of a failed SIFI can be placed in an OLA resolution without triggering contagious runs by the creditors of its subsidiaries. There are also strong doubts whether host country regulators with jurisdiction over a failed SIFI's subsidiaries will cooperate when a home country supervisor commences a resolution procedure for the SIFI's parent holding company. The SPOE resolution strategy would be unworkable if host country officials decide to "ring fence" subsidiaries or assets located within their jurisdictions.

SPOE also suffers from a problem that is well-known to bankruptcy lawyers. In corporate bankruptcies, managers almost always want to do a "prepack."[10] That is, corporate managers habitually believe that their firm's financial problems can be solved by a quick trip through bankruptcy that converts bondholders into shareholders. However, financial distress is

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[10] As explained by Robert K. Rasmussen and Randall S. Thomas:

> There are two general types of Chapter 11 proceeding initiated by large, publicly held companies—prepackaged bankruptcies and traditional, full-blown Chapter 11 bankruptcies. A prepackaged bankruptcy hinges on agreement. The managers of a firm in financial distress negotiate with the firm's main creditors over a plan of reorganization prior to the filing for bankruptcy. A bankruptcy petition is filed only after agreement among the creditors has been reached on the new debt structure. The benefit of a prepackaged bankruptcy, as opposed to an out-of-court restructuring, is that it eliminates the holdout problem endemic in out-of-court restructurings. Absent bankruptcy, debt holders cannot have their claims reduced without their consent. This creates a collective action problem. When a firm needs to alter its capital structure, individual creditors may opt not to participate in a restructuring that benefits the creditors as a whole. They hope that, although they refuse to reduce their own claims, other creditors will reduce theirs.

Whither the Race? A Comment on the Effects of the Delawarization of Corporate Reorganizations, 54 Vand. L. Rev. 283, 288 (2001).

not always caused by balance sheet problems; indeed, it is more often caused by operational problems.[11]

This is even more apt to be true in financial institutions, where liquidity problems, with the accompanying threat of going-concern insolvency, seem far more likely to occur than balance sheet insolvency. In addition, the new Financial Stability Oversight Council and the Fed would be likely to oppose transactions (whether voluntary acquisitions or emergency resolutions) that look like leveraged buyouts of SIFIs and increase the debt service burdens of the resulting institutions.

Moreover, any attempt to impose losses on a failed SIFI's TLAC debtholders would probably trigger widespread panic among investors holding bail-in debt issued by other SIFIs that are believed to be vulnerable. In February 2016, after regulators imposed losses on bondholders in failed Italian and Portuguese banks, a major selloff occurred in the market for contingent convertible bonds (CoCos) issued by European banks. That selloff has created substantial doubts about the ability of regulators to bail in TLAC debt without disrupting financial markets.

We begin part one of the paper with an overview of TLAC and SPOE, and their symbiotic relationship. The Fed declared that its TLAC proposal "is primarily focused on implementing the SPOE resolution strategy" for failed megabanks.[12] In the Fed's view, SPOE offers "substantial advantages" because it would fully protect the creditors of subsidiaries of a failed megabank and would thereby allow those subsidiaries "to continue normal operations."[13] In addition, by preventing any failure of the subsidiaries, SPOE would "avoid the need for separate proceedings for separate legal entities run by separate authorities across multiple jurisdictions."[14]

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[11] Stephen H. Case & Mitchell A. Harwood, *Current Issues in Prepackaged Chapter 11 Plans of Reorganization and Using the Federal Declaratory Judgment Act for Instant Reorganizations*, 1991 Ann. Surv. Am. L. 75, 87 (1992).

[12] Fed TLAC Proposal, *supra* note 9, at 74,928.

[13] *Id.*

[14] *Id.*

In part two of the paper, we explain the key problems with TLAC and SPOE. We argue that SPOE is an unrealistic strategy for resolving failed SIFIs, and that SPOE and TLAC in combination will probably impose losses on the very taxpayers that Dodd-Frank purports to protect.

We use the example of Lehman Brothers' failure to examine the utility of SPOE and TLAC in preventing the collapse of a SIFI. Ultimately we conclude that SPOE is ill-suited to address the very kind of failure that gave rise to OLA's creation. Lehman's value was the value of its broker-dealer operations, broadly defined. In the midst of market-wide skepticism about the value of the key assets held by Lehman's corporate group, imposing "haircuts" on holding company creditors would have done little to strengthen Lehman or stop the panic. Lehman Holdings could have survived only with the infusion of sufficient government funding to enable the company to survive the market disruption. Providing such funding would have looked very much like the type of bailout that Dodd-Frank has foresworn.

In part two of the paper we also identify the shortcomings of the various chapter 14 proposals, which themselves are tied to the use of SPOE. The shortcomings of SPOE are central to our argument that all of the chapter 14 bills that have been proposed to date are of very limited utility. While chapter 11 has a long and storied history of reorganizing major corporations like Texaco, Pacific Gas and Electric, and most major airlines in this country, the proposed chapter 14 is something of a one trick pony. Where chapter 11 is noted for its flexibility, chapter 14 would not work in any circumstance beyond a "holding company only" or SPOE style case.

For the same reasons that SPOE in OLA is unlikely to be of much use, we conclude that chapter 14 as currently proposed will also be of little use. Indeed, we suggest that the financial industry's warm embrace of chapter 14 is more likely explained by the industry's hope that a new chapter 14 would enable the Fed to provide financial assistance to the operating subsidiaries (and thus Wall Street creditors) under terms that would be more generous than the provisions of OLA, especially as applied by the FDIC.

The third part of the paper considers the ways in which SPOE, TLAC, and chapter 14 might be improved, if regulators are determined to move ahead with these proposals. First, regulators at the very least must require SIFIs to provide a host of detailed disclosures when they sell TLAC debt to investors. We believe those disclosures should include a description of the subsidy that TLAC bondholders are providing to operating company creditors, and it must be very clear that TLAC bondholders will be deeply subordinated within the capital structure of the overall corporate group. "Structural subordination" is a phrase that must be clearly explained to these bondholders. Our proposed disclosures would help to ensure that TLAC bonds pay higher interest rates that reflect the extraordinary risks inherent in bail-in debt. If higher interest rates encourage SIFIs to satisfy their TLAC mandates by issuing equity capital rather than bail-in debt, that would be a highly desirable result.

Second, regulators should strengthen TLAC to make it viable in a world where SPOE might not work. In particular, the proposed TLAC requirements should be enhanced to make OLA work in a world where liquidity problems are more apt to be the source of systemic problems. We argue that achieving this goal will require either a pre-funded Orderly Liquidation Fund, or a self- funded resolution reserve held by each financial holding company. Neither approach is likely to be popular with the management of SIFIs, but no other solution is likely to ensure that the necessary liquidity will be available (without government bailouts) in times of crisis.

We close the third part of the paper by briefly sketching the elements of a more viable chapter 14, which would allow for the use of "normal" bankruptcy style procedures when possible. But we also resist baking the choice of resolution mechanisms into the statute: flexibility is one of chapter 11's key attributes, and so it should be for chapter 14.

The most fundamental shortcoming of SPOE and TLAC, as currently proposed, is that both policies would entrench our perverse system for regulating SIFIs. While we recognize that a new and improved version of Dodd-Frank is unlikely to come out of the present Congress, we can at least

use current tools to shrink the TBTF subsidy by forcing SIFIs and their Wall Street creditors to internalize at least some of the costs of the enormous risks they create. The final part of our paper proposes reforms that would help to achieve that goal.

I. SPOE AND TLAC

Dodd-Frank's Orderly Liquidation Authority burst onto the scene as a kind of Frankenstein's monster, with bits of the Bankruptcy Code, the Securities Investor Protection Act, and bank receivership law glued together to create an insolvency system for financial companies.[15]

It seemed doubtful whether this new creation would actually work – how could the FDIC possibly run a massive corporate bankruptcy case all by itself, with a resolution tool that was obviously incomplete in several respects? It seemed that OLA was designed to answer a regulatory challenge and nothing more: *We had no choice but to let Lehman fail, and rescue AIG—we just didn't have the tools we needed to resolve them like we do banks. Give us those tools, and we swear, all your problems will go away*.[16]

Then came SPOE, which sought to make the use of OLA credible.[17] The idea was simple: only the holding company would go into an OLA receivership, while all the operating subsidiaries would continue to conduct business as usual.[18]

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[15] Stephen J. Lubben & Sarah Pei Woo, *Reconceptualizing Lehman*, 49 Tex. Int'l L.J. 297, 325 (2014). *See* Jamieson L. Hardee, *The Orderly Liquidation Authority: The Creditor's Perspective*, 15 N.C. Banking Inst. 259, 275 (2011); Thomas W. Joo, *A Comparison of Liquidation Regimes: Dodd-Frank's Orderly Liquidation Authority and the Securities Investor Protection Act*, 6 Brook. J. Corp. Fin. & Com. L. 47, 47 (2011).

[16] Richard Squire, *Clearinghouses as Liquidity Partitioning*, 99 Cornell L. Rev. 857, 911 (2014); Arthur E. Wilmarth, Jr., *The Dodd-Frank Act: A Flawed and Inadequate Response to the Too-Big-to-Fail Problem,* 89 Or. L. Rev. 951, 993 (2011).

[17] John Crawford, *"Single Point of Entry": The Promise and Limits of the Latest Cure for Bailouts*, 109 Nw. U.L. Rev. Online 103, 106-07 (2014); Lee, *supra* note 3, at 461-74.

[18] *See, e.g.,* Fed. Deposit Ins. Corp., Resolution of Systemically Important Financial Institutions: The Single Point of Entry Strategy, 78 Fed. Reg. 76,614, 76,616, 76,723 (Dec. 18, 2013) [hereinafter FDIC SPOE Proposal] (stating that, under SPOE, subsidiaries of the holding company would remain open for business while the parent holding company is

SPOE avoided the essential problem that while there is no such thing as a SIFI without cross-border operations, Dodd-Frank as drafted was even more domestically focused than the Bankruptcy Code.[19] As further discussed below, SPOE is designed to avoid cross-border resolution problems by limiting a SIFI's resolution to a single proceeding administered by the home country supervisor of the SIFI's parent holding company.[20] In addition, SPOE would enable the FDIC to avoid the supervisory burden of overseeing the operation of multiple subsidiaries of a failed SIFI. Instead, the FDIC would simply manage the resolution of the parent holding company.

