2016

Too Big and Unable to Fail

Arthur E. Wilmarth Jr.
George Washington University Law School, awilmarth@law.gwu.edu

Stephen Lubben
Seton Hall University School of Law

Recommended Citation

Lubben, Stephen J. and Wilmarth, Arthur E., Too Big and Unable to Fail (2016). GWU Law School Public Law Research Paper No. 2016-44; Arthur E. Wilmarth, Jr. and Stephen J. Lubben, Too Big and Unable to Fail, 69 FLA. L. REV. 1205 (2017).; GWU Law School Public Law Research Paper No. 2016-44; GWU Legal Studies Research Paper No. 2016-44; Seton Hall Public Law Research Paper. Available at SSRN: https://ssrn.com/abstract=2839946

TOO BIG AND UNABLE TO FAIL

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

Abstract

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. This Article expresses 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) rule 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. However, TLAC debt will create a new, more opaque way to impose the costs of resolving failed 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 conceived, is that both policies would entrench the existing perverse system for regulating SIFIs. The 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 this Article proposes reforms that would help to achieve that goal.

[*] Harvey Washington Wiley Chair in Corporate Governance & Business Ethics, Seton Hall University School of Law.

[**] Professor of Law, George Washington University Law School. I would like to thank my former students, Kevin Park and Ariel Stevenson, and Germaine Leahy, Head of Reference for the Jacob Burns Law Library, for their excellent research assistance. Unless otherwise indicated, this Article includes developments through February 28, 2017.

INTRODUCTION

The heart of 2010's Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act)[1] is the hope of ending TBTF. Since the most important American financial institutions remain very large, Dodd-Frank's long-term success necessarily turns on the ability of those financial institutions to fail. Failing without disrupting the broader economy, and thus requiring taxpayer assistance, is the key objective.[2]

To further this central aim, the Federal Reserve Board (Fed) recently adopted a new TLAC requirement.[3] The Fed's new TLAC mandate, which will take effect on January 1, 2019, is intended to "strengthen the ability of government authorities to resolve in an orderly way the largest domestic and foreign banks operating in the United States without any support from taxpayer-provided capital."[4]

The Fed's TLAC rule is closely tied to a proposed strategy for handling financial institution failure—or "resolution," in the industry argot—known as "single point of entry."[5] SPOE goes hand in hand with

---

1. Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified as amended in scattered sections of the U.S. Code).

2. *See id.* (preamble) (stating that Dodd-Frank is intended "to end 'too big to fail,' [and] to protect the American taxpayer by ending bailouts").

3. Press Release, Bd. of Governors of the Fed. Reserve Sys., Federal Reserve Board Adopts Final Rule to Strengthen the Ability of Government Authorities to Resolve in Orderly Way Largest Domestic and Foreign Banks Operating in the United States (Dec. 15, 2016), https://www.federalreserve.gov/newsevents/press/bcreg/20161215a.htm.

4. *Id.*

5. *See* Dan Weiss et al., *PwC Discusses Resolution: Single Point of Entry Strategy Ascends*, CLS BLUE SKY BLOG (Aug. 27, 2015), http://clsbluesky.law.columbia.edu/2015/08/27/

TLAC. SPOE cannot work without TLAC, and there is no reason to impose TLAC on financial institutions without SPOE.

This Article argues 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 who have noted that SPOE's strategy for resolving the failure of large SIFIs depends on a number of unrealistic assumptions and, therefore, is unlikely to work in actual practice.[6]

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 (FDIC) as receiver for failed SIFIs.[7] Title II requires the FDIC to liquidate failed SIFIs and to impose any resulting losses on their shareholders and creditors.[8] 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]."[9]

The FDIC recognized Title II's liquidation-only mandate in its early rulemakings under Dodd-Frank.[10] 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).[11] Accordingly, in 2011 megabanks and other Wall Street interests proposed a very different approach for resolving failed SIFIs.[12] This new approach, called "recapitalization-within-resolution," created a roadmap for resolving failed megabanks by using chapter 11-style reorganizations instead of liquidations.[13] Wall Street's reorganization

---

pwc-discusses-resolution-single-point-of-entry-strategy-ascends/.

6. *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) (noting the SPOE model is "premised on [a] number of significant assumptions or preconditions" that are questionable); Paul H. Kupiec & Peter J. Wallison, *Can the "Single Point of Entry" Strategy Be Used to Recapitalize a Failing Bank?* 4, 37 (Am. Enter. Inst., AEI Economic Working Paper No. 2014-08, 2014), http://ssrn.com/abstract=2519229 (discussing the authors' doubts about SPOE's assumptions).

7. 12 U.S.C. § 5383. *See* Stephen J. Lubben, *A New Understanding of the Bankruptcy Clause*, 64 CASE W. RES. L. REV. 319, 409 (2013).

8. 12 U.S.C. §§ 5384(a)(1), 5386(2), (3), 5394(a).

9. *Id.* § 5394(a).

10. *See* Arthur E. Wilmarth, Jr., *The Financial Industry's Plan for Resolving Failed Megabanks Will Ensure Future Bailouts for Wall Street*, 50 GA. L. REV. 43, 51–53 (2015) (describing the FDIC's rulemakings under Title II in 2010 and 2011).

11. *See id.* at 46–47, 76.

12. *Id.* at 53–54.

13. *Id.* at 53.

plan helped to provide the conceptual foundation for the SPOE resolution strategy.[14]

As described in Part I of this Article, 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.

The Fed's new TLAC regulation applies 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.[15] These, of course, are the very same institutions that are most likely to be subject to OLA.

The Fed's TLAC rule establishes and implements SPOE as the preferred strategy for resolving failed U.S. megabanks.[16] The TLAC rule requires the parent holding company of each SIFI to maintain a minimum level of Tier 1 shareholders' equity and TLAC debt.[17] 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.[18]

---

14. *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 51–65, 76–77 and accompanying text (describing the FDIC's participation in formulating the SPOE strategy and the agency's failure to give final approval to the strategy).

15. 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, 82 Fed. Reg. 8266, 8272 (Jan. 24, 2017) (to be codified at 12 C.F.R. pt. 252); *see also* 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 Fed. Reg. 74,926, 74,931 (proposed Nov. 30, 2015) (to be codified at 12 C.F.R. pt. 217, 252). 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. Total Loss-Absorbing Capacity, 82 Fed. Reg. at 8272 n.35.

16. *Id.* at 8288–89.

17. *Id.* at 8290.

18. *Id.* at 8270.

Adding TLAC debt to the capital structure of SIFIs would also facilitate the use of SPOE in other resolution proceedings, including cases filed under the Bankruptcy Code. 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 shown below, a large percentage of TLAC debtholders will likely be retail investors in brokerage accounts, mutual funds, and pension funds, because federal regulators will strongly discourage financial institutions from purchasing TLAC debt. Additionally, the SPOE strategy will 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—will be eligible for either direct financial support from the Fed or indirect assistance, funneled through the holding company, in the form of a taxpayer-financed bridge loan from the Treasury Department. Thus, SPOE and TLAC will impose most of the costs of resolving failed megabanks on ordinary citizens, either as investors or taxpayers, while giving 100% protection to Wall Street creditors.

This Article contends that 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. It is also very doubtful whether host country regulators with jurisdiction over a failed SIFI's subsidiaries will cooperate when the SIFI's home country supervisor commences a resolution procedure for the 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."[19] That is, corporate managers typically believe that their

---

19. 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

firm's financial problems can be solved by a quick trip through bankruptcy that converts bondholders into shareholders. However, financial distress is not always caused by balance sheet problems; indeed, it is more often caused by operational problems.[20]

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 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 will 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)—a form of bail-in debt—issued by European banks.[21] That selloff creates substantial doubts about the ability of regulators to bail in TLAC debt without disrupting financial markets.

Part I begins with an overview of TLAC and SPOE and their symbiotic relationship. The Fed has declared that TLAC "is primarily focused on implementing the SPOE resolution strategy" for failed megabanks.[22] 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."[23] In addition, by preventing any failure of the

---

> 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).

20. 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, 88–91.

21. *See* Robert W. Greene, *Understanding CoCos: What Operational Concerns & Global Trends Mean for U.S. Policymakers* 33 (Harvard Kennedy Sch. Mossavar-Rahmani Ctr. for Bus. & Gov't, Working Paper No. 62, 2016), http://ssrn.com/abstract=2913094.

22. 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 Fed. Reg. 74,928 (proposed Nov. 30, 2015) (to be codified at 12 C.F.R. pt. 217, 252).

23. *Id.*; *see also* Total Loss-Absorbing Capacity, 82 Fed. Reg. at 8270 n.29 (confirming that the Fed favors SPOE because it "could avoid losses to the third-party creditors of [a failed

subsidiaries, SPOE would "avoid the need for separate proceedings for separate legal entities run by separate authorities across multiple jurisdictions."[24]

Part II explains the key problems with TLAC and SPOE. It argues 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.

The example of Lehman Brothers's failure illustrates serious questions about the ability of SPOE and TLAC to prevent the collapse of a SIFI. This Article concludes 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 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 government funding sufficient 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.

Part II also identifies serious flaws in the various chapter 14 bankruptcy reform proposals, which are closely tied to the use of SPOE. The shortcomings of SPOE are central to this Article's claim that the proposed chapter 14 bills are of very limited utility. While chapter 11 has a long and storied history of success in 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. In contrast to chapter 11, which 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, chapter 14 as currently proposed will also be of little use. Indeed, the financial industry's eager embrace of chapter 14 more likely stems from 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 as applied by the FDIC.

