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## A Lack of Resolution

David Zaring

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## A LACK OF RESOLUTION

David Zaring\*

*[T]here is a clear need for a new “resolution authority.”*

—Paul A. Volcker<sup>1</sup>

*How few there are who have courage enough to own their Faults, or resolution enough to mend them!*

—Benjamin Franklin<sup>2</sup>

### ABSTRACT

*The failure to resolve—that is, impose a quick death penalty on—enormous financial intermediaries such as Lehman Brothers and AIG damaged the ability of the government to respond to the financial crisis. But expanding resolution authority to cover new systemically significant institutions—which is one of the lynchpins of financial regulatory reform—poses a problem of legitimacy with constitutional implications, as resolution authority is usually exercised with almost no predeprivation process and little postdeprivation compensation. At the same time, banking regulators have failed, every time they have been given more resolution authority, to exercise that authority when it is needed.*

*This Article reassesses resolution authority. It proposes (1) domestic solutions to protect against government overreach and (2) an international context to deal with the problem of underreach. First, it proposes that the government make an ex ante public list of potentially nationalizable institutions and, ex post, provide the owners of seized institutions a brief window in which to buy their institutions back from the regulators who took*

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\* Assistant Professor, Legal Studies Department, Wharton School of Business. Thanks to Douglas Arner, Matt Bodie, Larry Cunningham, Steven Davidoff, Adam Levitin, Patricia McCoy, David Skeel, workshops at the University of Connecticut Law School, Hong Kong University, and the Annual Meeting of the Law and Society Association, to Paul Fattarusio, Justin Simard, and Andrew Dressel for research assistance, and to the Zicklin Center at Wharton for research support.

<sup>1</sup> *Efforts to Control High-Risk Investment Activities by Banks: Hearing Before the S. Comm. on Banking, Hous. & Urban Affairs*, 110th Cong. (2010) (statement of Paul A. Volcker, Chairman, President’s Economic Recovery Advisory Board).

<sup>2</sup> BENJAMIN FRANKLIN, *POOR RICHARD’S ALMANACK* 87 (Skyhorse Publishing, Inc. 2007) (1732).

them. This proposal would add both a process check and a market check to this most severe form of decisionmaking. At the same time, this Article also proposes internationalizing the context of the decision to use resolution authority by including expert multinational committees of regulators in the decision. Because these regulators are somewhat insulated from ordinary domestic politics, this twofold approach is more likely to encourage the appropriate resolution of the largest institutions than any solely domestic approach.

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## INTRODUCTION

The Supreme Court has regulated the government's "power to destroy" since 1819.<sup>3</sup> But Congress and the Constitution have protected the interests of the insolvent by permitting them fresh starts and granting them a variety of rights through bankruptcy for even longer.<sup>4</sup> Because debtor protection goes hand in hand with the destruction of the interests of creditors, the fresh start and the power to destroy have been on uneasy terms ever since.

Consider the fate of big, struggling financial intermediaries like the Lehman Brothers and AIGs of the most recent financial crisis. During that crisis, these institutions all but collapsed, at tremendous economic cost. They could have been destroyed, or the government could have saved them or given them some other sort of fresh start. This sort of fresh start might have been accomplished by invoking its resolution authority. Resolution authority is the polite term for seizing failing financial institutions and either shutting them down or selling them off for the best possible price. Resolution is meant to be implemented before contagion sets in and the institutions' counterparties, including customers, traders, and even competitors, also fail, either through panic (which is not the fault of the counterparties) or poor risk management (which is, but still may exacerbate a crisis). It is a particular kind of instant bankruptcy, destroying the interests of some creditors quickly and unmercifully, while giving others, especially the bank's depositors, a fresh and happy start.

Well-deployed resolution authority could mean that financial cataclysms of the sort threatened by Lehman and AIG would not bother ordinary Americans; their banking needs would be unaffected by the occasional smoothly resolved collapse of an institution in which they may have placed their trust, along with a dollop of high-quality deposit insurance.<sup>5</sup> It might, at least in theory, stop financial crises before they start.

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<sup>3</sup> *McCulloch v. Maryland*, 17 U.S. (4 Wheat.) 316, 391 (1819) ("A right to tax without limit or control, is essentially a power to destroy.").

<sup>4</sup> The Constitution contains a Bankruptcy Clause granting the federal government the power to act in bankruptcy. U.S. CONST. art. I, § 8, cl. 4. Congress passed the first bankruptcy act in 1800. *See* Bankruptcy Act of 1800, ch. 19, 2 Stat. 19 (repealed 1803). That statute did not provide for voluntary proceedings, however. Congress passed the first act providing for voluntary bankruptcy in 1841 and added to the provisions in 1867. *See* Act of Mar. 2, 1867, ch. 176, § 11, 14 Stat. 517, 521 (repealed 1878); Act of Aug. 19, 1841, ch. 9, § 1, 5 Stat. 440 (repealed 1843).

<sup>5</sup> Ideally, resolution authority would be used, and has been used, to perfect the "weekend bankruptcy," in which a financial institution would fail on Friday and reopen on Monday under new management and with

However, neither Lehman nor AIG were subjected to this sort of discipline. Was that lack of resolution the reason why the financial crisis was so severe?

Congress and President Obama seem to think so, and in the wake of the crisis, they have passed and signed legislation designed to enhance and broaden the government's power to destroy through resolution. Properly conceived, resolution authority looks like a valuable exercise of government power, and it is a cornerstone of the government's ongoing efforts to keep the financial system stable.<sup>6</sup> But it is not a panacea, and this Article explores its problems in the context of the other ways that the government can exercise the power to destroy and the power to grant a fresh start.

Resolution authority's problems are twofold. The first is that it is a power to destroy *par excellence*, and those sorts of powers need to be limited—a need particularly worth considering at a time when Congress has dramatically expanded the government's resolution authority through the Dodd-Frank Act reforming financial regulation. The second is that the government, perhaps aware of the dramatic nature of the act, has proven to be loath to exercise its power to destroy. This Article proposes an approach that would deal with both problems, one that differs from the new sort of authority promulgated by Congress in Dodd-Frank. It suggests a way to cabin the power to destroy and a way to ensure that the government exercises that power when it should.