For example, imagine the following simple financial holding company, which we will assume is systemically important, despite being simple:

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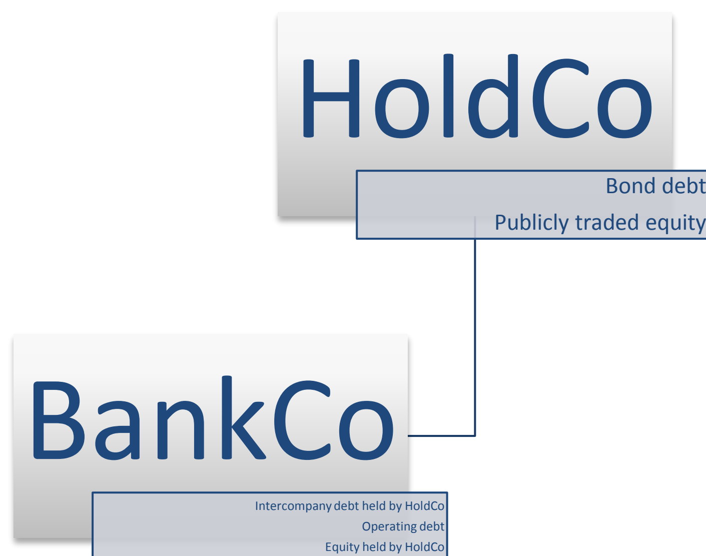
resolved in an OLA receivership). *See also* Michael Krimminger et al., *FDIC and Bank of England Signal Significant Cooperation on Resolution Issues in Joint Paper Describing "Single Point of Entry" Resolution of A Cross-Border SIFI*, 130 Banking L.J. 328, 329 (2013) (describing the joint plan for SPOE developed by the FDIC and the Bank of England).

[19] Edward F. Greene & Joshua L. Boehm, *The Limits of "Name-and-Shame" in International Financial Regulation*, 97 Cornell L. Rev. 1083, 1104 (2012).

[20] Jeffrey N. Gordon & Wolf-Georg Ringe, *Bank Resolution in the European Banking Union: A Transatlantic Perspective on What It Would Take*, 115 Colum. L. Rev. 1297, 1327 (2015).



Under the SPOE approach, Holdco cancels its bond debt and also cancels its intercompany debt with BankCo.[21] That debt cancellation solves routine balance sheet insolvency issues at both companies. Thus, SPOE's supporters argue that the SPOE strategy will work as long as HoldCo is required to issue a sufficiently large amount of bail-in debt, which can then be cancelled or converted into equity when Holdco is placed in an OLA receivership.

The Fed's TLAC proposal is designed to ensure that parent holding companies of SIFIs will hold enough bail-in debt. But before investigating TLAC, we will first examine SPOE in greater detail.

A. SPOE

Dodd-Frank's OLA applies to "covered financial companies," which are defined to exclude depository banks.[22] Other financial institutions become

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[21] It also cancels its equity, and gives new equity to old creditors.

[22] 12 U.S.C. § 5381(a)(8). *See also* 12 U.S.C. § 5381(a)(11(B)(iv) ("The term "financial company" means any company … [and] any subsidiary of any company … (other than a subsidiary that is an insured depository institution or an insurance company)").

covered financial companies if they are placed in receivership pursuant to OLA's required procedures as specified in § 203 of Dodd-Frank.[23]

A financial company can be placed in an OLA receivership if the Treasury Secretary satisfies a two-part test.[24] First, the Secretary must determine whether the financial company is in default, or in danger of default. This would include a financial company in bankruptcy or near bankruptcy, or otherwise likely to be insolvent.[25]

Second, the Treasury Secretary must determine whether the collapse of the financial institution, or its resolution outside OLA, would be likely to have "serious adverse effects on financial stability in the United States."[26] If the Treasury Secretary answers both questions in the affirmative (after receiving supporting recommendations from the Fed and the FDIC), the Treasury Secretary will appoint the FDIC as receiver and the FDIC will take control of the assets, obligations, and operations of the financial company.

Under OLA, the FDIC can take control of any type of financial company, except for FDIC-insured depository institutions and insurance companies. FDIC-insured depository institutions must be resolved under the FDIC's preexisting bank receivership process, and insurance companies must be resolved under the applicable state insurance company receivership process. The FDIC is permitted to commence a state insurance receivership, and, of course, the FDIC will be in charge of virtually all bank receiverships.[27]

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[23] 12 U.S.C. § 5383. "Financial companies" are defined as those companies that receive at least 85% of their consolidated revenues from finance, and for this definition the revenues of a subsidiary depository bank are included. 12 U.S.C. § 5381(b).

[24] Chrystin Ondersma, *Shadow Banking and Financial Distress: The Treatment of "Money-Claims" in Bankruptcy*, 2013 Colum. Bus. L. Rev. 79, 134.

[25] 12 U.S.C. § 5383(b)(1), (c)(4).

[26] 12 U.S.C. § 5383(b)(2).

[27] *See id.* §5381(a)(11)(B)(iv) (specifying that an FDIC-insured depository institution or insurance company is not a "financial company" that can be placed in an OLA receivership). The only banks that would not be placed in an FDIC receivership are those very rare banks that are not FDIC-insured, and thus subject to state bank receiverships.

Broker-dealers are subject to being cleaved between "good" brokers, which the FDIC takes charge of, and "bad" brokers, which remain the task of the Securities Investor Protection Corporation (SIPC).

Thus, under OLA, the FDIC will gain control over most, but not all, of the subsidiaries of a large financial holding company.[28] For example, Bank of America, which includes insurance companies, broker-dealers (notably, Merrill Lynch), and several depository banks operating under the Bank of America brand, would see the bulk of its broker-dealers pulled into OLA, while the depository banks would be turned over to the FDIC as bank receiver (and thus subject to different statutory instructions), and other entities would be farmed out to state insurance receiverships and some bits perhaps given to SIPC.[29]

In addition, OLA is by its terms limited to domestically incorporated entitles,[30] while the Bankruptcy Code is broad enough to allow for the reorganization of a foreign firm.[31] Thus, OLA intentionally slices off the foreign subsidiaries and affiliates of a financial institution that has been placed into an OLA receivership.

OLA thus applies only to the domestic core of the financial holding company. That limitation, combined with doubts about the FDIC's ability to manage the diverse assets that it might acquire as receiver of this core, has led to legitimate doubts about the practical workability of OLA.

The FDIC initially sought to address concerns about the feasibility of OLA by developing the SPOE concept. Under SPOE, only the holding company, and not its subsidiaries, would be placed in an OLA receivership. Operating subsidiaries would, in theory at least, continue to operate as if nothing was amiss with their parent company.

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[28] Thomas W. Merrill & Margaret L. Merrill, *Dodd-Frank Orderly Liquidation Authority: Too Big for the Constitution?*, 163 U. Pa. L. Rev. 165, 192 (2014).

[29] *See generally* Stephen J. Lubben, *Resolution, Orderly and Otherwise: B of A in OLA*, 81 U. Cin. L. Rev. 485 (2012).

[30] 12 U.S.C. § 5381(a)(11)(A); see also § 5381(a)(8).

[31] *See* Oscar Couwenberg & Stephen J. Lubben, *Corporate Bankruptcy Tourists*, 70 Bus. Law. 719 (2015).

In a May 2012 speech, FDIC Chairman Martin Gruenberg described SPOE as "the most promising resolution strategy" for dealing with a SIFI's failure. Mr. Gruenberg explained that SPOE would "place the parent [holding] company into receivership and pass its assets, principally investments in its subsidiaries, to a newly created bridge holding company. This will allow subsidiaries . . . to remain open and avoid the disruption that would likely accompany their closings."[32]

In December 2012, the FDIC and the Bank of England jointly identified SPOE as a desirable approach for resolving failures of global SIFIs. The FDIC and BoE agreed that SPOE would work well for global SIFIs because, "[b]y taking control of the SIFI at the top of the group, subsidiaries (domestic and foreign) carrying out critical services can remain open and operating, limiting the need for destabilizing insolvency proceedings at the subsidiary level."[33] The FDIC and BoE also agreed that SPOE could reduce cross-border complications by enabling the home country supervisor of a failed SIFI to control the resolution process at the "holding company level" while avoiding "foreign insolvency proceedings" for subsidiaries located in other countries.[34]

While the FDIC and BoE supported the SPOE concept, they indicated that the final outcome of an SPOE resolution would still be a liquidation of the failed SIFI. The agencies stated that SPOE's "top-down resolution" would be followed by "significant restructuring" that could include "shrinking the [SIFI's] balance sheet, breaking the company up into smaller entities, and/or selling or closing certain operations."[35]

In December 2013, the FDIC presented a detailed SPOE proposal and invited the public to comment on that proposal. The FDIC's proposal

[32] Remarks by FDIC Chairman Martin J. Gruenberg at the Federal Reserve Bank of Chicago Bank Structure Conference, May 10, 2012, available at https://www.fdic.gov/news/news/speeches/archives/2012/spmay1012.html; *see also* Lee, *supra* note 3, at 464-66 (discussing the FDIC's early development of the SPOE concept).

[33] *Resolving Globally Active, Systemically Important, Financial Institutions: A joint paper by the Federal Deposit Insurance Corporation and the Bank of England* (10 December 2012), at 6, available at https://www.fdic.gov/about/srac/2012/gsifi.pdf.

[34] *Id.* at 11.

[35] *Id.* at 9.

stated that an SPOE resolution would put a failed SIFI's parent holding company into an OLA receivership and would transfer its operating subsidiaries to a newly-formed bridge financial company (BFC). The FDIC would then wipe out the equity interests of the SIFI's shareholders and convert the claims of the SIFI's long-term debtholders into equity interests in the BFC. The failed SIFI's subsidiaries (including banks, securities broker-dealers, swap dealers, and insurance companies) would continue to operate without interruption under the BFC's control, and the rights of creditors of those subsidiaries would not be impaired.[36]

After completing an SPOE resolution, the FDIC would approve a "restructuring" plan to transfer the operating subsidiaries from the BFC to one or more successor companies. The restructuring plan "**might** result in the [BFC] being divided into several companies or parts of entities sold to third parties," and "the [BFC] **might** become smaller and less complex."[37] The FDIC's repeated use of the word "might" rather than "will," when discussing restructuring options, suggested a possible weakening of the FDIC's commitment to a liquidation-only approach.