Part III of this Article considers potential ways to improve SPOE, TLAC, and chapter 14. First, regulators should require SIFIs to provide a host of detailed disclosures when they sell TLAC debt to investors. Those disclosures should include a description of the subsidy that TLAC bondholders are providing to operating company creditors, and it should

---

megabank's] subsidiaries and could thereby allow the subsidiaries to continue normal operations").

24. Total Loss-Absorbing Capacity, 82 Fed. Reg. at 8270.

clarify 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 more of 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 new TLAC requirements should be developed to make OLA work in a world where liquidity problems are likely to be the source of most systemic crises. Achieving this goal will require either a prefunded Orderly Liquidation Fund (OLF) 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.

Part III briefly sketches the elements of a more viable chapter 14, which would allow for the use of "normal" bankruptcy style procedures when possible. But Part III also resists 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 conceived, is that both policies would entrench the current perverse system for regulating SIFIs. Because an improved version of Dodd-Frank, with stronger controls over SIFIs, is unlikely to be proposed by the Trump Administration or to be passed by Congress, regulators should use available 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. Part III proposes reforms that would help to achieve that goal.

I. SPOE AND TLAC

Dodd-Frank's OLA 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.[25]

25. 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).

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*.[26]

Then came SPOE, which sought to make the use of OLA credible.[27] The idea was simple: only the holding company would go into an OLA receivership, while all of its operating subsidiaries would continue to conduct business as usual.[28]

SPOE seeks to avoid the essential problem that, while there is no such thing as a SIFI without cross-border operations, OLA as drafted has an even narrower domestic focus than the Bankruptcy Code.[29] As further discussed below, SPOE is designed to solve 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.[30] In addition, SPOE would enable the FDIC to avoid the supervisory burden of overseeing the operation of multiple subsidiaries of a failed SIFI.[31] Instead, the FDIC would simply manage the resolution of the parent holding company.[32]

---

26. Richard Squire, *Clearinghouses as Liquidity Partitioning*, 99 CORNELL L. REV. 857, 911 (2014); *see also* 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) (explaining that the OLA seeks to provide a viable alternative to the choice that federal regulators faced during the financial crisis of either arranging a bailout or allowing a disorderly bankruptcy).

27. 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), http://www.northwesternlawreview.org/online/%E2%80%9Csingle-point-entry%E2%80%9D-promise-and-limits-latest-cure-bailouts; Lee, *supra* note 6, at 461–74.

28. *See, e.g.*, Resolution of Systemically Important Financial Institutions: The Single Point of Entry Strategy, 78 Fed. Reg. 76,614, 76,616, 76,723 (Dec. 18, 2013) (stating that, under SPOE, subsidiaries of the holding company would remain open for business while the parent holding company is 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 Paper for SPOE developed by the FDIC and the Bank of England).

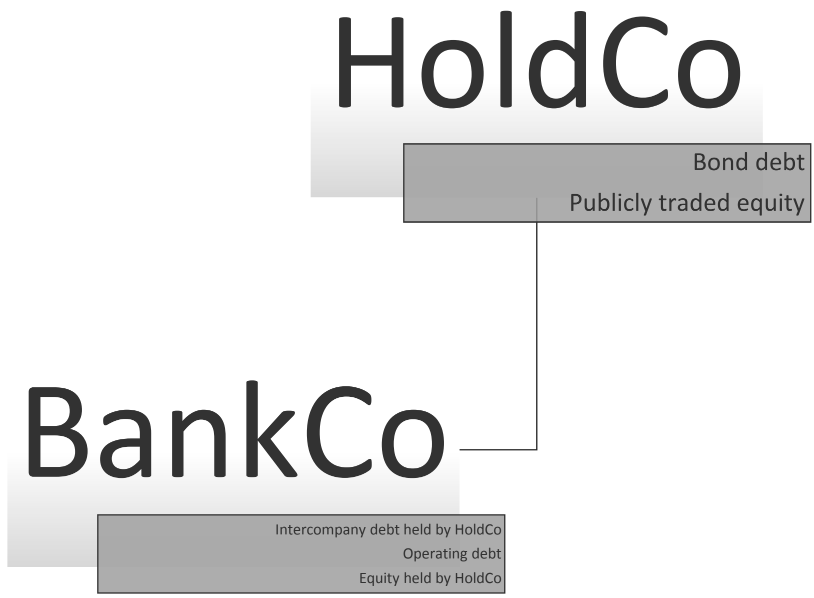
29. Edward F. Greene & Joshua L. Boehm, *The Limits of "Name-and-Shame" in International Financial Regulation*, 97 CORNELL L. REV. 1083, 1104–05 (2012).

30. 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).

31. *Id.* at 1300.

32. *Id.*

For example, imagine the following financial holding company, which we will assume is systemically important, despite the simplicity of its organizational structure:



Under the SPOE approach, HoldCo cancels its bond debt and also cancels its intercompany debt with BankCo.[33] That debt cancellation solves routine balance sheet insolvency issues at both companies.[34] 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.[35]

The Fed's TLAC rule seeks to ensure that parent holding companies of SIFIs will hold enough bail-in debt.[36] But before investigating TLAC, this Article first examines SPOE in greater detail.

---

33. It also cancels its old equity and gives new equity to old creditors.
34. Gordon & Ringe, *supra* note 30, at 1299–300.
35. *See id.* at 1353–54.
36. *See id.* at 1352.

A. *SPOE*

Dodd-Frank's OLA applies to "covered financial companies," which are defined to exclude depository banks.[37] Other types of financial institutions, including financial holding companies, become covered financial companies if they are placed in receivership pursuant to OLA's required procedures as specified in § 203 of Dodd-Frank.[38]

A financial company can be placed in an OLA receivership if the Treasury Secretary satisfies a two-part test.[39] First, the Secretary must determine whether the financial company is in default, or in danger of default.[40] This would include a financial company in bankruptcy or near bankruptcy, or otherwise likely to be insolvent.[41]

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."[42] 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.[43]

Under OLA, the FDIC can take control of any type of financial company, except for FDIC-insured depository institutions and insurance companies.[44] 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 the FDIC will oversee virtually all bank receiverships.[45]

---

37. 12 U.S.C. § 5381(a)(8) (2012); *see also id.* § 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) . . . .").

38. *Id.* § 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. *Id.* § 5381(b).

39. Chrystin Ondersma, *Shadow Banking and Financial Distress: The Treatment of "Money-Claims" in Bankruptcy*, 2013 COLUM. BUS. L. REV. 79, 134–35.

40. 12 U.S.C. § 5383(b)(1).

41. *Id.* § 5383(b)(1), (c)(4).

42. *Id.* § 5383(b)(2).

43. *Id.* § 5383.

44. *Id.* § 5381(a)(11)(B)(iv).

45. *See id.* (specifying that an FDIC-insured depository institution or insurance company is not a "financial company" that can be placed in an OLA receivership). The FDIC has authority to act as the receiver for any FDIC-insured bank that fails, whether it is chartered under federal or state law. *Id.* § 1821(c). The only banks that would not be placed in an FDIC receivership are

Broker-dealers are subject to being separated between "good" brokers, which the FDIC takes charge of, and "bad" brokers, which are liquidated by the Securities Investor Protection Corporation (SIPC).[46]

Thus, under OLA, the FDIC will gain control over most, but not all, of the subsidiaries of a large financial holding company.[47] 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.[48]

In addition, OLA is by its terms limited to domestically incorporated entitles,[49] while the Bankruptcy Code is broad enough to allow for the reorganization of a foreign firm.[50] Thus, OLA intentionally slices off the foreign subsidiaries and affiliates of a financial institution that have 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.[51] Under SPOE, only the holding company, and not its subsidiaries, would be placed in an OLA

---

those relatively few banks that are not FDIC-insured. Uninsured state banks would be governed by state bank receivership law, and uninsured national banks would be subject to a recently-adopted receivership regime promulgated by the Office of the Comptroller of the Currency, the federal regulator of national banks. Receiverships for Uninsured National Banks, 81 Fed. Reg. 92,594, 92,595 (Dec. 20, 2016) (to be codified at 12 C.F.R. pt. 51) (noting the existence of only fifty-two uninsured national banks, all of which were national trust banks).

46. 12 U.S.C. § 5385.

47. Thomas W. Merrill & Margaret L. Merrill, *Dodd-Frank Orderly Liquidation Authority: Too Big for the Constitution?*, 163 U. PA. L. REV. 165, 192 (2014).

48. *See generally* Stephen J. Lubben, *Resolution, Orderly and Otherwise: B of A in OLA*, 81 U. CIN. L. REV. 485, 485 (2012) (evaluating alternative approaches for handling the insolvency, bankruptcy, or "resolution" of large, complex financial institutions, in light of lessons learned from the collapse of Lehman Brothers, by examining the legal and financial structure of Bank of America).

49. 12 U.S.C. § 5381(a)(11)(A); *see id.* § 5381(a)(8).

50. *See* Oscar Couwenberg & Stephen J. Lubben, *Corporate Bankruptcy Tourists*, 70 BUS. LAW. 719, 721 (2015).