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new signs on the door. The same customers would remain in the books, however, their savings entirely intact and their financial relationships smoothly shifted from an insolvent old institution to a solvent new one. The cost would be borne by the institution's old managers and owners, who would be fired or wiped out; its nondepositor creditors, who will take a haircut; and the government, which will cover any shortfall. The Federal Deposit Insurance Corporation (FDIC) has placed its guidelines for resolution authority on its website. FDIC, DELEGATIONS OF AUTHORITY: BOARD RESOLUTION (2002), <http://www.fdic.gov/regulations/laws/matrix/index.html>.

<sup>6</sup> Indeed, the needs and risks of resolution (or its alternative, uncontrolled bank failures) might fairly be construed as the basis for the rest of the regulatory enterprise of banking law, including the mission to keep banks generally "safe and sound," the imposition of frequent examinations and visitations to ensure that insolvency will not be a shock, and everything else that the government does to oversee financial intermediation. As such, and in light of the recent financial crisis, resolution authority has been the subject of a growing literature. For a view that resolution authority should be paired with a very large reserve fund, see Jeffrey N. Gordon & Christopher Muller, *Confronting Financial Crisis: Dodd-Frank's Dangers and the Case for a Systemic Emergency Insurance Fund* (Ctr. for Law & Econ. Studies, Columbia Univ. Sch. of Law, Working Paper No. 374, 2010), available at <http://ssrn.com/abstract=1636456> (proposing the expansion of resolution authority to firms not classified as "banks" as part of a plan to address systematic failures in the financial system); see also Kenneth Ayotte & David A. Skeel, Jr., *Bankruptcy or Bailouts?*, 35 J. CORP. L. 469 (2010) (criticizing increases in resolution authority for institutionalizing the use of bailouts); Onnig H. Dombalagian, *Requiem for the Bulge Bracket?: Revisiting Investment Bank Regulation*, 85 IND. L.J. 777 (2010) (calling for industry participation in resolution decisions).

Getting resolution right is worth doing; we will have another financial crisis, and soon. The World Bank has identified 112 episodes of systemic banking crises in 93 countries since the 1970s, and American banking crises appear to come along once every decade or so.<sup>7</sup> These crises all feature institutions that go bust seemingly overnight, all calling for resolution, bankruptcy, or a bailout.

And the alternative to resolution reform—which in the United States amounts to unclear resolution authority with inadequate encouragement of its use—is an unhappy one. During the last financial crisis, the government occasionally exhibited what the shareholders of Washington Mutual, the largest thrift<sup>8</sup> in the country at the time, thought was a lack of control, demonstrated by the government’s seizing and resolving a bank when a strong case could be made for its continued solvency.<sup>9</sup>

But mostly, it evinced what we might call a lack of resolution. In some cases the government organized deals, on the fly, to handle insolvency, as when the Federal Reserve and the Treasury Department forced the sale of one investment bank that they did not regulate—Bear Stearns—to a commercial bank,<sup>10</sup> despite a lack of obvious authority to intervene in investment banking and through some rather extraordinary cajoling and fundraising.<sup>11</sup> It did not resolve this institution.

Sometimes the government simply bailed out the insolvent institution. It did so for the credit default swap titan AIG, which it also did not resolve.<sup>12</sup>

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<sup>7</sup> See Patrick Honohan & Daniela Klingebiel, *Controlling the Fiscal Costs of Banking Crises* 3 (The World Bank Dev. Research Grp. Fin. & Fin. Sector Strategy & Policy Dep’t, Policy Research Working Paper No. 2441, 2000).

<sup>8</sup> “Thriffs” are savings and loan institutions (S&Ls), which are obligated to devote a percentage of their loans to financing housing.

<sup>9</sup> See Eric Dash & Andrew Ross Sorkin, *In Largest Bank Failure, U.S. Seizes, Then Sells*, N.Y. TIMES, Sept. 26, 2008, at A1. For an overview of the controversy surrounding this arguably overhasty resolution, see Felix Salmon, *Revisiting WaMu*, REUTERS BLOG (May 26, 2009, 2:16 PM), <http://blogs.reuters.com/felix-salmon/2009/05/26/revisiting-wamu/>.

<sup>10</sup> Andrew Ross Sorkin, *In Sweeping Move, Fed Backs Buyout and Wall St. Loans*, N.Y. TIMES, Mar. 17, 2008, at A1.

<sup>11</sup> See Steven M. Davidoff & David Zaring, *Regulation by Deal: The Government’s Response to the Financial Crisis*, 61 ADMIN. L. REV. 463 (2009) (describing the dealmaking process).

<sup>12</sup> See William K. Sjostrom, Jr., *The AIG Bailout*, 66 WASH. & LEE L. REV. 943, 943 (2009); David A. Skeel, Jr., *Bankruptcy Boundary Games*, 4 BROOKLYN J. CORP. FIN. & COM. L. 1, 12 (2009). For a first draft of the AIG bailout history, see Monica Langley et al., *Bad Bets and Cash Crunch Pushed Ailing AIG to Brink*, WALL ST. J., Sept. 18, 2008, at A1 (“The rot stemmed largely from losses in a unit that sold a complex kind of derivative, called a credit-default swap, designed to protect investors against default in an array of assets, including subprime mortgages.”).