Five major financial industry trade associations enthusiastically endorsed the FDIC's SPOE proposal.[38] The same groups also rejected criticism of the proposal by former Fed Chairman Paul Volcker. Mr. Volcker observed that SPOE looks "more like a reorganization under Chapter 11 of the Bankruptcy Code than a liquidation as required by Title II [of Dodd-

[36] FDIC SPOE Proposal, *supra* note 18, at 76,616.

[37] *Id.* at 76,620 (emphasis added).

[38] *See* Comment Letter to FDIC, dated Feb. 18, 2014, from The Clearing House, the Securities Industry and Financial Markets Ass'n, the American Bankers Ass'n, the Financial Services Roundtable, and the Global Financial Markets Ass'n [hereinafter 2014 Wall Street SPOE Letter], available at https://www.theclearinghouse.org/~/media/Files/Association%20Documents/20140218%20Single%20Point%20of%20Entry%20Comment%20Letter.pdf.

Frank]."[39] Others agreed with Mr. Volcker's view that the SPOE strategy appeared to conflict with Title II's liquidation-only mandate.[40]

The financial industry trade groups claimed that Title II would accommodate an SPOE strategy that "treats claimants as consistently as possible with how they would have been treated in a successful **reorganization** under the Bankruptcy Code."[41] In fact, however, as the groups acknowledged, Title II only requires that creditors receive "**at least** as much value in satisfaction of their claims as they would have received in a **liquidation** under Chapter 7 of the Bankruptcy Code."[42] To bolster their argument that Title II would allow reorganizations of failed SIFIs, the Wall Street groups claimed that dissolving a failed SIFI's parent holding company would be sufficient to satisfy Title II's liquidation-only mandate. They also argued that Title II does not require any restructuring of subsidiaries after they are transferred to a BFC.[43] Other Wall Street

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[39] 2014 Wall Street SPOE Letter, *supra* note 38, at 25; *see also id.* at 25 n.90 (citing Mr. Volcker's remarks); Joe Adler, *Is the FDIC's 'Single Point' Resolution Plan a Stealth Bailout?*, American Banker, Dec. 13, 2013, 2013 WLNR 31174108 (same).

[40] *See* Adler, *supra* note 39 (quoting Arthur Wilmarth's opinion that SPOE "doesn't look like a liquidation" and instead "looks like a reorganization in which the [failed SIFI] survives to fight another day"); Written Testimony of David A. Skeel, Jr. before the Subcomm. on Oversight and Investigations of the House Comm. on Financial Services, May 15, 2013, at 3 ("[A]lthough Title II explicitly requires that its provisions be used for liquidation, [SPOE] is essentially a reorganization. It thus stands in tension with the explicit requirements of Title II."), available at http://financialservices.house.gov/uploadedfiles/hhrg-113-ba09-wstate-dskeel-20130515.pdf; *see also* Joe Adler, *How the FDIC Can Fix Its Big Bank Resolution Plan*, Am. Banker (Feb. 24, 2014), 2014 WLNR 4869133 (quoting letter dated Feb. 18, 2014, from former FDIC Chairman Sheila Bair, who warned that, "without further progress under Title I [of Dodd-Frank] to require U.S. SIFIs to simplify and rationalize their legal structures, the most likely outcome of the SPOE approach will be to replace one systemic firm with another. . . . [T]his new firm . . . could still have the same name, many of the same employees, and pose the same external risks to the system.").

[41] 2014 Wall Street SPOE Letter, *supra* note 38, at 26 (emphasis added). The trade groups did not cite any provision of Title II that explicitly mandates treatment for creditors similar to a reorganization under Chapter 11 of the Bankruptcy Code. However, the groups asserted that a "duty" to provide such treatment could be "implied" from Title II's overall purpose to "avoid or mitigate" the potential for "serious adverse effects on financial stability in the United States." *Id.* at 26 n.97.

[42] *Id.* (emphasis added in part) (citing Dodd-Frank §§ 210(a)(7)(B), (d)(2)(B)).

[43] *Id.* at 25, 27.

supporters agreed that Title II would allow a BFC and its subsidiaries to emerge intact as a new financial holding company following an SPOE resolution.[44]

Thus, Wall Street's version of SPOE contemplates little or no restructuring at either the holding company level or the subsidiary level after the FDIC transfers operating subsidiaries from a failed SIFI's parent holding company to a BFC. Wall Street obviously prefers a reorganization strategy that would convert a failed SIFI into a new, cleaned-up, and recapitalized SIFI with a minimum of structural changes. During the recapitalization, as indicated above, the SIFI's subsidiaries would be kept in operation and all of their creditors (including Wall Street creditors) would be fully protected from losses.[45]

The FDIC has not formally approved the SPOE proposal it issued in December 2013, and the FDIC may not necessarily agree with Wall Street's version of SPOE, which embraces a Chapter 11-style reorganization strategy. FDIC Vice Chairman Thomas Hoenig expressed serious reservations when the FDIC released its SPOE proposal, and he noted earlier this year that the FDIC "has not adopted [the SPOE] strategy."[46] In a speech delivered in September 2015, FDIC Chairman Gruenberg

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[44] *See Too Big to Fail: A Report of the Failure Resolution Task Force of the Financial Regulatory Reform Initiative of the Bipartisan Policy Center* 31 (Bipartisan Policy Center, May 2013) [hereinafter 2013 BPC SPOE Report], available at http://bipartisanpolicy.org/library/too-big-fail-path-solution-525/; *see also id.* at 30 (fig. 7) (showing graphically how the BFC would be converted into a new financial holding company). The principal authors of the 2013 BPC SPOE Report were John Bovenzi (a partner in the Oliver Wyman financial consulting firm), Randall Guynn (head of Davis Polk's financial institutions practice and originator of the "recapitalization-within-resolution" concept), and Thomas Jackson (a leading bankruptcy law scholar). *Id.* at 82. The Bipartisan Policy Center (BPC) is a think tank that receives significant funding from major financial institutions and financial trade groups, and BPC generally supports policies favorable to Wall Street. Wilmarth, *supra* note 7, at 59 n.62.

[45] 2013 BPC SPOE Report, *supra* note 44, at 26-32.

[46] Joe Adler, *Likely Battle Ahead for FDIC's 'Single Point' Resolution Plan*, Am. Banker (Dec. 11, 2013), 2013 WLNR 30941803 (reporting on Mr. Hoenig's critical comments when the FDIC released its SPOE proposal); "The Relative Role of Debt in Bank Resiliency and Resolvability," Remarks by FDIC Vice Chairman Thomas Hoenig at the Peterson Institute for International Economics (Jan. 20, 2016), n.3 [hereinafter Hoenig 2016 Speech], available at https://www.fdic.gov/news/news/speeches/spjan2016.html.

explained that Title II of Dodd-Frank gives the FDIC the necessary authority for "breaking up and winding down" a failed SIFI, and he "would expect some business lines or subsidiaries (such as broker-dealers) to quickly shrink and wind down and for other to be sold off" during an OLA resolution. Chairman Gruenberg also stated, "An explicit objective is to ensure that no systemically significant entity emerges from this process."[47] Thus, Chairman Gruenberg's speech did not endorse Wall Street's efforts to promote an SPOE resolution process that would operate as the functional equivalent of a Chapter 11 reorganization.

Nonetheless, there is some obvious tension between the recent remarks of Chairman Gruenberg and Vice Chairman Hoenig and the FDIC's repeated statements that ownership of the failed SIFI would be quickly returned to private control, by distributing the equity of the new holding company to creditors. The FDIC's ability to compel any sort of breakup of the SIFI would presumably markedly decline once it no longer controlled the holding company. Moreover, as explained in the next section, the Fed apparently does not share any of the skepticism that the FDIC may have about Wall Street's version of SPOE.

B. TLAC

As explained above, the Fed's TLAC proposal would entrench SPOE as the preferred strategy for resolving failures of SIFIs. The Fed's TLAC proposal accords with Wall Street's desire to maintain a continuity of existence for a failed G-SIB's subsidiaries as well as full protection for the subsidiaries' creditors. The Fed clearly prefers the SPOE strategy over the alternative "multiple point of entry" (MPOE) resolution approach. Unlike SPOE, MPOE would require "separate resolutions of different legal entities within the financial firm and could potentially be executed by multiple resolution

[47] Remarks by FDIC Chairman Martin J. Gruenberg to the FDIC Banking Research Conference, Sept. 17, 2015, available at https://www.fdic.gov/news/news/speeches/spsep1715.html.

authorities across multiple jurisdictions," a result the Fed plainly does not want.[48]

The Fed's TLAC proposal would require the parent holding company of each U.S. G-SIB to maintain "eligible external TLAC" equal to 18% of its risk-weighted assets (RWAs) or 9.5% of its total leverage exposure, whichever is greater. In addition, each U.S. G-SIB would be obliged to maintain a supplemental "external TLAC buffer" equal to 2.5% of RWAs plus the applicable surcharge under the Fed's G-SIB surcharge rule. The Fed projects that the four largest U.S. G-SIBs would be required to satisfy minimum TLAC ratios ranging from 18.5% of RWAs for Wells Fargo to 23.5% of RWAs for JPMorgan Chase.[49]

In addition to creating "external TLAC" rules for U.S. G-SIBs, the Fed's proposal would require each U.S. intermediate holding company owned by a foreign G-SIB to satisfy an "internal TLAC" requirement. This "internal TLAC" requirement would oblige each U.S. intermediate holding company to sell qualifying TLAC instruments to its parent foreign G-SIB, so that the failure of a U.S. holding company could be resolved by writing off the TLAC investments held by its parent foreign G-SIB.[50]

Under the Fed's proposal, each parent holding company of a U.S. G-SIB would be required to maintain qualifying TLAC that includes a combination of Tier 1 capital (common stock and non-cumulative perpetual preferred stock) and "eligible external long-term debt" (TLAC debt). Each G-SIB would be obliged to maintain a minimum ratio of TLAC debt equal to 6% of its RWAs plus its G-SIB surcharge or 4.5% of its leverage exposure, whichever is greater. The Fed expects that the four largest U.S. G-SIBs

[48] Fed TLAC Proposal, *supra* note 9, at 74,928.