51. Martin J. Gruenberg, Acting Chairman, FDIC, Remarks at the Bank Structure Conference (May 10, 2012), https://www.fdic.gov/news/news/speeches/archives/2012/spmay1012.html.

receivership.[52] Operating subsidiaries would, in theory at least, continue to operate as if nothing was wrong with their parent company.[53]

In a May 2012 speech, FDIC Chairman Martin Gruenberg described SPOE as "the most promising resolution strategy" for dealing with a SIFI's failure.[54] 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."[55]

In December 2012, the FDIC and the Bank of England (BoE) jointly identified SPOE as a desirable approach for resolving failures of global SIFIs.[56] 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."[57] 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.[58]

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.[59] 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."[60]

In December 2013, the FDIC presented a detailed SPOE proposal and invited the public to comment on that proposal.[61] The FDIC's proposal stated that an SPOE resolution would put a failed SIFI's parent holding company into an OLA receivership and would transfer its operating

52. *Id.*

53. *Id.*

54. *Id.*

55. *Id.*; *see also* Lee, *supra* note 6, at 464–66 (discussing the FDIC's early development of the SPOE concept).

56. FED. DEPOSIT INS. CORP. & BANK OF ENGLAND, RESOLVING GLOBALLY ACTIVE, SYSTEMICALLY IMPORTANT, FINANCIAL INSTITUTIONS ii (2012), https://www.fdic.gov/about/srac/2012/gsifi.pdf.

57. *Id.* at 6.

58. *Id.* at 11.

59. *Id.* at 6–7.

60. *Id.* at 9.

61. Resolution of Systemically Important Financial Institutions: The Single Point of Entry Strategy, 78 Fed. Reg. 76,614 (Dec. 18, 2013).

subsidiaries to a newly-formed bridge financial company (BFC).[62] 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.[63] 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.[64]

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. According to the FDIC's proposal, 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."[65] The proposal'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.[66] The same groups also rejected criticism of the proposal by former Fed Chairman Paul Volcker.[67] 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-Frank]."[68] Others agreed with Mr. Volcker's view that the SPOE strategy appeared to be incompatible with Title II's liquidation-only mandate.[69]

62. *Id.* at 76,615–16.

63. *Id.* at 76,616.

64. *Id.*

65. *Id.* at 76,620 (emphasis added).

66. *See* Letter from The Clearing House, the Sec. Indus. & Fin. Mkts. Ass'n, the Am. Bankers Ass'n, the Fin. Servs. Roundtable, and the Glob. Fin. Mkts. Ass'n, to FDIC (Feb. 18, 2014), https://www.theclearinghouse.org/~/media/Files/Association%20Documents/20140218%20Single%20Point%20of%20Entry%20Comment%20Letter.pdf [hereinafter 2014 Wall Street SPOE Letter].

67. *Id.* at 25.

68. *Id.*; *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?*, AM. BANKER, (Dec. 13, 2013), 2013 WLNR 31174108 (citing Mr. Volcker's remarks).

69. *See* Adler, *supra* note 68 (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"); *Who Is Too Big to Fail: Does Title II of the Dodd-Frank Act Enshrine Taxpayer-Funded Bailouts?: Hearing Before the Subcomm. on Oversight & Investigations of the H. Comm. on Fin. Servs.*, 130th Cong. 7 (2013) (written statement of David A. Skeel, Jr., Professor of Law, University of Pennsylvania Law School) ("[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."); *see also* Joe Adler, *How the FDIC Can Fix Its Big*

The financial industry trade groups asserted 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."[70] 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."[71] 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.[72] They also maintained that Title II does not require any restructuring of subsidiaries after they are transferred to a BFC.[73] Other Wall Street 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.[74]

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,

---

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").

70. 2014 Wall Street SPOE Letter, *supra* note 66, 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. *Id.* 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.

71. *Id.* at 26 (emphasis added in part) (citing 12 U.S.C. § 5390(a)(7)(B), (d)(2)(B)).

72. *Id.*

73. *Id.* at 25, 27.

74. *See* JOHN F. BOVENZI ET AL., BIPARTISAN POLICY CTR., TOO BIG TO FAIL: A REPORT OF THE FAILURE RESOLUTION TASK FORCE OF THE FINANCIAL REGULATORY REFORM INITIATIVE OF THE BIPARTISAN POLICY CENTER 31 (2013), http://bipartisanpolicy.org/library/too-big-fail-path-solution-525/ [hereinafter 2013 BPC SPOE Report]; *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 10, at 59 n.62.

cleaned-up, and recapitalized SIFI with a minimum of structural changes. During the recapitalization, as indicated above, the SIFI's subsidiaries would remain in operation and all of their creditors (including Wall Street creditors) would be fully protected from losses.[75]

The FDIC has not formally approved the SPOE proposal it issued in December 2013. In addition, the FDIC may not necessarily agree with Wall Street's version of SPOE, which embraces a chapter 11-style reorganization strategy. FDIC's Vice Chairman Thomas Hoenig expressed serious reservations when the FDIC released its SPOE proposal, and he noted that the FDIC "has not adopted [the SPOE] strategy" in a speech given in January 2016.[76] Similarly, in a speech delivered in September 2015, FDIC Chairman Gruenberg 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 others to be sold off" during an OLA resolution. Chairman Gruenberg further stated, "An explicit objective is to ensure that no systemically significant entity emerges from this process."[77] 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 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 decline markedly once it no longer controlled the holding company. Moreover, as the next Section explains, the Fed has enthusiastically embraced the SPOE resolution strategy and does not appear to share any of the doubts that the FDIC may have about Wall Street's chapter 11-style version of SPOE.

75. 2013 BPC SPOE Report, *supra* note 74, at 26–32.

76. 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); Thomas Hoenig, Vice Chairman, FDIC, Remarks at the Peterson Institute for International Economics: The Relative Role of Debt in Bank Resiliency and Resolvability, (Jan. 20, 2016), https://www.fdic.gov/news/news/speeches/spjan2016.html [hereinafter Hoenig 2016 Speech].

77. Martin J. Gruenberg, Chairman, FDIC, Remarks to the FDIC Banking Research Conference (Sept. 17, 2015), https://www.fdic.gov/news/news/speeches/spsep1715.html.

B. *TLAC*

The Fed's TLAC rule is clearly designed to entrench SPOE as the preferred strategy for resolving failures of SIFIs. The Fed's TLAC rule accords with Wall Street's desire to maintain a continuity of existence for the operating subsidiaries of a failed G-SIB and to provide full protection for the subsidiaries' creditors.[78] The Fed 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 authorities across multiple jurisdictions," a result the Fed plainly does not want.[79]

When it takes effect on January 1, 2019, the Fed's TLAC rule will 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 7.5% of its total leverage exposure, whichever is greater.[80] In addition, each U.S. G-SIB will be obliged to maintain supplemental "external TLAC buffers" equal to 2.5% of RWAs and 2% of its total leverage exposure.[81] If a U.S. G-SIB fails to maintain both required buffers, its ability to make capital distributions (including stock buybacks and dividends) and to pay discretionary bonuses will be restricted.[82]

In addition to creating "external TLAC" requirements for U.S. G-SIBs, the Fed's TLAC rule will require each U.S. intermediate holding company owned by a foreign G-SIB to satisfy a separate "internal TLAC" requirement. This "internal TLAC" requirement will oblige each U.S. intermediate holding company to sell qualifying TLAC instruments to its parent foreign G-SIB (or, in certain cases, to third-party investors). The "internal TLAC" mandate is designed to enable the failure of a U.S. intermediate holding company to be resolved by writing off the TLAC investments held by its parent foreign G-SIB (or, in certain cases, by third-party investors).[83]

---

78. 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, 82 Fed. Reg. 8266, 8279–80, 8298–301 (Jan. 24, 2017) (to be codified at 12 C.F.R. pt. 252).

79. 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 Fed. Reg. 74,926, 74,928 (proposed Nov. 30, 2015) (to be codified at 12 C.F.R. pt. 217, 252); *see* Total Loss-Absorbing Capacity, 82 Fed. Reg. at 8270 n.29.

80. Total Loss-Absorbing Capacity, 82 Fed. Reg. at 8272–73.

81. *Id.* at 8276–77.

82. *Id.* at 8272–78.

83. A U.S. intermediate holding company must issue qualifying TLAC instruments to its parent foreign G-SIB (or to its directly or indirectly wholly-owned subsidiary), if the failure of

Under the Fed's TLAC rule, each parent holding company of a U.S. G-SIB will 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).[84] In satisfying its total TLAC requirement, each G-SIB must 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.[85]

Each parent holding company of a G-SIB will be required to issue TLAC debt directly, instead of through subsidiaries, thereby ensuring that the TLAC debt can 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 incurred 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.[86]

Thus, TLAC debt will function as bail-in debt and will be used to recapitalize the failed G-SIB's operating subsidiaries.

Under the Fed's rule, 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.[87] TLAC debt must have a remaining maturity of at least one year and will be subject to a 50% haircut if its remaining maturity is less than two years.[88] TLAC debt must be "plain-vanilla" debt that does not include "[e]xotic features" (such as embedded derivatives), must be governed by

---

the foreign parent would be resolved under the SPOE strategy. Under the SPOE approach, the U.S. intermediate holding company would continue in operation and would not be placed in resolution. In contrast, a U.S. intermediate holding company would be allowed to issue TLAC instruments to third-party investors if the failure of the parent foreign G-SIB would be resolved under an MPOE strategy. Under the MPOE resolution approach, the parent foreign G-SIB's failure might trigger a separate resolution proceeding for the U.S. intermediate holding company. *Id.* at 8270–71, 8287–89. 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 intermediate U.S. holding companies owned by foreign G-SIBs.