And it both bailed out and seized the big secondary mortgage market makers Fannie Mae and Freddie Mac, placing both institutions under government receiverships while taking over their massive debt burdens.<sup>13</sup> The government also bailed out most of the other large players in the financial system even before figuring out whether they were solvent or not.<sup>14</sup> Those bailouts, of course, were unpopular and expensive propositions for the taxpayers,<sup>15</sup> which makes it all the more confusing that, as Federal Reserve Governor Daniel K. Tarullo has observed, the government in most cases (but not for Washington Mutual, Lehman Brothers, and Bear Stearns) “selected the bailout option” in lieu of bankruptcy or resolution.<sup>16</sup>

Legal constraints may have played a role in what the government did, not that the basis for its financial sector choices was ever entirely clear. The government might have suspected, for example, that the failure of Lehman Brothers could be catastrophic, but concluded that it was powerless to save the investment bank because Lehman was structured not as a “bank,” but as an institution that owned a bank and various other subsidiaries.<sup>17</sup> Such “holding companies” were not obviously covered by the government’s then extant

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<sup>13</sup> See Avni P. Patel, Recent Development, *Developments in Banking and Financial Law: 2008-2009—The Bailout of Fannie Mae and Freddie Mac*, 28 REV. BANKING & FIN. L. 21, 21–22 (2008); Carol J. Perry, Note, *Rethinking Fannie and Freddie’s New Insolvency Regime*, 109 COLUM. L. REV. 1752 (2009).

<sup>14</sup> See Edmund L. Andrews et al., *Fed in an \$85 Billion Rescue of an Insurer Near Failure*, N.Y. TIMES, Sept. 17, 2008, at A1.

<sup>15</sup> See Henry M. Paulson, Jr., Op-Ed., *Fighting the Financial Crisis, One Challenge at a Time*, N.Y. TIMES, Nov. 18, 2008, at A27.

<sup>16</sup> Daniel K. Tarullo, Governor, Fed. Reserve Sys., Address at the Institute of International Bankers Conference on Cross-Border Insolvency Issues (Nov. 10, 2009), available at <http://www.federalreserve.gov/newsevents/speech/tarullo20091110a.htm>.

<sup>17</sup> On September 15, 2008, Lehman Brothers filed a plenary Chapter 11 bankruptcy petition. Press Release, Lehman Bros. Holdings Inc., Lehman Brothers Holdings Inc. Announces It Intends to File Chapter 11 Bankruptcy Petition (Sept. 15, 2008), available at [http://www.lehman.com/press/pdf\\_2008/091508\\_lbhi\\_chapter11\\_announce.pdf](http://www.lehman.com/press/pdf_2008/091508_lbhi_chapter11_announce.pdf); see also Andrew Ross Sorkin, *Bids to Halt Financial Crisis Reshape Landscape of Wall St.*, N.Y. TIMES, Sept. 15, 2008, at A1. As a “truly global firm with over 7,000 legal entities in more than 40 countries,” Lehman’s insolvency “resulted in over 75 separate and distinct bankruptcy proceedings.” Press Release, Lehman Bros. Holdings Inc., Lehman Group of Companies Signs Cross-Border Insolvency Protocol (May 26, 2009), available at <http://documents.epiq11.com/ViewDocument.aspx?DocumentPk=400A7F75-7140-4BC3-990E-4B9733B51CF2>. The number of proceedings related to the number of legal entities under the Lehman umbrella, see *id.*, and the Lehman bankruptcy therefore did not operate under the auspice of Chapter 15, whereby a particular debtor would file a plenary proceeding in one jurisdiction and seek recognition from United States courts. See 11 U.S.C. §§ 1501–1532 (2006). Note that “[t]he drafters of the provisions seem to have contemplated that troubled brokerages [such as Lehman] would be liquidated in Chapter 7.” Skeel, *supra* note 12, at 4. Lehman, however, successfully filed under Chapter 11 by using a strategy similar to other brokerages in the past: “fil[ing] a Chapter 11 petition for its holding company, and ke[eping] its brokerage subsidiary out of bankruptcy until it had time to move all of the customer accounts.” *Id.*

resolution authority.<sup>18</sup> (However, this conclusion must have surprised the shareholders of quasi-resolved similar institutions like Bear Stearns, which was structured as a similar sort of holding company.)<sup>19</sup>

Without resolution, the government can always leave institutions like Lehman to bankruptcy, and indeed, it did exactly that. But bankruptcy can coincide with serious destabilization of the credit markets, as Lehman's insolvency did for its money market fund counterparties.<sup>20</sup> The results of the Lehman bankruptcy were ugly: as credit markets froze up, a money market fund holding Lehman debt "broke the buck" and then failed, leading to a panic in that market sector and general disappearance of commercial credit.<sup>21</sup> Lehman's failure also turned into a multinational mess, with parallel,

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<sup>18</sup> All of this is quite controversial as a matter of legal interpretation. See Joe Nocera & Edmund L. Andrews, *Running a Step Behind as a Crisis Raged*, N.Y. TIMES, Oct. 23, 2008, at A1 (presenting Treasury Secretary Henry Paulson's argument that "the Federal Reserve could bail out Lehman with a loan only if the bank had enough good assets to serve as collateral, which it did not"); David Zaring, *Richard Posner Has Some Questions*, THE CONGLOMERATE (July 30, 2009), <http://www.theconglomerate.org/2009/07/colleen-baker-points-me-to-richard-posners-a-list-of-questions-for-legal-academics-and-he-thinks-weve-been-remiss-about-answ.html>. It is unclear whether its limitations in this area are attributable to a statutory bar or the complexity of the task. As one senior Treasury official told *The New Yorker*: "It's one thing to [take over] a car company, which isn't relying on daily decisions by its counterparties . . . . With a financial institution, if there were a long period of uncertainty, customers, counterparties, creditors, and trading partners would flee, and the ultimate bill would be substantial." Ryan Lizza, *The Contrarian; Sheila Bair and the White House Financial Debate*, NEW YORKER, July 6, 2009, at 30, 34 (internal quotation marks omitted); see also Rachele Younglai & Kim Dixon, *Lehman's Fuld: Where Was Our Bailout?*, REUTERS, Oct. 6, 2008, available at <http://www.reuters.com/article/idUSTRE4954DL20081006> (noting that Fuld, the former head of Lehman Brothers, will wonder "[u]ntil the day they put [him] in the ground . . . why [Lehman was] the only one" not to get a bailout (internal quotation marks omitted)). The distinction has hurt regulators before. Indeed, Hal Scott has observed that BCCI was a problem because Luxemburg, its regulator, only had oversight power over the bank, but could do nothing about the holding company, to which the bank itself was trivial in comparison. HAL S. SCOTT, INTERNATIONAL FINANCE: TRANSACTIONS, POLICY, AND REGULATION 180–81 (16th ed. 2009).