[49] *See* Bd. of Governors of Fed. Res. Sys., "Depiction of Proposed LTD Requirement + Fully Phased-in Tier 1 Risk-Based Capital Requirements" (chart) [hereinafter FED LTD Chart], available at http://www.federalreserve.gov/aboutthefed/boardmeetings/ltd-chart-20151030.pdf.

[50] The remainder of this article will focus on the proposed "external TLAC" rules for U.S. G-SIBs and will not address the "internal TLAC" requirement for foreign G-SIBs.

would need to satisfy minimum TLAC debt ratios ranging from 8% of RWAs for Wells Fargo to 10.5% of RWAs for JPMorgan Chase.[51]

Each parent holding company of a G-SIB would be required to issue TLAC debt directly, instead of through subsidiaries, thereby ensuring that the TLAC debt could be written off in an SPOE resolution of the holding company. As the Fed's proposal explains, "Under the SPOE approach, only the [holding company] would enter resolution. The [holding company's] eligible [TLAC debt] would be used to absorb losses incurring throughout the banking organization, enabling the recapitalization of operating subsidiaries that had incurred losses and enabling those subsidiaries to continue operating on a going-concern basis."[52] Thus, TLAC debt would function as bail-in debt and would be used to recapitalize the failed G-SIB's operating subsidiaries.

Under the Fed's proposal, TLAC debt must be unsecured, must not be guaranteed by a G-SIB's holding company or any of its subsidiaries, and must not have any credit enhancements that would increase its seniority. TLAC debt must have a remaining maturity of at least one year and would be subject to a 50% haircut if its remaining maturity were less than two years. TLAC debt must be "plain-vanilla" debt, must be governed by U.S. law, and must not be convertible into equity prior to the date of the FDIC's appointment as receiver for the holding company.[53]

To ensure that parent holding companies of G-SIBs would be less difficult to resolve, the Fed's TLAC proposal also includes "clean holding company" provisions. Those provisions would prohibit each parent holding company of a G-SIB from entering into a number of transactions, including (i) issuing non-TLAC liabilities unless they have a status senior to TLAC debt, (ii) issuing non-TLAC liabilities that exceed 5% of the holding company's total liabilities, (iii) issuing any type of debt to non-affiliates with an original maturity of less than one year, or (iv) entering into any "qualifying financial contracts" (e.g., derivatives or repos) with non-affiliates. The "clean

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[51] Fed LTD Chart, *supra* note 49; Fed TLAC Proposal, *supra* note 9, at 74,931-32.
[52] Fed TLAC Proposal, *supra* note 9, at 74,934.
[53] *Id.* at 74,934-35.

holding company" provisions are designed to prevent G-SIB holding companies from issuing short-term liabilities or volatile exposures that would be subject to "the risk of destabilizing funding runs" by third-party creditors.[54]

II. The Shortcomings of the SPOE-TLAC Regime

In this part of the paper, we address several reasons for skepticism about the SPOE-TLAC regime. We begin by focusing on the concerns with SPOE and TLAC individually, and then turn to the concerns that arise from the joint operation of TLAC and SPOE. We conclude with some observations about the financial industry's problematic efforts to create a new chapter of the Bankruptcy Code, typically designated chapter 14, which would allow for SPOE to be used outside of OLA.

A. SPOE, Will It Work?

This basic SPOE approach – placing the top-level holding company and nothing else into resolution – is not new. Indeed, it is the initial favored approach for most corporate chapter 11 cases. Nonetheless, reality often intrudes in chapter 11, and much of the corporate group frequently is compelled to file for bankruptcy.

The reasons begin with the capital structure of most corporate groups. First, lenders, especially senior lenders, often obtain guarantees from the operating subsidiaries. Second, many lending agreements contain cross-default provisions and acceleration clauses, meaning that a bankruptcy filing by the parent company will automatically generate problems for its subsidiaries, even if the subsidiaries are otherwise solvent.

Federal regulators are not unaware of these issues, and have tried to adopt regulatory solutions that will buttress SPOE. For example, under intense regulatory pressure, the largest American financial institutions have agreed to amend the terms of their swaps contracts so that an insolvency of the parent holding company will not trigger the contractual

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[54] *Id.* at 74,944.

right to terminate a subsidiary's swaps contracts. There are efforts to expand the scope of this collective deal beyond the largest financial institutions, although not all counterparties are enthusiastic adopters of the new approach.[55]

More broadly, for the SPOE process to work regulators will have to vigilantly police against the creation of joint holding company and operating company liabilities throughout the entire corporate structure.[56] Regulation can preclude the creation of joint liabilities as a matter of contract, but state agency and tort law might be another matter. A branch employee who holds themselves out as an employee of "Chase" might well create liability for the holding company under agency law principles in a way that completely undermines the separation necessary for SPOE to work as designed. Likewise, joint holding and operating company liabilities might be created under foreign law, regardless of U.S. regulatory policy.

Another reason holding company chapter 11 cases often fail is that the holding company is rarely the source of financial distress. Indeed, the only instance where exclusive focus on the holding company typically makes sense is in those firms that have undergone a leveraged buyout. In such a case, financial distress clearly results from "too much debt." Removing the debt – often through the forcible conversion of bondholders to shareholders – solves the problem.

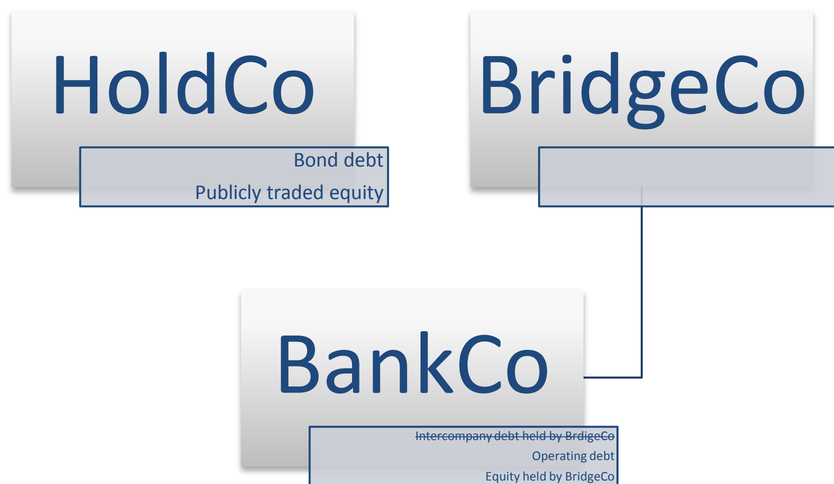
However, while SIFIs often operate with a high degree of leverage, we know of no case where a major financial institution failed because of its inability to make payments on long-term bonds. Instead, financial institutions typically fail because of some sort of run – broadly defined to include all instances where depositors or other short-term creditors flee the financial institution. These runs typically originate in a subsidiary. As

[55] http://www.pimco.com/EN/Insights/Pages/Unintended-Consequences-of-Staying-Early-Termination-Rights.aspx

[56] Kwon-Yong Jin, *How to Eat an Elephant: Corporate Group Structure of Systemically Important Financial Institutions, Orderly Liquidation Authority, and Single Point of Entry Resolution*, 124 Yale L.J. 1746, 1772 (2015).

we explain below, SPOE does not provide persuasive answers for solvency problems affecting subsidiaries of SIFIs.

An SPOE-style OLA proceeding would commence with the transfer of the parent holding company's assets (primarily the stock of its subsidiaries) to a bridge bank, while the holding company's liabilities would stay behind in the "receivership estate."[57] If we use our simple model financial holding company from earlier in the paper, and ignore the complications resulting from nature of the principal subsidiary (which as a depository bank might not provide a proper basis for an OLA proceeding), we would find the following:



BridgeCo, a holding company and also a blank slate, could sell stock and bonds to recapitalize its corporate group. The timing gap between commencement of the OLA and the sale of these securities could be bridged by obtaining funding from the FDIC through the Orderly Liquidation Fund, as described below.[58]

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[57] Strictly speaking, and unlike the Bankruptcy Code, OLA does not provide for the creation of an estate.

[58] 12 U.S.C. § 5390(n). Of course, arguably the fund would not be used for "liquidation" when used in connection with SPOE.

BankCo would be recapitalized by having its debt to HoldCo/BridgeCo forgiven either directly or indirectly by means of an exchange of the debt claims of HoldCo/BridgeCo for new equity in BankCo.[59] Of course, debt forgiveness would only solve the problem of balance sheet insolvency, and would not inject new funding into the corporate group. Thus, debt forgiveness (or debt-for-equity swaps) would not address likely liquidity problems. If BridgeCo could successfully borrow funds by issuing new bonds, it could downstream those funds to its subsidiaries in exchange for new intercompany debt or yet more equity.

If, however, the BridgeCo debt is not able to sell bonds (due to a lack of demand in the bond market), the Orderly Liquidation Fund (OLF) would be the obvious source for operating company liquidity. Lending from the OLF is limited during the first 30 days of the resolution process, when such lending is apt to be most vital, to just 10% of the financial company's assets. In the present example, that restriction would limit lending to BridgeCo to a figure that equaled the total value of BankCo, less BankCo's operating debt, multiplied by 0.10. It is not clear that OLF loans equal to 10% of the financial company's assets would be sufficient to solve the liquidity problems of a bank or securities broker-dealer whose parent company has just been placed into OLA.[60]

After the first month of the case, the FDIC can provide additional loans through the OLF "equal to 90 percent of the fair value of the total consolidated assets of each covered financial company that are available for repayment."[61] Thus, the FDIC might have to operate BridgeCo with only a 10% equity cushion during this latter period, again subject to the assumption that the financial institution was able to survive the first 30 days of the case, when the FDIC's ability to lend is significantly constrained.