84. *Id.* at 8270.

85. *Id.* at 8272–75; *see also* 12 C.F.R. §§ 217.400–.406 (2016) (prescribing requirements for calculating the G-SIB capital surcharge applicable to each U.S. G-SIB).

86. Total Loss-Absorbing Capacity, 82 Fed. Reg. at 8279.

87. *Id.*

88. *Id.* at 8278.

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.[89]

To ensure that parent holding companies of G-SIBs will be less difficult to resolve, the Fed's TLAC rule includes "clean holding company" provisions.[90] Those provisions will 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 TLAC, (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.[91] The "clean holding company" provisions will 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.[92]

II. THE SHORTCOMINGS OF THE SPOE–TLAC REGIME

This Part discusses several reasons for questioning the workability of the SPOE–TLAC regime. It begins by focusing on the concerns with SPOE and TLAC individually, and then turns to the concerns that arise from the joint operation of TLAC and SPOE. It concludes 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 a new idea. Indeed, it is the initial favored approach for most corporate chapter 11 cases. However, 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

---

89. *Id.* at 8278–84. The TLAC rule includes a "grandfathering provision," which will allow U.S. G-SIBs to include long-term debt that would not otherwise satisfy the standards for TLAC debt, if that long-term debt was issued prior to December 31, 2016, and meets certain criteria. *Id.* at 8278–79.

90. *Id.* at 8266.

91. *Id.* at 8298.

92. *Id.* at 8298–302. The 5% limit on non-TLAC liabilities will not apply if all TLAC debt issued by the G-SIB's parent holding company is contractually subordinated to the company's other liabilities. *Id.* at 8283–301.

operating subsidiaries.[93] 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.[94]

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 right to terminate a subsidiary's swaps contracts.[95] There are efforts to expand the scope of this collective deal beyond the largest financial institutions, although not all counterparties are enthusiastic about adopting the new approach.[96] In addition, the "clean holding company" provisions of the Fed's TLAC rule will bar U.S. G-SIBs from providing guarantees with cross-default rights for obligations of their subsidiaries and will also prohibit subsidiaries from providing upstream guarantees for the holding company's obligations.[97]

More broadly, for the SPOE process to work regulators will have to police against the creation of joint holding company and operating company liabilities throughout the entire corporate structure.[98] Regulation can preclude the creation of joint liabilities as a matter of contract (as the "clean holding company' provisions of the TLAC rule seek to accomplish), but state agency and tort law might be another matter. For example, employees of operating subsidiaries of JPMorgan Chase who hold themselves out as employees 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 policies.

Another reason why 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

---

93. William H. Coquillette, *Guaranty of and Security for the Debt of a Parent Corporation by a Subsidiary Corporation*, 30 CASE W. RES. L. REV. 433, 434 (1980).

94. *Id.* at 442.

95. William G. De Leon et al., *Unintended Consequences of "Staying" Early Termination Rights*, PIMCO (Dec. 2014), http://www.pimco.com/EN/Insights/Pages/Unintended-Consequences-of-Staying-Early-Termination-Rights.aspx.

96. *Id.*

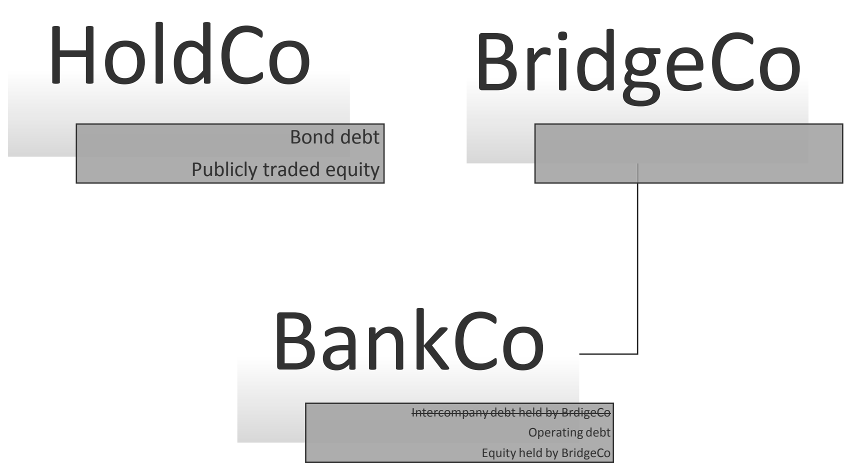
97. Total Loss-Absorbing Capacity, 82 Fed. Reg. at 8300–01.

98. 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).

makes sense is with a firm that has undergone a leveraged buyout.[99] In such a case, financial distress can result from "too much debt" issued by the holding company.[100] Removing the debt—often through the forcible conversion of the holding company's bondholders to shareholders—solves that problem.

However, while SIFIs often operate with a high degree of leverage, a major financial institution has never failed because of its inability to make payments on long-term bonds. Instead, financial institutions typically fail because of some sort of "run" by holders of short-term debt—broadly defined to include all instances where depositors or other short-term creditors flee the financial institution. Those "runs" typically originate in an operating subsidiary. As explained 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 financial company, the BFC, while the holding company's liabilities would stay behind in the "receivership estate."[101] Consider the simple model financial holding company presented earlier in this Article, and ignore any complications resulting from the nature of the principal subsidiary (which, as a depository bank, might not provide a proper basis for an OLA proceeding):



99. BRADLEY DRAKE ET AL., A NOTE ON LEVERAGED BUYOUTS, DEFAULTS & BANKRUPTCY 2 (2014), https://turnaround.org/sites/default/files/%232%20A%20Note%20on%20Leveraged%20Buyouts%20Defaults%20and%20Bankruptcy.pdf.

100. *Id.*

101. Strictly speaking, and unlike the Bankruptcy Code, OLA does not provide for the creation of an estate. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, §§ 204–05, 210(a)(7)(D), 124 Stat. 1376 (2010) (codified as amended in scattered sections of 12 U.S.C.).

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 securities by BridgeCo could be overcome if the FDIC provides interim funding to BridgeCo through the Orderly Liquidation Fund, as described below.[102]

The subsidiary, 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.[103] Of course, debt forgiveness would only solve the problem of balance sheet insolvency and would not inject any new funding into the corporate group. Thus, debt forgiveness (or debt-for-equity swaps) by BridgeCo would not address the liquidity problems that BankCo would likely confront. If BridgeCo could borrow funds by issuing new bonds, it could downstream those funds to BankCo or other subsidiaries in exchange for new intercompany debt or yet more equity.

In the more likely situation where BridgeCo is not able to sell any new bonds (due to a lack of private-sector demand), the OLF would be the obvious source for providing needed liquidity to BankCo. Lending from the OLF is limited during the first thirty days of the resolution process, when such lending is apt to be most vital, to just 10% of the financial company's assets.[104] In the present example, that restriction would limit lending from the OLF to BridgeCo to a figure equal to 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 immediate liquidity problems of a bank or securities broker–dealer whose parent company has just been placed into OLA.[105]

After the first month of an OLA proceeding, 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."[106] 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 thirty days of the case, when the FDIC's ability to lend is significantly constrained.

The FDIC's ability to provide OLF loans based on the "fair value" of BridgeCo's assets—a phrase as flexible as other legal favorites like

102. 12 U.S.C. § 5390(n) (2012). Of course, arguably the fund would not be used for "liquidation" when used in connection with SPOE.

103. The latter might be wise to avoid any fraudulent transfer claims.

104. 12 U.S.C. § 5390(n)(6)(A).

105. *Id.*

106. *Id.* § 5390(n)(6)(B).

"reasonable" or "material"—indicates that OLF loans to BridgeCo would not be limited by the current fair market value of the assets of BankCo.[107] Accordingly, the FDIC might be exposed to a risk of substantial losses when it borrows from the OLF to provide needed liquidity to BridgeCo's operating subsidiaries. Moreover, the FDIC could effectively be performing a liquidity transformation service—similar to that provided by the Fed's "discount window"—in allowing BridgeCo to monetize the value of its subsidiaries at a point when private financing would probably be unavailable.[108]

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, which covered all of Continental's depositors and other creditors.[109] Despite 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.[110]

By the end of August 1984, the FDIC, the Fed, and a supporting group of private banks had provided more than $15 billion of funding to Continental and held almost half of Continental's total liabilities.[111] 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 withdrawals. That in turn could require large drawdowns from the FDIC's credit line with the Treasury [under the OLF]."[112]

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.

---

107. *Id.* § 5390(n).

108. *See* Kristin N. Johnson, *Governing Financial Markets: Regulating Conflicts*, 88 WASH. L. REV. 185, 228–29 (2013).

109. 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, 2016), http://ssrn.com/abstract=2756472.

110. *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").

111. *Id.* at 9–12, 13 tbl.3.

112. *Id.* at 30.

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 laws 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 vitally needed cash to a distressed parent company for transfer to a troubled subsidiary? Would such a distribution constitute a fraudulent transfer? And if the subsidiary is a regulated entity, would its regulator permit such a transfer?