<sup>19</sup> For the government's view of a possible distinction between Lehman Brothers and Bear Stearns at the time of its decision, see *Paulson Insists No Bailout for Lehman*, DIRECTORSHIP.COM (Sept. 12, 2008), <http://www.directorship.com/paulson-insists-no-bailout-for-lehman/> ("There are two things that make this different from Bear Stearns. The market's been aware of the situation for a long time and has had time to prepare. Second, the Primary Dealer Credit Facility was created by the Fed to allow time for an orderly process." (internal quotation marks omitted)).

<sup>20</sup> This argument is controversial. Some scholars argue that, employed consistently, bankruptcy is a desirable mechanism for culling the value from failing institutions in a cost-effective manner. See, e.g., Skeel, *supra* note 12.

<sup>21</sup> But see David A. Skeel, *The Lehman Myth in the Financial Crisis*, N.Y. TIMES DEALBOOK BLOG (Oct. 6, 2009, 2:00 PM), <http://dealbook.blogs.nytimes.com/2009/10/06/dealbook-dialogue-david-skeel-the-lehman-myth/> ("The claim that Lehman's default caused the chaos that came afterward is similarly dubious.").



competing bankruptcy proceedings in the United Kingdom and the United States.<sup>22</sup>

But the bailout option is just as unpalatable.<sup>23</sup> Apart from its political unpopularity, AIG initially cost the taxpayers more money than did the failure of any other company; indeed, it has cost the taxpayers more than the annual budgets of many beloved federal departments, such as the Departments of Veterans Affairs, Housing and Urban Development, and Justice, combined.<sup>24</sup> Fannie Mae and Freddie Mac together required a similar magnitude of commitment of government resources for their bailouts.<sup>25</sup>

Resolution authority is one way to disincentive the bailout, while avoiding bankruptcy. It could be fairer than picking winners through government assistance, especially if it gave the government the power to resolve the largest financial institutions.<sup>26</sup> After all, with the exception of Washington Mutual

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<sup>22</sup> Bankruptcies do not always go smoothly. David Skeel and Kenneth Ayotte have described the Lehman bankruptcy as promising in some ways and problematic in others. See Ayotte & Skeel, *supra* note 6, at 481, 482 (observing that “Lehman could hardly have been less prepared for Chapter 11,” but describing certain successes of the Lehman bankruptcy process including the fact that “faced with extreme time pressure, buyers materialized, and Lehman quickly sold its viable subsidiaries, allowing them to remain in business under different ownership”). Although the multinational nature of bankruptcies is often thought to be a problem, Ayotte and Skeel describe the European aspect of the Lehman bankruptcy as workable, stating simply that “[i]ts operations in Europe, the Middle East, and Asia were bought by Nomura, a large Japanese brokerage firm.” *Id.* at 481. Skeel thinks that many of the problems of bankruptcy arose because of the expectation of a bailout. He has suggested that Lehman’s bankruptcy was largely a problem because the rescue of Bear Stearns created expectations of a ubiquitous government safety net. See *Too Big to Fail—The Role for Bankruptcy and Antitrust Law in Financial Regulation Reform: Hearing Before the Subcomm. on Commercial & Admin. Law of the H. Comm. on the Judiciary*, 111th Cong. 4 (2009) (written testimony of David A. Skeel, Jr., Professor, University of Pennsylvania Law School) (“When Lehman filed for bankruptcy, no one even knew who Lehman owed money to and who the counterparties on its derivatives contracts were. AIG behaved in very similar fashion. These responses are perfectly understandable given both companies’ assumption—an assumption shared by nearly everyone as a result of the Bear Stearns bailout—that regulators would rescue any big, troubled financial institution.”).

<sup>23</sup> See Tarullo, *supra* note 16.

<sup>24</sup> Alice Gomstyn, *AIG Price Tag: \$1,400 Per Taxpayer Family*, ABC NEWS/MONEY (Mar. 2, 2009), <http://abcnews.go.com/Business/Economy/story?id=6990305&page=1>. The government made \$180 billion available to AIG. Sharona Coutts & Paul Kiel, *How Big Is AIG’s Bailout . . . Really?*, PROPUBLICA (July 7, 2009, 1:46 PM), <http://www.propublica.org/article/how-big-is-aigs-bailout-really-707>. Meanwhile, the budgets of the Departments of Housing and Urban Development, Justice, and Veterans Affairs totaled \$134.7 billion as of 2010. See OFFICE OF MGMT. & BUDGET, BUDGET OF THE U.S. GOVERNMENT 85, 95, 117 (2010) (HUD budget is \$48.5 billion, Justice budget is \$29.2 billion, and Veterans Affairs budget is \$57 billion).

<sup>25</sup> Lorraine Woellert & John Gittelsohn, *Fannie-Freddie Fix at \$160 Billion with \$1 Trillion Worst Case*, BLOOMBERG (June 13, 2010, 7:00 PM), <http://www.bloomberg.com/news/2010-06-13/fannie-freddie-fix-expands-to-160-billion-with-worst-case-at-1-trillion.html>.

<sup>26</sup> In bailouts, by contrast, creditors get their entire investment back, while the government bears the brunt of the failure. Consider, for instance, the government bailout of AIG. There, the equity holders went to

and arguably Lehman Brothers, during the last crisis, large banks got bailouts, but many smaller institutions were subjected to resolution (indeed the list of failed institutions is well into triple digits).<sup>27</sup>

Accordingly, developing the power to take large financial firms like Lehman Brothers or AIG through resolution without resorting to bankruptcy court is a cardinal goal of the Dodd-Frank Act's reform of financial regulation. The Dodd-Frank Act has sought to prevent the government from bailing out a failing institution.<sup>28</sup> And, perhaps most importantly, it has dramatically expanded resolution authority to cover the sorts of financial companies not clearly within the ranks of regulated banks.<sup>29</sup>

But where should this expansive resolution authority end? Should the ability to quickly nationalize and fail apply to financial intermediaries like hedge funds? One powerful international organization of banking regulators

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zero while creditors were paid out at—rather scandalously, in the view of many—100 cents on the dollar. *See* Serena Ng & Carrick Mollenkamp, *New York Fed Caved in to AIG Creditors*, WALL ST. J., Nov. 17, 2009, at C1.