The ability to lend against "fair value" – a phrase as definitive as other legal favorites like "reasonable" or "material" – also suggests the prospect that the FDIC's ability to obtain loans from the OLF would not be determined by

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[59] The latter might be wise to avoid any fraudulent transfer claims.
[60] 12 U.S.C. § 5390(n)(6)(A).
[61] § 5390(n)(6)(B).

the current fair market value of the assets of BankCo. Accordingly, the FDIC might be exposed to a real risk of loss when it borrows from the OLF to obtain the necessary funds to provide needed liquidity to the operating subsidiaries. Moreover, the FDIC could effectively be performing a liquidity transformation service – similar to that provided by the Fed at the "discount window" – in allowing HoldCo to monetize the value of its subsidiaries at a point when private financing could well be unavailable.[62]

The FDIC's experience during its rescue of Continental Illinois (Continental) in 1984 indicates that the FDIC should be prepared to provide large amounts of liquidity assistance to a SIFI after it has been placed in an OLA receivership. After Continental experienced a massive "silent run" by uninsured domestic and foreign depositors, the Fed provided discount window loans to Continental and the FDIC issued a blanket guarantee in May 1984 that covered all of Continental's depositors and other creditors.[63] In spite of those measures, the run on Continental continued and federal regulators announced a permanent assistance plan in July 1984. Under that plan, the FDIC injected $1 billion of new capital into Continental by purchasing preferred stock, and the FDIC also assumed responsibility for paying off Continental's loans from the Fed.[64]

By the end of August 1984, the FDIC, the Fed, and a supporting group of private banks were providing more than $15 billion of funding to Continental and held almost half of Continental's total liabilities.[65]
The FDIC's experience with Continental "suggests that, if an institution needs to be resolved using OLA, the FDIC should be prepared for the possibility that short-term creditors will make enormous demands for

[62] *See* Kristin N. Johnson, *Governing Financial Markets: Regulating Conflicts*, 88 Wash. L. Rev. 185, 228 (2013).

[63] Mark A. Carlson & Jonathan Rose, *Can a Bank Run Be Stopped? Government Guarantees and the Run on Continental Illinois* 6-8 (Bank for Int'l Settlements Working Paper No. 554), available at http://ssrn.com/abstract=2756472.

[64] *Id.* at 8-9 (noting that the federal assistance plan for Continental "was one of the most expensive ever arranged by financial regulators at the time: [T]he FDIC estimated its cost for the bailout at $1.1 billion").

[65] *Id.* at 9-12, 13 (tbl. 3).

withdrawals. That, in turn, could require large drawdowns from the FDIC's credit line with the Treasury [under the OLF]."[66]

A final source of liquidity for troubled subsidiaries of a failed SIFI might be other subsidiaries in the group. A particularly "flush" subsidiary could pay a dividend to BridgeCo, which could in turn loan the money to any operating subsidiaries that need additional funds.

Whatever the liquidity source, the foregoing discussion illustrates several problems that could well result from attempting to "resolve" a SIFI through a holding-company only insolvency process. First, the proposal assumes that funds will freely flow across the corporate group. Foreign regulators, and state corporate and debtor-creditor law might present practical impediments here. For example, would it be consistent with state fiduciary duties for the board of directors of a subsidiary not in OLA to distribute potentially vital cash to a distressed parent company? Would such a distribution constitute a fraudulent transfer? And if the subsidiary is a regulated entity, would the regulator permit such a transfer?

Next, there is the matter of the subsidiary that caused the problems in the first instance. The SPOE model implicitly assumes that entity should be recapitalized in nearly all cases. But in many plausible cases, opening a potential funding spigot from the parent holding company will do little to address the fundamental problem at issue.

Consider Lehman's basic problem: it was heavily dependent on short-term overnight repo funding, which it obtained by borrowing against its extensive holdings of mortgage backed securities.[67] When the market began to doubt the value of those securities, Lehman could no longer obtain sufficient funding by rolling over its repos. Lehman's parent company did not have sufficient reserves to solve this problem by loaning money to its trading subsidiaries. In Lehman's situation, an SPOE resolution by itself would not provide any source of external funding; SPOE

[66] *Id.* at 30.

[67] John Crawford, *Wargaming Financial Crises: The Problem of (in)experience and Regulator Expertise*, 34 Rev. Banking & Fin. L. 111, 151 (2014).

would simply move the operating subsidiaries' problem to the holding company level. To rescue its trading subsidiaries, Lehman's holding company would have been required to purchase the subsidiaries' mortgage backed securities, but that requirement would have led right back to the question of how the holding company could fund that purchase. Absent a government-arranged source of liquidity, Lehman inevitably would have failed.[68]

A similar example can be seen in the case of AIG, where one part of AIG – its financial products division – issued credit default swaps that represented a disastrous bet on the continued health of the American housing market, while another division used funds received from lending out the insurance companies' securities to make huge investments in nonprime mortgage backed securities.[69] Neither of AIG's problems could be solved through an infusion of cash from the parent company until the parent company itself received massive assistance from the Fed and the Treasury.

In short, SPOE seems well designed to address balance sheet problems in financial conglomerates, but balance sheet problems are unlikely to be the primary source of potential crises at such a conglomerate.

A final reason to doubt the efficacy of SPOE turns on the realities of how corporate groups operate, and the very real potential for group contagion. As a rule, corporate groups, both inside and outside finance, manage their liquidity and cash on a groupwide basis.[70] From a reputational perspective, corporate groups face the market as a single, integrated whole, despite being comprised of hundreds, if not thousands, of separate legal entities.[71]

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[68] *See* Lee, *supra* note 3, at 454-61.

[69] *See generally* William K. Sjostrom, Jr., *The AIG Bailout*, 66 Wash. & Lee L. Rev. 943 (2009).

[70] Brad B. Erens et. al., *Bankrupt Subsidiaries: The Challenges to the Parent of Legal Separation*, 25 Emory Bankr. Dev. J. 65, 131 (2008). *See also* Lynn M. Lopucki, *The Death of Liability*, 106 Yale L.J. 1, 49 (1996)

[71] Douglas G. Baird, Robert K. Rasmussen, *Antibankruptcy*, 119 Yale L.J. 648, 657 (2010).

This provides some reason to doubt that all will be "business as usual" at the operating subsidiaries of a SIFI that has gone into OLA, especially if we remember that OLA is most apt to be invoked in times of systemic stress. For conglomerate firms with retail operations, especially in nonbank subsidiaries that are not protected by the FDIC, any attempt to persuade brokerage or insurance customers that "their" subsidiary is separate from the parent holding company that just failed is likely to be a very hard sale. Even institutional investors might hesitate to "stay the course," especially so long as the OLA process remains comparatively untested and unknown, especially as compared with its SIPA and chapter 11 counterparts. In short, placing the parent holding company into an SPOE resolution would pose a substantial risk of precipitating a run on the nominally solvent operating subsidiaries.

B. Who Wants to Buy TLAC Debt and Become Structurally Subordinated?

As a practical matter, Wall Street's SPOE strategy and the Fed's TLAC proposal would create a very high probability of imposing losses from a G-SIB's failure on ordinary citizens, either as investors or as taxpayers. As described above, SPOE and TLAC would protect a failed G-SIB's subsidiaries and their creditors from suffering any losses. The Fed's proposal states that SPOE and TLAC are designed to make sure that losses from resolving a failed G-SIB "would instead be borne by the external TLAC holders of the [parent] holding company," including shareholders and bail-in debtholders.[72] The Fed's proposal contends that a blanket guarantee for a failed G-SIB's subsidiaries and their creditors is essential because such a guarantee would "help to maintain the confidence of the operating subsidiaries' creditors and counterparties, reducing their incentives to engage in potentially destabilizing funding runs." [73] Thus, the Fed's proposal would provide 100% protection for Wall Street creditors, including uninsured depositors and holders of commercial paper, repos, and derivatives, in order to create "reduced incentives to run" among those creditors.[74]

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[72] Fed TLAC Proposal, *supra* note 9, at 74,928, 74,944 (quote).
[73] *Id.* at 74,928.
[74] *Id.* at 79,944-45.

Who would be the target audience for buying the parent holding company's TLAC debt, which would be used to protect subsidiaries and their Wall Street creditors? The Fed's proposal strongly indicates that individual investors, especially those holding interests in mutual funds and pension funds, would be expected to buy this loss-absorbing TLAC debt. As the proposal emphasizes, "it is desirable that the holding company's creditors be limited to those entities that can be exposed to losses **without materially affecting financial stability**."[75]

The Fed's proposal would strongly discourage depository institutions and their holding companies from investing in TLAC debt. Banking and thrift organizations would be required to deduct any investments in TLAC debt from their regulatory capital. As the proposal explains, this mandatory capital deduction "would substantially reduce the incentive of a [depository] institution to invest in unsecured debt issued by a [G-SIB], thereby increasing the prospects for an orderly resolution of a [G-SIB] by reducing the risk of contagion spreading to other [depository] institutions."[76] Similarly, the Financial Stability Board has mandated a 100% regulatory capital deduction to discourage G-SIBs around the world from investing in TLAC debt issued by other G-SIBs.[77] Insurance regulators are expected to adopt similar capital deduction rules to deter insurance companies from investing in TLAC debt.

If depository institutions and insurance companies do not buy TLAC debt, the most likely investors for such debt would be hedge funds, mutual funds, and pension funds. Individual investors might also buy TLAC debt through their brokerage accounts.

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[75] *Id.* at 74,945 (emphasis added).

[76] *Id.* at 74,950.

[77] Financial Stability Board, "Principles on Loss-absorbing and Recapitalisation Capacity of G-SIBs in Resolution: Total Loss-absorbing Capacity (TLAC) Term Sheet" (Nov. 9, 2015) [hereinafter FSB TLAC Principles], at 17 (Principle 15, "Regulation of Investors") ("In order to reduce the risk of contagion, G-SIBs must deduct from their own TLAC or regulatory capital [all] exposures to eligible external TLAC instruments and liabilities issued by other G-SIBs."), available at http://www.financialstabilityboard.org/wp-content/uploads/TLAC-Principles-and-Term-Sheet-for-publication-final.pdf.