Next is the matter of the subsidiary that caused the problems in the first instance. The SPOE model implicitly assumes that the troubled subsidiary should be recapitalized in nearly all cases. However, in many cases, opening a 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.[113] When the market began to doubt the value of those securities, Lehman could no longer obtain sufficient funding by rolling over its repos.[114] Lehman's parent company did not have sufficient reserves to solve this problem by loaning money to its operating subsidiaries.[115] In Lehman's situation, an SPOE resolution by itself would not provide any new sources of external funding; SPOE would simply move the operating subsidiaries' problems to the holding company level. To rescue its operating 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 such a purchase, given the unwillingness of private-sector firms to provide additional loans to Lehman. Absent a government-arranged source of liquidity, Lehman inevitably would have failed.[116]

American International Group (AIG) provides a similar example. 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' high-quality securities to make huge and

113. John Crawford, *Wargaming Financial Crises: The Problem of (In)experience and Regulator Expertise*, 34 REV. BANKING & FIN. L. 111, 151 (2014).

114. *Id.*

115. *Id.* at 153.

116. *See* Lee, *supra* note 6, at 454–61.

risky investments in nonprime mortgage-backed securities.[117] 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 insolvency problems in financial conglomerates from an accounting standpoint, but balance sheet problems are unlikely to be the source of potential crises at such a conglomerate. Instead, liquidity shortfalls at troubled subsidiaries are likely to be the most pressing concern, and it is far from clear whether SPOE can succeed in replenishing those shortfalls without relying on a government source of funding such as the OLF.

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 group-wide basis.[118] 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.[119]

This practical reality makes it highly improbable that all will be "business as usual" at the operating subsidiaries after a SIFI's parent holding company has gone into OLA, because OLA is most likely 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" as 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.[120]

---

117. *See generally* William K. Sjostrom, Jr., *The AIG Bailout*, 66 WASH. & LEE L. REV. 943 (2009) (analyzing AIGs over-exposure to credit default swaps and mortgage-backed securities in the lead-up to the financial crisis).

118. 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) (discussing how corporate groups manage their cash as a single fund).

119. Douglas G. Baird & Robert K. Rasmussen, *Antibankruptcy*, 119 YALE L.J. 648, 657 (2010).

120. *See* Arthur E. Wilmarth, Jr., *Wal-Mart and the Separation of Banking and Commerce*, 39 CONN. L. REV. 1539, 1606–09 (2007) (providing historical examples of contagious runs on subsidiaries that were triggered by the failures of their parent holding companies).

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 rule 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 operating subsidiaries of failed G-SIBs, and creditors of those subsidiaries, from suffering any losses. The Fed has stated 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.[121] The Fed contends that blanket protection for a failed G-SIB's subsidiaries and their creditors is essential because such an assurance will "help to maintain the confidence of the operating subsidiaries' creditors and counterparties, reducing their incentives to engage in potentially destabilizing funding runs."[122] Thus, the Fed's TLAC rule will 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.[123]

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 TLAC rule strongly indicates that individual investors, especially those holding interests in mutual funds and pension funds, are expected to buy most of this loss-absorbing TLAC debt. As the rule emphasizes, "it is desirable that the holding company's

121. 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 Fed. Reg. 74,926, 74,928, 74,944 (proposed Nov. 30, 2015) (to be codified at 12 C.F.R. pt. 217, 252); *see also* 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, 82 Fed. Reg. 8266, 8299–300 (Jan. 24, 2017) (to be codified at 12 C.F.R. pt. 252) (stating that "SPOE resolution relies on imposing losses on the covered holding company's [TLAC] creditors while protecting the creditors and counterparties of its material operating subsidiaries" so that those "subsidiaries would continue to operate normally upon the covered holding company's entry into resolution").

122. Total Loss-Absorbing Capacity, 80 Fed. Reg. at 74,928; *see also* Total Loss-Absorbing Capacity, 82 Fed. Reg. at 8298 (SPOE and TLAC are designed to reduce the incentives of short-term creditors of operating subsidiaries to "run," since those creditors "would not bear losses incurred by the subsidiaries because those losses would instead be transferred to the [parent] holding company and therefore borne by the external TLAC holders").

123. Total Loss-Absorbing Capacity, 80 Fed. Reg. at 74,944–45.

creditors be limited to those entities that can be exposed to losses *without materially affecting financial stability*."[124]

The Fed and other federal bank regulators will undoubtedly take steps to discourage depository institutions and their holding companies from investing in TLAC debt. In November 2015, the Financial Stability Board (FSB) declared that any investments in TLAC equity or debt by global G-SIBs should be subject to a 100% deduction from their regulatory capital in order to discourage them from investing in TLAC instruments issued by other G-SIBs.[125] The Basel Committee on Bank Supervision (BCBS) took note of the FSB's mandate when the BCBS issued a new capital standard in October 2016.[126] The new BCBS standard revises the Basel III international capital accord to govern the treatment of TLAC instruments.[127] Under this new standard, internationally active banks must deduct from their regulatory capital any holdings of TLAC instruments issued by G-SIBs that exceed a specified threshold.[128] When the Fed adopted its TLAC rule two months later, the Fed indicated that it "will work with other federal banking agencies to adopt the [capital] deduction requirement on a coordinated basis" in accordance with the BCBS standard.[129]

The new BCBS standard for TLAC instruments applies to all internationally active banks (including both G-SIBs and non-G-SIBs).[130] In adopting the new standard, the BCBS explained that the required capital deduction for TLAC investments "reduces a significant source of contagion in the banking system. Without deduction, holdings of TLAC could mean that the failure of one G-SIB leads to a reduction in the loss absorbency and recapitalization capacity of another bank."[131] Thus, the new capital deduction is expressly designed to provide "sufficient disincentives for banks to invest in TLAC."[132] Insurance regulators will

124. Total Loss-Absorbing Capacity, 82 Fed. Reg. at 8,299 (emphasis added).

125. FIN. STABILITY BD., PRINCIPLES ON LOSS-ABSORBING AND RECAPITALISATION CAPACITY OF G-SIBS IN RESOLUTION: TOTAL LOSS-ABSORBING CAPACITY (TLAC) TERM SHEET 17 (2015) [hereinafter FSB TLAC Principles], http://www.financialstabilityboard.org/wp-content/uploads/TLAC-Principles-and-Term-Sheet-for-publication-final.pdf ("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.").

126. BASEL COMM. ON BANK SUPERVISION, STANDARD: TLAC HOLDINGS: AMENDMENTS TO THE BASEL III STANDARD ON THE DEFINITION OF CAPITAL 1 (2016) [hereinafter BCBS TLAC Standard], http://www.bis.org/bcbs/publ/d387.pdf.

127. *Id.*

128. *Id.* at 1–2.

129. Total Loss-Absorbing Capacity, 82 Fed. Reg. at 8269.

130. BCBS TLAC Standard, *supra* note 126, at 1.

131. *Id.* at 1–2.

132. *Id.* at 2.

likely adopt similar capital deduction rules to deter insurance companies from investing in TLAC debt.

Assuming that depository institutions and insurance companies will not buy TLAC debt, the most likely investors for such debt will be hedge funds, mutual funds, and pension funds. Individual investors might also buy TLAC debt through their brokerage accounts. According to a recent study, asset managers (including mutual funds and pension funds) purchased about half of the CoCos issued by foreign banks between 2013 and 2015.[133] Hedge funds accounted for more than 10% of such purchases.[134] CoCos are a form of bail-in bonds that include many of the features of TLAC debt.[135]

We anticipate that regulators will 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.[136] 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.[137]

In contrast, regulators and executives of megabanks view mutual funds and pension funds as leading prospective targets for sales of bail-in debt.[138] 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.[139] Mr. Flint declared that society must choose between imposing the costs of resolving failed megabanks on ordinary investors or on taxpayers.[140] 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*."[141]

Mr. Flint did not mention the possibility that SIFIs or their insiders might share any of the losses resulting from excessive risk-taking. His

---

133. Greene, *supra* note 21, at 27.

134. *Id.*

135. *Id.*

136. Laura Noonan, *Prime Brokerage Reassessed as Banks Seek Growth and Stable Earnings*, FIN. TIMES (Apr. 27, 2016), https://next.ft.com/content/403c2b14-0c64-11e6-9456-444ab5211a2f.

137. *See* Wilmarth, *supra* note 10, at 62.

138. *See id.* at 63–64.

139. *Id.* at 64.

140. *Id.*

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

assertion that "society" must continue to bail out megabanks provides a very revealing glimpse into the mindset that has prevailed among senior executives on Wall Street and in the City of London before, during, and after the financial crisis.[142] 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 the longer-term losses imposed by SIFIs.[143]

C. *TLAC and SPOE Together*

Think back again to our model financial holding company, 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. Because HoldCo's claims are structurally subordinated to those of other creditors of BankCo—since HoldCo's debt claims against BankCo will be forgiven upon its insolvency under SPOE, 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

142. *Id.* at 64–65.

143. *Id.*; *see* SIMON JOHNSON & JAMES KWAK, 13 BANKERS: THE WALL STREET TAKEOVER AND THE NEXT FINANCIAL MELTDOWN 12 (1st ed. 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 10, 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").

> financial company, and ultimately to emergence as a new firm.[144]

The assumption that SPOE will work so long as HoldCo has "sufficient resources" (including bail-in debt) ignores the likely outer limit to such "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 do not exceed the cash flow generated by its debt and equity holdings 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.[145]

Thus, a post-insolvency BridgeCo is likely to have substantially diminished borrowing capacity. It therefore seems highly doubtful that BridgeCo will be able to obtain enough *new* private sector funding to recapitalize 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.[146] 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.[147]

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 adverse effect on the financial system of the United States."[148] During a future financial crisis, many large banks probably

---

144. REBECCA J. SIMMONS, BANKING PERSPECTIVE, SINGLE POINT OF ENTRY: A STRATEGY TO RESOLVE LARGE AND COMPLEX FINANCIAL COMPANIES, 36, 41 (2014), www.sullcrom.com/siteFiles/Publications/007singlepointofentry.pdf.