<sup>27</sup> Eric Dash, *Small Banks Fail at Growing Rate, Straining F.D.I.C.*, N.Y. TIMES, Oct. 10, 2009, at A1.

<sup>28</sup> Although this Article will not discuss at length Congress's efforts to prevent the government from bailing out banks again, they are worth noting. For example, Congress has amended the Federal Reserve's ability to open its discount window to individual institutions, limiting such assistance to a "program or facility with broad-based eligibility." Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 716, 124 Stat. 1376 (2010) [hereinafter Dodd-Frank Act]. Section 214 of the Act prohibits the use of taxpayer funds for bailouts. *Id.* § 214. Further, Title XIII of the Act is titled the "Pay It Back Act" and requires the Treasury to return the bailout money granted to it under the TARP. *Id.* Rather hopefully, President Barack Obama has declared that "[b]ecause of this law, the American people will never again be asked to foot the bill for Wall Street's mistakes." Ross Colvin, *Obama Signs Sweeping Wall Street Overhaul into Law*, REUTERS (July 21, 2010), available at <http://www.reuters.com/article/idUSTRE66K1QR20100722>.

<sup>29</sup> The new rules on resolution authority comprise Title II of the Dodd-Frank Act. For examples of discussions of the push for more authority, see *Hearing Before the H. Fin. Servs. Comm.*, 111th Cong. (2009) (written testimony of Timothy F. Geithner, Secretary, United States Department of the Treasury), available at <http://www.ustreas.gov/press/releases/tg335.htm> ("We must build a system in which individual firms, no matter how large or important, can fail without risking catastrophic damage to the economy."); Albert Bozzo, *US Is Seeking Tougher Powers in Too-Big-to-Fail Legislation*, CNBC NEWS (Oct. 26, 2009, 12:43 PM), <http://www.cnbc.com/id/33314791>. It would be incorrect to characterize resolution authority as another example of regulation-by-deal, though sometimes it is consummated with a deal on the fly, as was the government's response to the financial crisis at times. *See* Davidoff & Zaring, *supra* note 11 and accompanying text. Dealmaking is private ordering, and there is nothing private about the authority invoked by the government to wrap up failed institutions. The FDIC has a preset program, is accustomed to dealing with failing institutions, and does not hire legal counsel to negotiate when it seizes a bank. *See* FED. DEPOSIT INS. CORP., RESOLUTIONS HANDBOOK (2003) [hereinafter FDIC HANDBOOK], available at <http://www.fdic.gov/bank/historical/reshandbook/index.html>. It relies on powers explicitly granted to it by statute. *See* 12 U.S.C. § 1822 (2006). So seizure is not private ordering; it is instead public ordering.

has concluded that it should.<sup>30</sup> Market participants like private equity funds? The European Union has proposed bringing private equity within the ambit of prudential financial supervision—an ambit that probably would include the power to seize and fail such institutions.<sup>31</sup> Should job-producing commercial companies, such as, say, auto manufacturers, be subject to resolution authority, lest the government be tempted into expensive bailouts of its national champions? The United States has a rich tradition of bailing out these sorts of manufacturers; more resolution authority, it is thought, could reduce the temptation to do so in the future.<sup>32</sup>

These examples illustrate the problems of resolution authority, including old problems of constitutional law and the propriety of agency action. The right way to broaden the government's ability to destroy through resolution would address resolution authority's legitimacy, both as a matter of policy and as a matter of legality. An even better solution would pair enhanced resolution authority with restrictions that promise to protect against its misuse.

This Article argues that a revised resolution authority with a scope limited to a list of publicly identified institutions would ensure that the government's power to destroy is not overly broad. Moreover, although Congress and administrative lawyers rarely turn to markets to solve governance problems, a market check would do a great deal of good in ensuring that resolution authority, once deployed, is deployed for good reason and on reasoned terms. Permitting buybacks of resolved institutions—or at least giving the owners of those institutions the chance to make public bids—would be a salutary check on overzealous resolution.

Better resolution authority, however, is not only a matter of potential government overreaching. The parlous history of the exercise of resolution authority during financial crises is also a case study of repeated government failures to act.<sup>33</sup> Banks not taken through the quick bankruptcy process

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<sup>30</sup> See *infra* notes 196–97 and accompanying text (recounting efforts of the Basel Committee to improve resolution authority in the aftermath of the recent financial crisis).

<sup>31</sup> Friederich K. Kübler, *European Initiatives for the Regulation of Nonbank Financial Institutions* 1–2 (Dec. 2, 2009) (unpublished manuscript) (on file with author) (summarizing EU action in this area).

<sup>32</sup> Phillip Longman, *Washington's Turnaround Artists*, WASH. MONTHLY, Mar.–Apr. 2009, at 14, 14–18; see also Joseph R. Mason & Daniel A. Schiffman, *Too Big to Fail, Government Bailouts, and Managerial Incentives: The Case of Reconstruction Finance Corporation Assistance to the Railroad Industry During the Great Depression*, in *TOO BIG TO FAIL: POLICIES AND PRACTICES IN GOVERNMENT BAILOUTS* 49 (Benton E. Gup ed., 2004).

<sup>33</sup> Robert Teitelman, *Transactions: March 8, 2010*, THE DEAL (Mar. 5, 2010, 1:27 PM), <http://www.thedeal.com/newsweekly/community/transactions/transactions:-march-8,-2010.php> (“Resolution authority

overseen by the Federal Deposit Insurance Corporation (FDIC) have required expensive bailouts, as with Continental Illinois in the early 1980s<sup>34</sup> and Fannie Mae, Freddie Mac, Citibank, and AIG during the recent financial crisis.<sup>35</sup>

Even worse, institutions that should be resolved but are not can become “zombie banks”—insolvent but taking risks, losing lending discipline, and piling up losses because the government is unwilling to close them. Japan’s “lost decade” of zero growth in the 1990s often has been attributed to the Japanese government’s failure to come to grips with the essential insolvency of its financial sector.<sup>36</sup> And the expense of resolution may also keep the government from exercising its power until matters are very bad. One World Bank study has estimated that the resolution costs of most banking crises since 1980 have amounted to more than 10% of the originating country’s GDP.<sup>37</sup> How can we ensure that the government will exercise its resolution authority when it ought to do so?