We expect that regulators would discourage G-SIBs from selling substantial amounts of TLAC debt to hedge funds, because many of those funds are major borrowers from megabanks through prime brokerage arrangements.[78] A write-off of TLAC debt held by hedge funds could undermine financial stability by causing those funds to default on the obligations they owe to G-SIBs.[79]

In contrast, regulators and executives of megabanks view mutual funds and pension funds as prospective targets for sales of bail-in debt.[80] Government officials and G-SIB leaders evidently believe that, *unlike* Wall Street creditors, retail investors in mutual funds and pension funds can bear the costs of resolving failed megabanks without undermining financial stability. HSBC chairman Douglas Flint expressed that belief with remarkable candor during his testimony before a Parliamentary committee in October 2014. Mr. Flint declared that society must choose between imposing the costs of resolving failed megabanks on retail investors or on taxpayers. In his view, "At the end of the day, **the burden of failure rests with society**. Whether you take it out of society's future income through taxation or whether you take it through their pensions or savings, **society is bearing the cost**."[81]

Mr. Flint did not mention the possibility that SIFIs or their insiders might share any of the losses resulting from excessive risk-taking. His assertion that "society" must continue to bail out megabanks provides a revealing glimpse into the mindset that has prevailed among leaders of Wall Street and the City of London before, during, and after the financial crisis. Those leaders continue to believe that SIFIs and their insiders should keep all of the short-term profits and bonuses produced by their high-risk activities, while governments and ordinary citizens must bear the burden of paying for longer-term losses.[82]

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[78] https://next.ft.com/content/403c2b14-0c64-11e6-9456-444ab5211a2f

[79] *See* Wilmarth, *supra* note 7, at 62.

[80] *See id.* at 63-64.

[81] *Id.* at 64 (quoting Mr. Flint's testimony before the U.K. House of Lords' Select Committee on the European Union on Oct. 21, 2014) (emphasis added).

[82] *See* Simon Johnson & James Kwak, *13 Bankers: The Wall Street Takeover and the*

C. TLAC and SPOE Together

Think back again to our simple financial institution, in which HoldCo owns BankCo. In good times, HoldCo's only assets will be a package of debt and equity claims against BankCo. As a matter of basic corporate finance, the overall value of this package can never be larger than the value of BankCo itself. And because HoldCo's claims are subordinated to those of other creditors of BankCo – since HoldCo's debt claims will be forgiven upon its insolvency, and HoldCo's equity claims are inherently subordinated – much of the value of BankCo will be captured by other claimants of BankCo.

It is often suggested that SPOE's success will depend on the financing of HoldCo. For example, one commentator explains that

> The critical element of the SPOE strategy is the recapitalization of the company's material operating subsidiaries with the resources of the parent company. For the SPOE top-down approach to work effectively, there must be sufficient resources at the holding company level to absorb all the losses of the firm, including losses sustained by the operating subsidiaries. The capitalization of the bridge financial company must be sufficient, simply by virtue of the fact that the failed holding company's indebtedness is not transferred to the bridge, not only to allow the operating subsidiaries to obtain needed capital from the bridge to continue operations but also to allow stakeholders and the broader public to view the entity as safe and viable as it transitions from failed firm to bridge financial company, and ultimately to emergence as a new firm.[83]

The assumption that SPOE will work so long as HoldCo has "sufficient resources" (including bail-in debt) ignores the likely outer limit to such

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Next Financial Meltdown 12 (2010) ("The basic, massive subsidy scheme [for SIFIs] remains unchanged: when times are good, the banks keep the upside as executive and trader compensation; when times are bad and potential crisis looms, the government picks up the bill."); *see also* Wilmarth, *supra* note 6, at 65 n.86 (noting that "major U.K. banks pushed for deregulation and 'light touch' supervision" before the financial crisis, and ultimately "U.K. authorities were forced to bail out four of the nine largest U.K. banks").

[83] http://goo.gl/SFmEuy

"resources." In short, HoldCo will only be able to issue as much debt as its assets – the debt and equity claims it holds against BankCo – will support.

At the very outer limit, HoldCo can only borrow to the point where its interest payments equal the cash flow generated by its debt and equity claims in BankCo. That situation would leave HoldCo facing extreme refinancing risk, such that it is hard to imagine prudential regulators ever allowing such a high degree of debt financing.

Moreover, following entry into OLA, the borrowing ability of HoldCo/BridgeCo is apt to drop off a cliff. After all, the holding company's borrowing ability is a function of the value of its subsidiaries' assets, and presumably a large portion of those assets will have just experienced an adverse shock that was significant enough to warrant the invocation of OLA.[84]

Thus, a post-insolvency BridgeCo will have substantially diminished borrowing capacity. It therefore seems highly doubtful whether BridgeCo will be able to obtain enough *new* private sector funding to recapitalized its troubled subsidiaries. As shown above, if funds invested by HoldCo's shareholders and TLAC debtholders are not sufficient to recapitalize HoldCo's subsidiaries, and if additional private sector funding is not available, the FDIC would have to rely on taxpayer-financed loans from the OLF to fill the remaining gap. During congressional deliberations over Dodd-Frank, Wall Street repeatedly blocked proposals that would have required SIFIs to pay risk-based premiums to prefund the OLF.[85] As a result, the OLF currently has a zero balance, and the FDIC must take out Treasury-approved loans from the OLF to cover any net losses from resolving a failed G-SIB.[86]

Ordinarily the FDIC must repay OLF loans within five years by imposing special assessments on large financial institutions. However, the Treasury Department can extend OLF loans indefinitely in order "to avoid a serious

[84] *See* 12 U.S.C. § 5383 (Dodd-Frank Act § 203).
[85] Wilmarth, *supra* note 6, at 46, 73-74.
[86] *Id.* at 66-67, 74.

adverse effect on the financial system of the United States."[87] During a future financial crisis, many large banks probably would be too weak to pay special assessments, and Treasury would therefore feel obliged to extend OLF loans far beyond their standard five-year term. As a result, OLF loans would become lengthy, taxpayer-financed bridge loans. The foregoing analysis makes clear that SPOE and TLAC would continue to shift the burden of bailing out failed SIFIs from Wall Street creditors to ordinary citizens, either as investors or taxpayers.[88]

The SPOE-TLAC strategy relies on the further assumption that regulators can successfully impose losses on TLAC debtholders after a SIFI fails without encountering serious political problems and without triggering runs by uninsured creditors at other troubled SIFIs. In fact, however, any decision by regulators to impose losses on bail-in debtholders of a failed SIFI would probably face serious political obstacles and would also be likely to trigger contagious spillover effects for other vulnerable SIFIs. In a 2014 paper, Charles Goodhart and Emilios Avgouleas warned that any attempt to impose large losses on bail-in debt held by mutual funds and pension funds could ignite a political firestorm.[89] In addition, as they pointed out,

> [T]riggering the bail-in process is likely to generate a capital flight and a sharp rise in funding costs whenever the need for large-scale recapitalisations becomes apparent. Creditors who sense in advance the possibility of a bail-in, or creditors of institutions that are similar in terms of nationality or business models will have a strong incentive to withdraw deposits, sell debt, or hedge their positions through the short-selling of equity or the purchase of credit protection at an ever higher premium disrupting the relevant markets.[90]

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[87] *Id.* at 67 (discussing and quoting 12 U.S.C. §§ 5390(n)(9)(B), (o)(1)(B), (C)).

[88] *Id.* at 61-68.

[89] Charles Goodhart & Emilios Avgouleas, *A Critical Evaluation of Bail-Ins as Bank Recapitalisation Mechanisms* 30-31 (Aug. 11, 2014), available at http://ssrn.com/abstract=2478647.

[90] *Id.* at 32.

Recent events have confirmed the prescience of their warnings. In December 2015, the Italian government rescued four regional banks and imposed almost $400 million of losses on holders of their subordinated debt. Many of the debtholders were consumers who had been persuaded by their banks to convert their deposits into subordinated bonds. The debtholders' losses provoked a strong political backlash against Prime Minister Matteo Renzi and caused many investors to dump their holdings of subordinated debt in Italian banks.[91]

On December 29, 2015, the Portuguese government caused a similar outcry when it imposed €2 billion of losses on institutional bondholders at Novo Banco, a bridge bank created in 2014 following the collapse of Banco Espirito Santo (BES). The government decreed that certain bonds issued by Novo Banco would be transferred to a "bad bank," which held BES's toxic assets, in order to help cover the costs of resolving BES. The bond transfer sparked strong protests as well as a lawsuit by affected bondholders. The government's action also led to widespread investor sales of bonds issued by Novo Banco and other Portuguese banks.[92]

The losses suffered by bondholders in Italy and Portugal set the stage for a much larger market disruption in February 2016. Investors expressed growing doubts about the resilience of leading European banks, including the ability of Deutsche Bank and Credit Suisse to meet debt service obligations on their bonds after both banks reported large year-end losses.

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[91] Tom Beardsworth & Sonia Sirletti, *International Banking: Italy Banks Facing Funding Threat as Bond Sales Scrutinized*, 105 Bloomberg BNA's Banking Report 929 (Dec. 21, 2015); James Politi, *Italy bank rescues spark bail-in debate as anger at Renzi grows,* FT.com (Dec. 22, 2015), available at https://next.ft.com/content/54cda5e4-a6ac-11e5-955c-1e1d6de94879; Giada Zampano & Liam Moloney, *Renzi Confident on Italian Banks Amid Rescue Plan Storm*, Wall Street Journal (Dec. 29, 2015) (online edition, available on Proquest).

[92] Martin Arnold & Thomas Hale, *Southern Europe's banks feel cost of Portuguese actions at Novo Banco,* FT.com (Jan. 17, 2016), available at https://next.ft.com/content/93be3c46-bbba-11e5-b151-8e15c9a029fb; Philippe Bodereau, *Discrimination at Portuguese bank Novo Banco sets a dangerous precedent*, FT.com (Jan. 12, 2016), available at https://next.ft.com/content/198e08ea-b62c-11e5-8358-9a82b43f6b2f; Thomas Hale & Martin Arnold, *Novo Banco: Fourteen asset managers sue Portuguese central bank*, FT.com (April 4, 2016), available at https://next.ft.com/content/e4762f38-fa97-11e5-8f41-df5bda8beb40.