145. *See* 12 U.S.C. § 5383 (2012).

146. Wilmarth, *supra* note 10, at 46.

147. *Id.* at 66–67, 74.

148. *Id.* at 67 (discussing and quoting 12 U.S.C. § 210(n)(9)(B), (o)(1)(B), (C) (2012)).

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. Thus, SPOE and TLAC are very likely to shift most or all of the burden of bailing out failed SIFIs from Wall Street creditors to ordinary citizens, either as investors or taxpayers.[149]

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 likely trigger contagious spillover effects for other vulnerable SIFIs. In a 2014 paper, Professors 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.[150] 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.[151]

Recent events have confirmed the prescience of their warnings.[152] In December 2015, the Italian government rescued four regional banks and imposed almost $400 million of losses on holders of their subordinated debt.[153] Many of the debtholders were consumers who had been persuaded by their banks to convert their deposits into subordinated

149. *Id.* at 61–68.

150. Charles Goodhart & Emilios Avgouleas, *A Critical Evaluation of Bail-Ins as Bank Recapitalisation Mechanisms* 30–31 (Ctr. for Econ. Policy, Research Discussion Paper No. 10065, 2014), http://ssrn.com/abstract=2478647.

151. *Id.* at 32.

152. James Politi, *Italy Bank Rescues Spark Bail-in Debate as Anger at Renzi Grows,* FIN. TIMES (Dec. 22, 2015), https://next.ft.com/content/54cda5e4-a6ac-11e5-955c-1e1d6de94879.

153. Giada Zampano & Liam Moloney, *Renzi, Confident on Italian Banks Amid Rescue Plan Storm*, WALL ST. J. (Dec. 29, 2015), https://www.wsj.com/articles/renzi-confident-on-italian-banks-amid-rescue-plan-storm-1451405238.

bonds.[154] The debtholders' losses provoked a strong political backlash against then Prime Minister Matteo Renzi and caused many investors to dump their holdings of subordinated debt in Italian banks.[155]

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).[156] 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.[157] The bond transfer sparked strong protests as well as a lawsuit by affected bondholders.[158] The government's action also led to widespread investor sales of bonds issued by Novo Banco and other Portuguese banks.[159]

The losses suffered by bondholders in Italy and Portugal set the stage for a much larger disruption of the market for CoCos issued by European banks in February 2016.[160] 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 CoCos and other bonds after both banks reported large year-end losses.[161] Investors also voiced increasing concerns about the potential impact of the Bank Recovery and Resolution Directive (BRRD) issued by the European Union (EU).[162] The BRRD, which took effect in January 2016, requires regulators to impose losses on bail-in bondholders when

---

154. *Id.*

155. Tom Beardsworth & Sonia Sirletti, *Italy Banks Facing Funding Threat as Bond Sales Scrutinized*, 105 Banking Rep. (BNA) 929, 105 BBR 929 (BNA) (Dec. 21, 2015); Politi, *supra* note 152; Zampano & Moloney, *supra* note 153.

156. Thomas Hale & Martin Arnold, *Novo Banco: Fourteen Asset Managers Sue Portuguese Central Bank*, FIN. TIMES (Apr. 4, 2016), https://next.ft.com/content/e4762f38-fa97-11e5-8f41-df5bda8beb40.

157. *Id.*

158. *Id.*

159. Martin Arnold & Thomas Hale, *Southern Europe's Banks Feel Cost of Portuguese Actions at Novo Banco*, FIN. TIMES (Jan. 17, 2016), https://next.ft.com/content/93be3c46-bbba-11e5-b151-8e15c9a029fb; Philippe Bodereau, *Discrimination at Portuguese Bank Novo Banco Sets a Dangerous Precedent*, FIN. TIMES (Jan. 12, 2016), https://next.ft.com/content/198e08ea-b62c-11e5-8358-9a82b43f6b2f; Hale & Arnold, *supra* note 156.

160. Jim Brunsden & Alex Barker, *Bank Turmoil: Are Europe's New Bail-In Rules to Blame?*, FIN. TIMES (Feb. 11, 2016), https://next.ft.com/content/8ad2ed98-d0a0-11e5-986a-62c79fcbcead.

161. Tom Beardsworth & Cordell Eddings, *Systemic Risk: The $102 Billion of Bank Debt That's Making Investors Nervous*, 106 Banking Rep. (BNA) 231, 106 BBR 231 (BNA) (Feb. 9, 2016).

162. Christos Hadjiemmanuil, *Limits on State-Funded Bailouts in the EU Bank Resolution Regime* (European Banking Inst.., Working Paper No. 2, 2017), http://ssrn.com/abstract=2912165.

European banks fail.[163] In response to increased uncertainty about the future performance of bail-in debt, investors engaged in a massive selloff of CoCos issued by European banks, and Deutsche Bank and Credit Suisse were among the hardest-hit institutions.[164] 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.[165]

Another potential crisis involving bail-in debt emerged in December 2016, as Italy struggled to prevent the collapse of Banca Monte dei Paschi di Siena (MPS), the country's third-largest bank.[166] Italy requested the EU's permission to inject several billion euros of new capital into MPS as a "precautionary recapitalization," an approach that would sidestep the BRRD's strict mandate for imposing losses on bail-in bonds issued by insolvent banks.[167] Italy crafted its recapitalization plan to avoid imposing losses on some 40,000 retail investors who owned MPS's subordinated debt.[168] Italian officials hoped that sparing those retail bondholders would avert the type of political explosion that occurred in late 2015, when (as described above) Italy forced retail investors to incur losses on subordinated debt issued by four troubled regional banks.[169]

Some European officials and commentators warned that the EU would

---

163. *Id.*

164. For analysis of the disruption that occurred in the market for European bank CoCos in early 2016, see Beardsworth & Eddings, *supra* note 161; Brunsden & Barker, *supra* note 160; John Glover, *Deutsche Bank CoCo Holders See What Regulators Mean by Risk*, 106 Banking Rep. (BNA) 233, 106 BBR 233 (BNA) (Feb. 11, 2016); Greene, *supra* note 21, at 33–34; Thomas Hale, *Music Stops for Buyers of Bank Coco Debt*, FIN. TIMES (Feb. 11, 2016), https://next.ft.com/content/f921e592-d0af-11e5-831d-09f7778e7377. For an overview of the BRRD's requirements for resolving failed European banks, including the mandatory imposition of losses on bail-in bonds, see Hadjiemmanuil, *supra* note 162.

165. *The Trouble with CoCos*, BLOOMBERG: VIEW (Feb. 12, 2016, 7:00 A.M.), http://www.bloombergview.com/articles/2016-02-12/the-trouble-with-cocos.

166. James Politi & Rachel Sanderson, *Italy's Cabinet Approves Monte dei Paschi Bailout*, FIN. TIMES (Dec. 23, 2016), https://www.ft.com/content/a018e818-c831-11e6-9043-7e34c07b46ef.

167. Alexander Weber, *International Banking: Monte Paschi Rescue May Usher in New Bailout Era, Watchdog Says*, 108 Banking Rep. (BNA) 159, 108 BBR 159 (BNA) (Jan. 23, 2017).

168. Jim Brunsden et al., *Monte dei Paschi Bailout Comes Under Fire in Berlin*, FIN. TIMES (Dec. 23, 2016), https://www.ft.com/content/b407a570-c918-11e6-8f29-9445cac8966f.

169. For analysis of the controversy surrounding Italy's recapitalization plan for MPS, see Jim Brunsden et al., *supra* note 168; Hadjiemmanuil, *supra* note 162; Politi & Sanderson, *supra* note 166; Weber, *supra* note 167.

seriously undermine the BRRD's credibility if the EU allowed Italy to go forward with its recapitalization plan for MPS and thereby avoid the BRRD's stringent bail-in rules for insolvent banks. The European Central Bank (ECB) gave provisional approval to the MPS recapitalization plan at the end of 2016.[170] However, as this Article went to press in early 2017, it was not clear whether the EU would concur with the ECB and permit Italy to proceed with the plan.[171]

The market disruptions and political controversies surrounding European bank CoCos and other types of bail-in bonds highlight the volatility and fragility associated with bail-in debt. As shown by the herd-like behavior of investors in European bank CoCos, TLAC debt is not likely to perform a robust loss-absorbing function during periods of market stress.[172] Moreover, during a future financial crisis it is doubtful whether politicians and regulators would be willing to trigger a political crisis by imposing large losses on ordinary investors in mutual funds and pension funds that own TLAC debt. If TLAC debt fails to perform 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.[173] However, there are legitimate doubts about the usefulness of the current Code as applied to a financial institution.[174] 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,[175] and the "safe harbors" that exempt certain types of securities and derivatives contracts from core elements of the Code.[176]

Almost from the moment Dodd-Frank was enacted, various groups have proposed ways to amend the Bankruptcy Code to facilitate the

170. Brunsden et al., *supra* note 168.

171. Alex Barker et al., *Brussels and ECB Split on Monte dei Paschi's Capital Proposals*, FIN. TIMES (Feb. 23, 2017), https://www.ft.com/content/9635b04c-f923-11e6-bd4e-68d53499ed71; Brunsden et al., *supra* note 168.