It is here that one of the most complicated problems of resolving a financial institution—the cross-border problem—might illuminate the way to proceed. The financial institutions that really matter—the ones with international exposure, of the sort that Lehman Brothers had during the recent financial crisis—create the prospect of incredibly complicated bankruptcies, involving multiple jurisdictions with little reason to cooperate when dividing the assets of a collapsed multinational.

Financial regulators have known since the 1970s that their big banks, if they fail, can create a dangerous chain of international dominoes.<sup>38</sup> They have

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resembles proactive bubble defense: The optimal time to use it is before the anticipated corpse turns blue. But if Paulson had shuttered Lehman right after Bear collapsed, would he be praised, pilloried or prosecuted like a dog?”).

<sup>34</sup> See *infra* note 54 and accompanying text.

<sup>35</sup> See *infra* note 88 and accompanying text.

<sup>36</sup> See HAL S. SCOTT, INTERNATIONAL FINANCE: TRANSACTIONS, POLICY, AND REGULATION 285–91 (15th ed. 2008) (describing causes of the Japanese financial crisis in the 1990s).

<sup>37</sup> The study arose out of the World Bank’s efforts to create a comprehensive financial crisis database. See Honohan & Klingebiel, *supra* note 7 (“By one count, 112 episodes of systemic banking crises occurred in 93 countries since the late 1970s and 51 borderline crises were recorded in 46 countries.”).

<sup>38</sup> On June 26, 1974, German regulators forced Bank Herstatt into liquidation, which left without remedy a number of banks that had released payment of German marks to Herstatt in Frankfurt in exchange for United States dollars that were to be delivered in New York. 3 JERRY W. MARKHAM, A FINANCIAL HISTORY OF THE UNITED STATES: FROM THE AGE OF DERIVATIVES INTO THE NEW MILLENNIUM 1970-2001, at 20 (2001). The British-Israel Bank, based in the United Kingdom, and the Franklin National Bank, based in the United States, also failed. See ETHAN B. KAPSTEIN, SUPERVISING INTERNATIONAL BANKS: ORIGINS AND IMPLICATIONS OF

accordingly, since that time, met in Basel, Switzerland, in an effort to coordinate approaches to the financial externalities that would otherwise spill across borders.<sup>39</sup>

And, in the aftermath of the financial crisis, it is with the so-called Basel Committee on Banking Supervision that some of the furthest reaching of the proposed financial reforms have appeared.<sup>40</sup> For example, the possibility of leverage caps for banks—rules that will make them smaller—have originated with the Basel Committee rather than any domestic regulator.<sup>41</sup> The Committee is insulated from some of the domestic pressures that have deterred regulators from pulling the resolution trigger. It is a place where national regulators meet and jawbone and act like experts, rather than like captured, chary regulators.<sup>42</sup> And it is an institution committed to developing an approach to cross-border insolvencies.

This Article posits that it is via this peer pressure that domestic regulators best can be encouraged to exercise their resolution authority.<sup>43</sup> It is only through the Basel process of peer review and insulation from domestic lobbying pressures<sup>44</sup> that United States regulators will be able to force themselves to do some of the difficult work of resolving financial institutions.

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THE BASLE ACCORD 4-5 (1991) (discussing the history surrounding the establishment of the Basel Committee).

<sup>39</sup> See David Zaring, *International Institutional Performance in Crisis*, 10 CHI. J. INT'L L. 475, 479-81 (2010) [hereinafter Zaring, *Crisis Performance*].

<sup>40</sup> However, the G-20 has also been a source of such proposals. See *id.* at 493-99.

<sup>41</sup> Though the Basel Committee did not cover itself in glory during the crisis, see David Zaring, *Three Challenges for Regulatory Networks*, 43 INT'L LAW. 211, 215-17 (2009) [hereinafter Zaring, *Three Challenges*], it has been the delegate of the G-20 for passing new tough rules on banks in the past. And even if it is not a perfect solution to the problems of global financial crises (and the point of this Article is not to suggest that it is), the Committee may be a place to coordinate the impetus to, in fact, exercise resolution authority over the particularly big international financial institutions. The Basel Committee, for example, has urged stronger leverage caps than the 15:1 ratio provided by the Dodd-Frank financial reforms. See *infra* note 221 and accompanying text for a discussion of the Basel Committee's ambitions.

<sup>42</sup> See *infra* note 221 and accompanying text.

<sup>43</sup> The United States has not always embraced the Basel Committee to the fullest extent; it has implemented the Committee's capital adequacy accords slowly, on occasion, and strong-armed the Committee in certain directions on others. See DAVID ANDREW SINGER, *REGULATING CAPITAL: SETTING STANDARDS FOR THE INTERNATIONAL FINANCIAL SYSTEM* 36-66 (2007). But the SEC, for example, used Basel II for its most sophisticated investment banks (albeit with disastrous results). For a review by the former SEC chair of the program, see Press Release, U.S. Sec. & Exch. Comm'n, Chairman Cox Announces End of Congressional Supervised Entities Program (Sept. 26, 2008), available at <http://www.sec.gov/news/press/2008/2008-230.htm>.

<sup>44</sup> David Zaring, *Informal Procedure, Hard and Soft, in International Administration*, 5 CHI. J. INT'L L. 547, 555-60 (2005).

It is by no means a panacea to turn to informal, relatively unregulated international organizations to discipline domestic regulators to exercise their strongest powers.<sup>45</sup> But its real world advantages probably mean that this international approach is the source of the most likely solutions to the problems involved with getting any domestic government to exercise the powers that it actually possesses, and then using insulation to free up the expertise that has always been, at bottom, the justification for administrative agencies.