Investors also voiced increasing concerns about the potential impact of the EU's BRRD rules, which took effect in January and will require bail-in bondholders to incur losses when European banks fail. Investors therefore engaged in a massive selloff of CoCos issued by European banks, and Deutsche Bank and Credit Suisse were among the hardest-hit institutions.[93] As the editors of Bloomberg observed,

> The incident serves to reinforce concerns, expressed by various financial economists, that CoCo bonds may make investors in banks and their debt more apt to take flight when trouble looms. . . . CoCos are complicated instruments. In a time of stress, uncertainty over the conditions that trigger conversions [into equity] may add to the sense of alarm.[94]

The dumping of CoCos in Europe underlines the volatility and fragility of bail-in debt. As shown by the herd-like behavior of investors in CoCos, TLAC debt is not likely to perform a robust loss-absorbing function during periods of market stress. And if TLAC does not work as designed, SPOE will not work as designed either.

D. Chapter 14

Under Title I of Dodd-Frank, SIFIs are obliged to prepare resolution plans – often referred to as "living wills" – that outline plans for their resolution under the Bankruptcy Code.[95] However, there are legitimate doubts about the usefulness of the current Code as applied to a financial institution.[96]

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[93] Tom Beardsworth & Cordell Eddings, *Systemic Risk: The $102 Billion of Bank Debt That's Making Investors Nervous*, 106 Bloomberg BNA's Banking Report 231 (Feb. 15, 2016); John Glover, *Systemic Risk: Deutsche Bank CoCo Holders See What Regulators Mean by Risk*, 106 Bloomberg BNA's Banking Report 233 (Feb. 15, 2016); Jim Brunsden & Alex Barber, *European banking union: Bank turmoil: are Europe's new bail-in rules to blame?*, FT.com (Feb. 11, 2016), available at https://next.ft.com/content/8ad2ed98-d0a0-11e5-986a-62c79fcbcead; Thomas Hale, *European banks: Music stops for buyers of bank coco debt*, FT.com (Feb. 11, 2016), available at https://next.ft.com/content/f921e592-d0af-11e5-831d-09f7778e7377.

[94] "The Trouble With CoCos," Bloomberg (Feb. 12, 2016) (editorial), available at http://www.bloombergview.com/articles/2016-02-12/the-trouble-with-cocos.

[95] 12 U.S.C. § 5365(d). *See* Jonathan C. Lipson, *Against Regulatory Displacement: An Institutional Analysis of Financial Crises*, 17 U. Pa. J. Bus. L. 673, 721-22 (2015).

[96] Randall D. Guynn, *Are Bailouts Inevitable?,* 29 Yale J. on Reg. 121, 137-38 (2012).

Key concerns include the lack of any statutorily defined role for banking regulators under the Code, bankruptcy's traditional focus on creditor recovery, which might conflict with systemic stability,[97] and the "safe harbors" that exempt certain types of securities and derivatives contracts from core elements of the Code.[98]

Almost from the moment Dodd-Frank was enacted, various groups have proposed ways to amend the Bankruptcy Code to facilitate the resolution of financial institutions.[99] In some cases, these proposals would supplement OLA, in others they would replace it entirely. All such proposals are often designated as "chapter 14" proposals, after a proposal first put forth by the Hoover Institution's Working Group on Economic Policy.[100]

Perhaps the most significant of these proposals is the Financial Institution Bankruptcy Act of 2016, which passed the House in early 2016.[101] This bill would create a new subchapter V within chapter 11 of the Bankruptcy Code to allow the SPOE approach to be used in bankruptcy court.

A holding company would be placed into bankruptcy, and its assets – equity in and debt claims against subsidiaries – would be transferred to a bridge institution.[102] The legislation would also require expedited judicial review by a bankruptcy judge randomly chosen from a pool of judges designated in advance and selected by the Chief Justice of the Supreme

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[97] Edward J. Janger, *Arbitraging Systemic Risk: System Definition, Risk Definition, Systemic Interaction, and the Problem of Asymmetric Treatment*, 92 Tex. L. Rev. See Also 217, 224 (2014).

[98] Stephen D. Adams, *Swap Safe Harbors in Bankruptcy and Dodd-Frank: A Structural Analysis*, 20 Stan. J.L. Bus. & Fin. 91, 113 (2014).

[99] Bruce Grohsgal, *Case in Brief Against "Chapter 14",* Am. Bankr. Inst. J., May 2014, at 44, 44.

[100] Thomas H. Jackson & David A. Skeel, Jr., *Dynamic Resolution of Large Financial Institutions*, 2 Harv. Bus. L. Rev. 435, 458 (2012). Lubben expressed some doubt about the workings of this initial proposal in his *New York Times* column. http://dealbook.nytimes.com/2013/04/10/whats-wrong-with-the-chapter-14-proposal/?_r=0

[101] The similar Taxpayer Protection and Responsible Resolution Act, S. 1841, is currently in committee in the Senate.

[102] http://src.bna.com/d2q

Court for their experience, expertise, and willingness to preside over these cases.

Amending the Bankruptcy Code to accommodate financial institutions makes a good deal of sense if Dodd-Frank's preference for normal bankruptcy procedures is to be realized.[103] That said, the Financial Institution Bankruptcy Act, and many other similar proposals, do little more than allow the use of SPOE in bankruptcy proceedings outside of OLA. The current chapter 14 proposals do nothing to facilitate the use of more established and broadly applicable insolvency tools – most notably chapter 11 – by financial institutions.

Thus, the usefulness of these proposals will rise and fall with one's appraisal of the workability of SPOE. As already noted, we harbor significant doubts on that score.

We speculate that one of SPOE's important goals is to give the Fed expanded authority to bail out the operating subsidiaries of failed SIFIs and thereby protect those subsidiaries' Wall Street counterparties. The Fed does not have authority to make discount window loans to nondepository companies such as securities broker-dealers.[104] In addition, Dodd-Frank places significant constraints on the Fed's ability to provide financial assistance to nondepository companies under Section 13(3) of the Federal Reserve Act.[105]

However, the Fed does retain the ability under Section 13(3), as amended by Dodd-Frank, to provide liquidity assistance to nondepository companies pursuant to a "program or facility with broad-based eligibility," as long as

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[103] David A. Skeel, Jr. & Thomas H. Jackson, *Transaction Consistency and the New Finance in Bankruptcy*, 112 Colum. L. Rev. 152, 198 (2012).

[104] *See* 12 U.S.C. § 343; "Market and Funding Liquidity: An Overview," Remarks by President William C. Dudley of the Fed. Res. Bank of NY at the Fed. Res. Bank of Atlanta's 2016 Fin. Markets Conf. (May 1, 2016), available at https://www.newyorkfed.org/newsevents/speeches/2016/dud160501.

[105] 12 U.S.C. § 343(3)(A); *see* John Crawford, *The Moral Hazard Paradox of Financial Safety Nets*, 25 Cornell J.L. & Pub. Pol'y 95, 121 (2015); Wilmarth, *supra* note 16, at 1001-02.

the recipients of that liquidity assistance are not insolvent.[106] Following the quick balance sheet restructuring contemplated by SPOE, nondepository operating subsidiaries of a failed SIFI could argue they are not insolvent, and are therefore eligible to receive help from the Fed under such a program. Thus, SPOE could boost the Fed's ability to assist operating subsidiaries of a troubled SIFI under Section 13(3), and that would be true under either OLA or the proposed chapter 14.

In addition, we think there are at least three reasons why Wall Street strongly supports proposed chapter 14 and is much less enthusiastic about OLA. First, when a SIFI is placed in receivership under OLA, Section 206(4) of Dodd-Frank compels the FDIC to remove all executives and directors who were responsible for the SIFI's failure.[107] In contrast, chapter 14 proposals do not contain any similar requirement for removing executives or directors of a failed SIFI. Second, as discussed above, the FDIC is required to impose special assessments on large financial institutions in order to repay any OLF loans that cannot be paid off from the assets of a failed SIFI.[108] In contrast, the financial industry would bear no responsibility for repaying any loans that the Fed might advance to operating subsidiaries of a failed SIFI under Section 13(3).

Third, Wall Street would strongly prefer to work with the Fed rather than the FDIC in resolving failed SIFIs. Compared with the Fed, the FDIC has generally followed a much stricter policy toward megabanks. The two agencies' different supervisory philosophies reflect their contrasting missions and structures. The FDIC is primarily concerned with protecting depositors and maintaining the solvency of the deposit insurance fund. That mission causes the FDIC to resist aggressive risk-taking by megabanks. The FDIC is also insulated from industry influence due to its monopoly position as deposit insurer, its support from the public, and its status as an independent agency. In contrast, one of the Fed's core objectives is to

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[106] 12 USC § 343(3)(A). *See* Troy S. Brown, *Legal Political Moral Hazard: Does the Dodd-Frank Act End Too Big to Fail?*, 3 Ala. C.R. & C.L.L. Rev. 1, 82 (2012); Wilmarth, *supra* note 16, at 1002-03.

[107] 12 U.S.C. § 5386(4).

[108] *See supra* note 87 and accompanying text.

preserve financial stability, and that goal gives the Fed strong incentives to support large financial institutions and prevent their failure. In addition, the Fed's private-public ownership and governance structure – in which member banks own shares in regional Federal Reserve Banks and elect two-thirds of Reserve Bank directors, who in turn nominate Reserve Bank Presidents – has fostered a cozy relationship between the banking industry and the Fed.[109]

Thus, the apparent goals of proposed chapter 14 are to provide more generous public support and more favorable regulatory treatment for failed SIFIs and their operating subsidiaries, while also evading Dodd-Frank's mandates for removal of senior managers of a failed SIFI and for repayment of the public costs of an OLA resolution by large financial institutions. In our view, none of these objectives would make a positive contribution toward solving the too-big-to-fail problem.