172. Greene, *supra* note 21, at 31–35.

173. 12 U.S.C. § 5365(d) (2012); *see* Jonathan C. Lipson, *Against Regulatory Displacement: An Institutional Analysis of Financial Crises*, 17 U. PA. J. BUS. L. 673, 721–22 (2015).

174. Randall D. Guynn, *Are Bailouts Inevitable?*, 29 YALE J. ON REG. 121, 137–38 (2012).

175. Edward J. Janger, *Arbitraging Systemic Risk: System Definition, Risk Definition, Systemic Interaction, and the Problem of Asymmetric Treatment*, 92 TEX. L. REV. 217, 224 (2014).

176. Stephen D. Adams, *Swap Safe Harbors in Bankruptcy and Dodd-Frank: A Structural Analysis*, 20 STAN. J.L. BUS. & FIN. 91, 113 (2014).

resolution of SIFIs.[177] In some cases, these proposals would supplement OLA, in others they would replace it entirely. Such proposals are frequently designated as "chapter 14" proposals, after a proposal first put forth by the Hoover Institution's Working Group on Economic Policy.[178]

Perhaps the most significant of these proposals is the Financial Institution Bankruptcy Act of 2016, which was passed by the House in early 2016.[179] 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.

Under this bill, a financial holding company would be placed into bankruptcy, and its assets—equity in and debt claims against subsidiaries—would be transferred to a bridge institution.[180] 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 Court for their experience, expertise, and willingness to preside over these cases.[181]

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.[182] That said, the Financial Institution Bankruptcy Act and many 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 indicated above, this Article strongly questions the ability of SPOE to handle most resolutions of failed SIFIs.

In a recent paper, Professor Howell E. Jackson and law student Stephanie Massman identify the ability to move capital among different

---

177. Bruce Grohsgal, *The Case in Brief Against "Chapter 14,"* AM. BANKR. INST. J. (May 2014), http://blogs.harvard.edu/bankruptcyroundtable/2014/06/17/the-case-in-brief-against-chapter-14/.

178. 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. Stephen J. Lubben, *What's Wrong with the Chapter 14 Proposal*, N.Y. TIMES (Apr. 10, 2013, 6:17 PM), http://dealbook.nytimes.com/2013/04/10/whats-wrong-with-the-chapter-14-proposal/?_r=0.

179. The similar Taxpayer Protection and Responsible Resolution Act, S. 1841, 114th Cong. (2016), is currently in committee in the Senate.

180. H.R. REP. NO. 114-477, at 15 (2016).

181. *Id.* at 16.

182. David A. Skeel, Jr. & Thomas H. Jackson, *Transaction Consistency and the New Finance in Bankruptcy*, 112 COLUM. L. REV. 152, 198 (2012).

entities within the corporate group as one of the key differences between OLA and chapter 14.[183] In an OLA proceeding the FDIC controls the entire process, and can compel the movement of capital from the parent holding company to the endangered subsidiary that needs it.[184] In a chapter 14 proceeding, however, creditors might object to the transfer of assets out of the parent holding company's bankruptcy estate.[185] And transfers made by the parent holding company prior to the bankruptcy might be subject to avoidance as fraudulent transfers, since the parent might not have received "reasonably equivalent value" for those transfers.[186] Thus, as Jackson and Massman point out, "[w]hile a bankruptcy court judge might ultimately accept the downstream [transfers] of holding-company value that SPOE strategy contemplates, experience . . . suggests the process will not be easy, adding another mark against the bankruptcy court alternative as opposed to OLA under Title II [of Dodd-Frank]."[187]

Jackson and Massman propose to solve this problem by using section 365(o) of the Bankruptcy Code.[188] That section was enacted as part of the Comprehensive Thrift and Bank Fraud Prosecution and Taxpayer Recovery Act of 1990.[189] Section 365(o) provides that "[i]n a case under chapter 11 of this title, the trustee shall be deemed to have assumed (consistent with the debtor's other obligations under section 507), and shall immediately cure any deficit under, any commitment by the debtor to a Federal depository institutions regulatory agency."[190] In short, in a chapter 11 case dealing with a failed bank's parent holding company, the holding company's bankruptcy trustee must assume any agreement that the holding company made with the FDIC to recapitalize its insured bank subsidiary.

Jackson and Massman propose that a G-SIB's parent holding company could route all of its recapitalization commitments for operating subsidiaries through an FDIC-insured subsidiary bank, so that in chapter 14 the bankruptcy trustee for the parent holding company will be compelled to assume those obligations.[191]

In addition to its assumption and immediate cure requirement, section 365(o) addresses the priority of a claim arising from an obligation under

---

183. Howell E. Jackson & Stephanie Massman, *The Resolution of Distressed Financial Conglomerates*, 3 RUSSELL SAGE FOUND. J. SOC. SCI. 48, 50 (2017).

184. *Id.* at 50, 61.

185. *Id.* at 55.

186. 11 U.S.C. § 548 (2012).

187. Jackson & Massman, *supra* note 183, at 61.

188. *Id.* at 65.

189. Crime Control Act of 1990, Pub. L. No. 101-647, § 2522, 104 Stat. 4859, 4866 (1990).

190. 11 U.S.C. § 365(o).

191. Jackson & Massman, *supra* note 183, at 65–66.

a capital maintenance commitment made by a bank holding company.[192] The second portion of the statute provides that any claim for a "subsequent breach of . . . obligations [under a commitment to maintain the capital of a federally insured depository institution] shall be entitled to priority under section 507."[193] The reference to section 507 in section 365(o) directs the reader to section 507(a)(9). That provision, also enacted as part of the Comprehensive Thrift and Bank Fraud Prosecution and Taxpayer Recovery Act of 1990, places "unsecured claims based upon any commitment by the debtor to a Federal depository institutions regulatory agency . . . to maintain the capital of an insured depository institution" in ninth priority in a bankruptcy case.[194]

The priority issue raised by section 507 immediately suggests a potentially significant problem with the Jackson–Massman approach—putting to one side the FDIC's likely lack of enthusiasm for tying the insured bank to all recapitalization commitments for other operating subsidiaries. Namely, the obligation by a bankruptcy trustee to assume a contract does not necessarily translate into immediate performance of the contract, and it is important not to conflate the two. Instead, the trustee might choose to assume the contract and then breach it, leaving the holding company's subsidiaries with priority claims in a reorganization plan that might be years away from completion. Holding such bankruptcy claims will do nothing to keep the subsidiaries operating in the meantime.

Section 365(o) provides that the parent holding company shall immediately cure any default under a recapitalization agreement with a federal banking agency.[195] That seems to require performance, but by its terms the obligation to cure only applies if the debtor stays in chapter 11 (or one presumes, "chapter 14"). A bankruptcy trustee in a chapter 7 liquidation would have no such obligation to cure, and for this reason alone some creditors might prefer to proceed under that chapter.

Moreover, as one bankruptcy treatise notes, there might be plausible reasons for the holding company to delay its performance under such an agreement:

> [S]ection 365(o) does not extend any commitment that would otherwise be terminated by any act of a federal depository institutions regulatory agency. While no cases address this point, a plain reading of the statute suggests that section 365(o) does not enlarge the power of a federally insured depository institution to enforce a debtor's commitment to maintain capital if the institution's own

192. 11 U.S.C. § 365(o).

193. *Id.*

194. *Id.* § 507(a)(9).

195. *Id.* § 365(o).

> actions would have otherwise terminated that commitment. *This also suggests that the immediate curing requirement would be delayed if there is a dispute regarding whether the institution's own action would have otherwise terminated the commitment.*[196]

Thus, while Jackson and Massman have identified a real problem with importing SPOE into the Bankruptcy Code, their proposed solution may not be practicable under bankruptcy law.[197] More generally, one of SPOE's central goals seems to be to create a resolution model that would enable the Fed to bail out the operating subsidiaries of failed SIFIs and thereby protect those subsidiaries' Wall Street counterparties. The Fed does not have authority, however, to make discount window loans to nondepository companies such as securities broker–dealers.[198]

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.[199] Under section 13(3) as amended by Dodd-Frank, the Fed does retain the ability to provide liquidity assistance to nondepository companies pursuant to a "program or facility with broad-based eligibility," provided the recipients of that liquidity assistance are not insolvent.[200] Following the quick balance sheet restructuring contemplated by SPOE, nondepository operating subsidiaries of a failed SIFI could argue that they are not insolvent and, therefore, are eligible to receive loans from the Fed under such a "broad-based" program. Thus, the SPOE resolution strategy could potentially 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 our view, 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

---

196. BLOOMBERG LAW: BANKRUPTCY TREATISE, pt. I, ch. 48, at § 365(o), (Hon. D. Michael Lynn et al. eds., 2017) (emphasis added) (footnote omitted).

197. Perhaps somewhat more realistically, it has recently been proposed that all SIFIs adopt two holding companies, so that the second layer holding company can act as a central hub for group funds, while the top level holding company goes into SPOE.

198. *See* 12 U.S.C. § 343 (2012); William C. Dudley, President and Chief Executive Officer, Remarks at the Fed. Reserve Bank of Atlanta 2016 Financial Markets Conference, Market and Funding Liquidity: An Overview (May 1, 2016), https://www.newyorkfed.org/newsevents/speeches/2016/dud160501.