In what follows, this Article first provides an overview of existing resolution authority and considers some proposals to broaden this authority in the wake of the financial crisis. It then considers the legal impediments to such a broadening. Finally, it offers a solution that might ensure that resolution authority, when deployed, is deployed usefully.

## I. THE CURRENT LACK OF RESOLUTION

### A. *Existing Resolution Authority and the Financial Crisis*

This section of the Article surveys the history and law of resolution authority. The goals are to show how the government's seizure powers have evolved over time, what they look like today, and how the Dodd-Frank Act will change them. This section also surveys the way the government actually exercises its takeover authority, with a focus on the recent financial crisis. As this Article demonstrates, and as the recent financial crisis exemplifies, the FDIC, the agency responsible for taking over banks, acts procyclically. That is, the worse the economic conditions, the more banks it fails. Although that may be an inevitable fact, it has nonetheless been bemoaned by economists hoping for a more countercyclical regulatory approach that might smooth out disruptions to the financial system caused by hard times and failing counterparties.<sup>46</sup> Moreover, the early warning system put into place after the last big domestic financial crisis (known as "prompt corrective action" or "PCA" authority) was designed to cajole regulators into closing banks quickly and more countercyclically, and to "place foam on the runway" to make

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<sup>45</sup> David Zaring, *International Law by Other Means: The Twilight Existence of International Financial Regulatory Organizations*, 33 TEX. INT'L L.J. 281 (1998) [hereinafter Zaring, *International Law*].

<sup>46</sup> For a review of the issues and concerns, see Mariya Deryugina, *Shaping Global Financial Reform: A Symposium for Private and Public Sector Leaders*, 28 REV. BANKING & FIN. L. 683 (2009); Daniel Indiviglio, *The Senate Plan's Resolution Authority*, THE ATLANTIC (Nov. 11, 2009, 10:50 AM), <http://www.theatlantic.com/business/archive/2009/11/the-senate-plans-resolution-authority/29972/>.

resolution easier to do. Yet this system has not been used. Indeed, the FDIC issued prompt corrective action orders in only 19% of the cases in which it ultimately failed banks during 2009, the year that marks the apogee of the recent crisis.

### *1. A Brief History of Resolution Authority*

This subsection of the Article briefly tours some of the government's rescues and seizures of financial institutions before the most recent financial crisis. It pairs past resolutions and bailouts with the statutory authority—designed to limit the prospect of future crises—given to the government in their aftermath.<sup>47</sup>

Today, resolution authority is managed by the FDIC.<sup>48</sup> But the government power that it represents stretches back much further; the seizure of property by federal marshals, for example, or the appointment of bankruptcy trustees, dates back to the nineteenth century.<sup>49</sup>

Apart from its longstanding ability to disempower creditors through the complex process of bankruptcy, Congress has in the past used insolvency to adjust the relationship between creditors and debtors in other ways. During the Great Depression, it uniformly modified farm mortgages—a controversial interference with the contractual rights of creditors, but one ultimately upheld

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<sup>47</sup> The FDIC received its resolution authority through the Federal Deposit Insurance Act (FDIA). 12 U.S.C. § 1819 (2006). This authority was expanded in the FDIA's amendments, passed after the S&L crisis, known as the Federal Deposit Insurance Corporation Improvement Act (FDICIA) of 1991. 12 U.S.C. § 1824 (2006). However, that authority is not the only basis on which the government either has exercised its power to destroy, or elected to save, businesses. S&Ls are organizations that accept savings deposits and make personal loans to their members. A combination of lax regulation, poor oversight, rising interest rates, risky decisionmaking, and declining commercial real estate values caused more than 700 S&Ls to fail in the 1980s and 1990s, as is discussed in a bit more detail later in this Article. 1 FED. DEPOSIT INS. CORP., DIV. OF RESEARCH & STATISTICS, HISTORY OF THE 80S: LESSONS FOR THE FUTURE 167–88 (1997). The costs of the collapse were massive: \$160 billion with \$124 billion coming from federal taxpayers. Timothy Curry & Lynn Shibut, *The Cost of the Savings and Loan Crisis: Truth and Consequences*, 13 FDIC BANKING REV. 26, 33 (2000).

<sup>48</sup> See Federal Deposit Insurance Act, 12 U.S.C. § 1811 (2006); Federal Deposit Insurance Corporation Improvement Act of 1991, 12 U.S.C. § 1824 (2006).

<sup>49</sup> Though the government's bankruptcy power is subject to the Takings Clause, this rarely creates a practical limitation. See generally James Steven Rogers, *The Impairment of Secured Creditors' Rights in Reorganization: A Study of the Relationship Between the Fifth Amendment and the Bankruptcy Clause*, 96 HARV. L. REV. 973 (1983) (discussing reasons why the Takings Clause has little real effect on the government's bankruptcy power).

by the post-*Lochner* Supreme Court.<sup>50</sup> And Congress occasionally has bailed out individual debtors through legislation, making good on its obligations with taxpayer funds. This action also has been upheld as constitutional, even when accompanied with resolution, bankruptcy, and other pain for the creditors and owners of the debtor.<sup>51</sup> In addition to reorganizing (and partly nationalizing) the nation's rail companies, the government became involved in the aircraft business when it rescued Lockheed in 1971 with a \$250 million loan.<sup>52</sup> It has bailed out Chrysler twice, first at a cost of \$1.5 billion in 1980 and second at a cost of \$1.6 billion in 2009.<sup>53</sup> There is no question, then, that the power to intervene through resolution, bailout, or bankruptcy, in a variety of ways and as a basic matter, has been understood as within the government's legal powers.

But the government most often rescues or resolves banks through the FDIC, which is the current resolver of last resort. This process has evolved into a seizure with little process or recourse. A well-known example is Continental Illinois, which was the seventh-largest bank in the United States when it was both bailed out and wound up at a cost of \$1.8 billion, with serious consequences to the shareholders and employees of the institution.<sup>54</sup>

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<sup>50</sup> See *Wright v. Vinton Branch of Mountain Trust Bank of Roanoke*, 300 U.S. 440, 470 (1937) (holding that the Frazier-Lemke Farm Mortgage Moratorium Act did not unreasonably modify mortgagees' rights and was thus valid). The first version of this statute, however, was held to be unconstitutional. See *Louisville Joint Stock Land Bank v. Radford*, 295 U.S. 555, 602 (1935).