III. Improving SPOE, TLAC, and "Chapter 14"

For the reasons stated above, we believe that SPOE's ability to restructure the parent holding company of a failed G-SIB while keeping its subsidiaries in operation is open to serious question, especially during a systemic financial crisis. Neel Kashkari, President of the Federal Reserve Bank of Minneapolis, recently stated that SPOE, TLAC and other new resolution tools might work "when the economy and our financial system are otherwise healthy and stable." However, he was "far more skeptical that these tools will be useful to policymakers in . . . a stressed environment." Based on his experience as a senior Treasury official during the height of the financial crisis in 2008 and his appreciation of "the massive

[109] *See* Arthur E. Wilmarth, Jr., *Turning a Blind Eye: Why Washington Keeps Giving in to Wall Street*, 81 U. Cin. L. Rev. 1283, 1401-05 (2013); Arthur E. Wilmarth, Jr., *The Financial Services Industry's Misguided Quest to Undermine the Consumer Financial Protection Bureau*, 31 Rev. Banking & Fin. L. 881, 941-50 (2012), available at http://ssrn.com/abstract=1982149.

externalities on Main Street of large bank failures in terms of lost jobs, lost income and lost wealth," Mr. Kashkari concluded:

> [N]o rational policymaker would risk restructuring large [financial] firms and forcing losses on creditors and counterparties using the new tools in a risky environment, let alone in a crisis environment like we experienced in 2008. They will be forced to bail out failing institutions – as we were.[110]

In this part of the paper we begin with the assumption that the statutory framework for regulating SIFIs, including Dodd-Frank, will remain in its current form, and that any improvements must be made within the extant structure. Given those practical constraints, we offer several suggestions for making TLAC, SPOE, and even "chapter 14" advance the basic goal of ending too big to fail.

First, as the Fed has recognized, the sale of TLAC debt must be accompanied by adequate disclosures of the extraordinary risks embedded in that debt. We submit that the Fed's proposed disclosure requirements are both too vague and too mild.[111]

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[110] "Lessons from the Crisis: Ending Too Big to Fail," Speech by Minneapolis Fed President Neel Kashkari at the Brookings Institution, Washington, DC, Feb. 16, 2016 [hereinafter Kashkari 2016 Speech], available at https://www.minneapolisfed.org/news-and-events/presidents-speeches/lessons-from-the-crisis-ending-too-big-to-fail.

[111] In full, the proposed rule provides:

§ 252.65 Disclosure requirements.

(a) A global systemically important BHC must publicly disclose a description of the financial consequences to unsecured debtholders of the global systemically important BHC entering into a resolution proceeding in which the global systemically important BHC is the only entity that would be subject to the resolution proceeding.

(b) A global systemically important BHC must provide the disclosure required by paragraph (a) of this section:

(1) In the offering documents for all of its eligible debt securities; and

(2) Either:

(i) On the global systemically important BHC's Web site; or

(ii) In more than one public financial report or other public regulatory reports, provided that the global systemically important BHC publicly provides a summary table specifically indicating the location(s) of this disclosure.

Under our approach, individual investors purchasing TLAC debt directly through their online brokerage accounts would be presented with an online warning box, much like the warnings often provided for purchases of high-yield debt. All written offering documents for TLAC debt would contain a highlighted, "black box" warning about the risks associated with such instruments. For both electronic and written disclosures, the box would contain a simple, straightforward, standardized warning, such as

> If the Company fails and is "taken over" by regulators, it is expected that these securities will receive little or no recovery. You could lose your entire investment.

Similarly, we would require mutual funds or pension funds that invest in TLAC debt to disclose the bail-in risks to investors and to include in their offering materials the "black box" warning proposed above. Each such fund would also disclose the percentage of the fund's assets that could potentially be invested in TLAC debt, and the possible correlation and contagion risks presented by such debt, even if issued by multiple SIFIs.

We further propose that each SIFI that issues TLAC debt should maintain a dedicated web page addressing its resolution plan. On that page, the company should set forth, in both text and diagrams, the complete "waterfall" for allocating losses incurred by the parent holding company among holders of its equity and debt. Based on that "waterfall" disclosure, current or prospective TLAC debtholders should be able to ascertain the point at which they will begin to incur losses, and the point at which their entire investments will be vaporized.

Each SIFI's resolution web page should also contain a straightforward discussion of the role of TLAC debt in the SIFI's capital structure. TLAC debtholders should be clearly told that their claims are deeply subordinated, and that they are taking on risks that creditors and counterparties of operating subsidiaries are unwilling to assume. Only with such disclosures can we be reasonably confident that TLAC debt will be appropriately priced by the market.

It is likely that our proposed disclosures would compel SIFIs to pay relatively high interest rates on TLAC debt that reflect the bail-in risks inherent in TLAC debt. If SIFIs wish to avoid paying such interest rates, they could issue larger amounts of equity capital to satisfy their TLAC mandates. Such an outcome would be highly desirable, in our view.

Second, the Fed should revise its proposal by allowing SIFIs to meet their entire TLAC obligation by issuing Tier 1 equity capital. Unlike debt, Tier 1 equity instruments (common stock and perpetual, non-cumulative preferred stock) do not have any maturity dates, do not have any fixed obligations to pay interest, and can forgo paying dividends when necessary to conserve capital. As regulators have recently acknowledged, Tier 1 equity capital provides a far superior buffer for absorbing losses, compared with debt.[112] Accordingly, the Fed should remove a provision of its proposal that would require SIFIs to maintain a minimum amount of TLAC debt.[113]

Third, with regard to SPOE, we recommend two alternatives for establishing mandatory liquidity reserves. Because the use of SPOE necessitates the provision of massive amounts of liquidity to operating subsidiaries, dedicated liquidity reserves must be in place in advance of financial distress. Ideally, in our view, such reserves should be created by amending Dodd-Frank to require that SIFIs pay risk-based premiums to establish a pre-funded OLF.[114] Barring such a change to Dodd-Frank, we

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[112] *See* Wilmarth, *supra* note 7, at 66; Dept. of Treasury (Off. of Comptroller of the Currency), Bd. of Governors of Fed. Res. Sys., and FDIC, “Final rule: Regulatory Capital Rules,” 79 Fed. Reg. 24,528, 24,535 (May 1, 2014) (affirming that common equity Tier 1 capital has "the highest capacity to absorb losses" while non-cumulative perpetual preferred stock "has strong loss-absorbing capacity"). For a comprehensive demonstration of the clear superiority of equity capital over debt as a loss-absorbing buffer for banks, see ANAT ADMATI & MARTIN HELLWIG, THE BANKERS' NEW CLOTHES: WHAT'S WRONG WITH BANKING AND WHAT TO DO ABOUT IT (2013).

[113] *See* Fed TLAC Proposal, *supra* note 9, at 74,931-33 (discussing proposal to require G-SIBs to maintain minimum levels of TLAC debt); *id.* at 74959 (setting forth proposed 12 C.F.R. § 259.62, which would codify that requirement).

[114] *See* Jeffrey N. Gordon & Christopher Muller, *Confronting Financial Crisis: Dodd-Frank's Dangers and the Case for a Systemic Emergency Insurance Fund*, 28 Yale J. on Reg. 151, 190-91 (2011); Wilmarth, *supra* note 7, at 73-79.

propose that SIFIs should be required to maintain dedicated reserves of "internal" liquidity funds within their holding companies.

In this paper we have expressed our doubts about the presumed ability of parent holding companies of SIFIs to add limitless amounts of debt to their capital structure.[115] However, SIFIs could certainly build their liquidity reserves by issuing additional Tier 1 equity. Whatever the source, each SIFI's parent holding company must maintain a substantial amount of dedicated, uncommitted liquid funds that are available for immediate loans to distressed subsidiaries if SPOE is to have any hope of working. Simply forgiving intercompany debt will not solve problems resulting from demands for immediate liquidity from operating subsidiaries, and it cannot be assumed that "prepositioned" capital will just happen to be located in the right place at the onset of financial distress.

Finally, if SPOE is to work, we submit that it also has to migrate into something more like "dual point of entry." That is, there is needs to be a well specified plan for resolution of both the holding company and any distressed subsidiary. Only such a plan will provide a realistic description of how financial distress within a SIFI might be contained. Such a plan might realistically save the non-distressed subsidiaries, but it will also have to address the reality that a parent holding company is not likely to solve serious funding problems at multiple distressed subsidiaries without the functional equivalent of a government bailout.

With regard to chapter 14, or any other attempt to make the Bankruptcy Code work better for SIFIs, we recommend that SPOE should be reworked as we have outlined. We also believe that the Bankruptcy Code should be amended for large financial companies in a way that does not tie its use to SPOE. Instead, a new subchapter of chapter 11 – like that already in place for railroads[116] – could be enacted with provisions that address the specific problems and challenges of financial institutions, regardless of the method that a SIFI chooses to reorganize or liquidate.

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[115] *See supra* notes 83-84 and accompanying text.
[116] *See* 11 U.S.C. §§ 1161 et seq.

Specific provisions of such a subchapter could include standing for regulators, the ability of regulators to institute involuntary cases against SIFIs, specific statutory ability to conduct short notice "363 sales" to bridge companies, as was done in Lehman and the automakers' chapter 11 cases, and a short stay on the "safe harbors."[117] The new subchapter should not lock a SIFI into any particular resolution mechanism.

CONCLUSION

SPOE, TLAC, and chapter 14 are all designed to accomplish Dodd-Frank's stated goal of ending the "too big to fail" problem. The process of implementing Dodd-Frank has undoubtedly improved the ability of financial regulators to respond to the collapse of a large financial institution. However, as we have shown in this article, significant doubts remain about the ability of a major financial company to fail without imposing substantial losses on taxpayers. Accordingly, it is far too soon to conclude that Dodd-Frank has eliminated the risk of future bailouts of SIFIs.

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[117] Lubben would of course argue that, rather than create an "exception to the exception," the safe harbors should be reconsidered wholesale. *E.g.,* Stephen J. Lubben, *Transaction Simplicity*, 112 Colum. L. Rev. Sidebar 194 (2012); Stephen J. Lubben, *The Bankruptcy Code Without Safe Harbors*, 84 Am. Bankr. L.J. 123, 123 (2010). *See also* Adam J. Levitin, *Prioritization and Mutualization: Clearinghouses and the Redundancy of the Bankruptcy Safe Harbors*, 10 Brook. J. Corp. Fin. & Com. L. 129, 130 (2015).