199. 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 26, at 1001–02.

200. 12 U.S.C. § 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 26, at 1002–03.

Dodd-Frank compels the FDIC to remove all executives and directors who were responsible for the SIFI's failure.[201] 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.[202] 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). The obligation to repay such loans would rest with the borrower alone.

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 preserve financial stability, and that goal inclines the Fed 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 Reserve Bank directors, who in turn participate in nominating Reserve Bank Presidents—has promoted a cozy relationship between the banking industry and the Fed.[203]

Thus, the apparent goals of Wall Street in promoting the chapter 14 approach 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. None of those objectives would make a positive contribution toward solving the TBTF problem. In fact, the chapter 14 approach threatens to perpetuate and entrench TBTF treatment for troubled SIFIs and their Wall Street creditors.

201. 12 U.S.C. § 5386(4).

202. *See supra* note 148 and accompanying text.

203. *See* 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); 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).

III. IMPROVING SPOE, TLAC, AND "CHAPTER 14"

For the reasons stated above, SPOE's claimed 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. In a 2016 speech, Neel Kashkari, President of the Federal Reserve Bank of Minneapolis, noted that SPOE, TLAC, and other new resolution tools might work "while the economy and [our] financial system are otherwise healthy and stable."[204] However, he was "far more skeptical that these tools will be useful to policymakers in . . . a stressed economic environment."[205] Based on his experience as a senior Treasury official during the height of the financial crisis in 2008 and his recognition of "the massive externalities on Main Street of large bank failures in terms of lost jobs, lost income and lost wealth,"[206] 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."[207]

This Part begins 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 existing regulatory structure. Given those practical constraints, this Part offers several suggestions for making TLAC, SPOE, and even "chapter 14" advance the basic goal of ending TBTF.

First, as the Fed has acknowledged, the sale of TLAC debt must be accompanied by adequate disclosures of the extraordinary risks embedded in that debt.[208] However, the Fed's disclosure requirements for TLAC debt are far too vague and too mild.[209] A much more robust disclosure regime for TLAC debt is urgently needed.

---

204. Neel Kashkari, President, Fed. Reserve Bank of Minneapolis, Speech at the Brookings Institution: Lessons from the Crisis: Ending Too Big to Fail, (Feb. 16, 2016) (transcript available at https://www.minneapolisfed.org/news-and-events/presidents-speeches/lessons-from-the-crisis-ending-too-big-to-fail).

205. *Id.*

206. *Id.*

207. *Id.*

208. 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, 82 Fed. Reg. 8266, 8303 (Jan. 24, 2017) (to be codified at 12 C.F.R. pt. 252).

209. In full, the disclosure provision of the Fed's TLAC rule provides:

> § 252.65 Disclosure requirements.
>
> (a) A global systemically important BHC must publicly disclose a description of

Under our recommended 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 <u>entire</u> investment. [210]

Similarly, we would require mutual funds or pension funds that invest in TLAC debt to disclose the bail-in risks to investors and include in their offering materials the "black box" warning proposed above. Each such fund would also be required to disclose the maximum 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 also recommend that each SIFI that issues TLAC debt should maintain a dedicated web page that is readily accessible on its main website and describes the material provisions of its resolution plan in reasonable detail. 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

---

> 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 [TLAC] 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.

Total Loss-Absorbing Capacity, 82 Fed. Reg. at 8310.

210. In adopting its final TLAC rule, the Fed considered the possibility of requiring issuers of TLAC debt to include such a prominent disclosure box in their offering materials, but the Fed chose not to do so. *Id.* at 8303.

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 candid and detailed 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 TLAC rule to allow G-SIBs to meet their entire TLAC obligations 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.[211]

In adopting its final rule, the Fed considered the possibility of allowing G-SIBs to satisfy their entire TLAC mandates by issuing Tier 1 equity capital.[212] However, the Fed decided to retain its requirement that each G-SIB must maintain a minimum amount of TLAC debt.[213] The Fed justified that decision by claiming that a minimum requirement for TLAC debt "would enhance the prospects for the successful resolution of a failed GSIB and thereby better address the [TBTF] problem."[214]

The Fed did not present any evidence to support its remarkable claim that TLAC debt will have a better loss-absorbing capacity than Tier 1 equity. That assertion is refuted by the highly dubious recent record of CoCos and other forms of bail-in debt at European banks, as well as compelling evidence of the superior performance of Tier 1 equity as a

211. *See* 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"); Wilmarth, *supra* note 10, at 66. For a comprehensive demonstration of the clear superiority of equity capital over debt as a loss-absorbing buffer for banks, see generally ANAT ADMATI & MARTIN HELLWIG, THE BANKERS' NEW CLOTHES: WHAT'S WRONG WITH BANKING AND WHAT TO DO ABOUT IT (2013).

212. Total Loss-Absorbing Capacity, 82 Fed. Reg. at 8273–74.

213. *Id.*

214. *Id.*

loss-absorbing buffer.[215] If the Fed's claim were correct, the Fed should compel G-SIBs to satisfy *all* of their TLAC mandates by issuing TLAC debt rather than Tier 1 equity. Of course, neither the Fed nor anyone else (except, perhaps, some supporters and executives of megabanks) believes that would be a sound policy. Accordingly, the Fed should allow G-SIBs to satisfy their entire TLAC requirements by issuing Tier 1 equity and should remove the provision of its TLAC rule that requires G-SIBs to maintain a minimum amount of TLAC debt.[216]

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 SIFIs to pay risk-based premiums to establish a pre-funded OLF.[217] Barring such a change to Dodd-Frank, we propose that SIFIs should be required to maintain dedicated reserves of "internal" liquidity funds within their holding companies.

This Article has identified several reasons for doubting the ability of parent holding companies of SIFIs to add limitless amounts of debt to their capital structure.[218] 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, it also must migrate into something more like "dual point of entry." That is, there 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

215. *See supra* notes 160–72, 211 and accompanying text.

216. *See* Total Loss-Absorbing Capacity, 82 Fed. Reg. at 8308 (adopting 12 C.F.R. § 252.62, which would codify that requirement).

217. *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 10, at 73–79.

218. *See supra* notes 113–08, 144–46 and accompanying text.

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 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[219]—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.

Specific provisions of such a subchapter should include: standing for regulators to participate in proceedings involving SIFIs; 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 any financial claims covered by "safe harbors."[220] The new subchapter should not lock a SIFI into any particular resolution mechanism.

In addition, we should not pretend that private market funding for chapter 14 cases will always be available. Many of the largest U.S. G-SIBs are themselves key players in the "DIP loan" market, which provides liquidity to chapter 11 debtors. This fact alone suggests that chapter 14 can never be a complete solution for financial distress involving these large financial institutions. Instead, the Bankruptcy Code and OLA should be amended so that they will work hand in hand. We therefore strongly oppose proposals to repeal OLA and replace it with chapter 14.

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 this Article has shown, 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.

---

219. *See* 11 U.S.C. § 1161 (2012).

220. Lubben would of course argue (and Wilmarth agrees) that, rather than create an "exception to the exception," the safe harbors should be reconsidered wholesale. *E.g.*, Stephen J. Lubben, *The Bankruptcy Code Without Safe Harbors*, 84 AM. BANKR. L.J. 123, 123 (2010); Stephen J. Lubben, *Transaction Simplicity*, 112 COLUM. L. REV. SIDEBAR 194, 196 (2012); *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).

We write this Article at a time of great uncertainty. Shortly after his inauguration in January 2017, President Donald Trump announced that he intended to "[do] a big number on Dodd-Frank" and expected "to be cutting a lot out of Dodd-Frank."[221] When this Article went to press shortly thereafter, it was unclear what parts of Dodd-Frank the President actually intended to repeal or amend.[222] One proposal—supported by Rep. Jeb Hensarling (R-TX), the current chair of the House Financial Services Committee—sought to repeal OLA and replace it with one of the "chapter 14" proposals described in this Article.[223] As we have explained, that approach provides a "solution" for SIFI failures that is more pretend than real. Only time will tell how current efforts to change Dodd-Frank play out.

---

221. Ben Bain & Jesse Hamilton, *Regulatory Reform: Trump Pledges 'Big Number' on Dodd-Frank in Anti-Rule Push*, 108 Banking Rep. (BNA) 202, 108 BBR 202 (BNA) (Feb. 6, 2017); Ben Protess & Julie Hirschfeld Davis, *Trump Vows Cuts in Wall St. Rules from Obama Era*, N.Y. TIMES, Feb. 4, 2017, at A9.

222. Victoria Finkle, *Dodd-Frank: Banks Less Keen Than GOP for Sweeping Dodd-Frank Overhaul*, 108 Banking Rep. (BNA) 242, 108 BBR 242 (BNA) (Feb. 13, 2017); Robert Schmidt et al., *Dodd-Frank: Dodd-Frank's Tentacles Go Deep—Won't Be Cut Fast or Easily*, 108 Banking Rep. (BNA) 250, 108 BBR 250 (BNA) (Feb. 13, 2017).

223. Jeff Bater, *Systemic Risk: Yellen at Odds with GOP on Resolving Failing Banks*, 108 Banking Rep. (BNA) 286, 108 BBR 286 (BNA) (Feb. 20, 2017) (reporting on testimony before the House committee by Fed Chair Janet Yellen, in which she disagreed with Rep. Hensarling's proposal to repeal OLA).