<sup>51</sup> See *Reg'l Rail Reorganization Act Cases*, 419 U.S. 102 (1974).

<sup>52</sup> BARRY RITHOLTZ, *BAILOUT NATION: HOW GREED AND EASY MONEY CORRUPTED WALL STREET AND SHOOK THE WORLD ECONOMY* 11 (2009).

<sup>53</sup> *Id.* For a discussion of the second Chrysler bailout, see Martin Crutsinger, *US Set to Lose \$1.6b on Loan to Chrysler*, *Treasury Reports*, BOS. GLOBE, May 18, 2010, at B8.

<sup>54</sup> See Fed. Deposit Ins. Corp., *Continental Illinois and "Too Big to Fail,"* in 1 HISTORY OF THE EIGHTIES—LESSONS FOR THE FUTURE: AN EXAMINATION OF THE BANKING CRISES OF THE 1980S AND EARLY 1990S, at 235, 244 (1997) ("[T]hree bank regulatory agencies decided to provide a \$2 billion assistance package to Continental: the FDIC provided \$1.5 billion, and participated [sic] an additional \$500 million to a group of commercial banks. The capital infusion was in the form of interest-bearing subordinated notes at a variable rate 100 basis points higher than that on one-year Treasury bills. The Federal Reserve stated that it would meet any liquidity needs Continental might have, and a group of 24 major United States banks agreed to provide more than \$5.3 billion in funding on an unsecured basis while a permanent solution was sought. In what was perhaps the most controversial move by the regulators, the FDIC promised to protect all of Continental's depositors and other general creditors, regardless of the \$100,000 limit on deposit insurance. The assistance package was to remain in place while the regulators searched for a permanent solution to Continental's problems.").



Resolution authority was first given to the FDIC through the Federal Deposit Insurance Act (FDIA).<sup>55</sup> This authority was enhanced after the FDIC's failure to make active use of that authority during the last great financial housing crisis—the S&L crisis of the 1980s. The blame for this crisis has been assigned to macroeconomic factors (rising interest rates at the end of the 1970s devastated the balance sheets of thrifts locked into long-term, low-yield mortgages, often with fixed interest rates)<sup>56</sup> and the culture of risky, even fraudulent, behavior on the part of the thrifts themselves.<sup>57</sup> Regulators also failed to curtail this behavior through their ordinary supervision. The result was an extraordinarily widespread failure rate across the thrift sector.

In response to the crisis, Congress enacted the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), which created the Resolution Trust Corporation (RTC) to

clean up the savings and loan industry by restoring its health and preventing the depletion of its deposit insurance fund. In order to fulfill its duty of restoring liquidity to thrift associations, the RTC takes over insolvent S&Ls, sells their assets, and distributes the proceeds of the sales to the shareholders. The RTC's primary goal is to achieve the most cost-effective resolution of the S&L crisis for the taxpayers.<sup>58</sup>

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<sup>55</sup> 12 U.S.C. § 1811 (2006). Agency predecessors of the FDIC—including the Home Owners' Loan Corporation (HOLC) and the Federal Asset Disposition Association (FADA)—had similar resolution capabilities, and state financial regulators long exercised resolution authority over state banks that failed within their jurisdictions. Bert Ely, *The Resolution Trust Corporation in Historical Perspective*, 1 HOUSING POL'Y DEBATE 53 (1990).

<sup>56</sup> Marjorie I. Stein, Student Work, *Developments in Banking Law: 1993—VI: Resolution Trust Corporation*, 13 ANN. REV. BANKING L. 57, 57–58 (1994).

<sup>57</sup> The Federal Home Loan Bank Board—today's Office of Thrift Supervision (OTS)—referred 11,000 cases to the DOJ in 1987 and 1988. See KITTY CALAVITA ET AL., BIG MONEY CRIME: FRAUD AND POLITICS IN THE SAVINGS AND LOAN CRISIS 27–28 (1997). By 1992, there had been 1,000 convictions and a reported conviction rate of 91%. The U.S. Government Accountability Office concluded that, of the 26 largest thrift failures, 60% had been marred by “serious criminal activity.” The Resolution Trust Corporation (RTC) said criminal fraud was a significant contributor to the failure of 33% of its institutions. *Id.*

<sup>58</sup> Stein, *supra* note 56, at 59. For additional background on the founding and purpose of the RTC, see Lee Davidson, *Politics and Policy: The Creation of the Resolution Trust Corporation*, 17 FDIC BANKING REV. 17 (2005) (offering a detailed discussion of the RTC's founding and extensive background on its legislative history, as well as information about its structure and oversight); Daniel B. Gail & Joseph J. Norton, *The Financial Institutions Reform, Recovery and Enforcement Act of 1989: Dealing with the Regulators*, 107 BANKING L.J. 196 (1990) (summarizing the Financial Institutions Reform, Recovery, and Enforcement Act of 1989); Wayne M. Josel, Note, *The Resolution Trust Corporation: Waste Management and the S&L Crisis*, 59 FORDHAM L. REV. 339 (1991) (providing a general discussion of the RTC with focus on its ability to override state banking laws).

Between 1989 and 1995,<sup>59</sup> the RTC took over insolvent thrifts and resolved them slowly, funding its operations through a major grant of bailout money by Congress and whatever assets it could take advantage of in the failed thrifts themselves. The scale of the RTC's actions was breathtaking. From 1986 to 1995, 1,043 thrifts failed, to the tune of over \$500 billion.<sup>60</sup> Taxpayers paid \$124 billion to insured depositors; the thrift industry put in another \$29 billion or so.<sup>61</sup>

To resolve the failed thrifts, the RTC used three methods: (1) liquidating assets and reimbursing depositors; (2) merging, consolidating, or reorganizing the insolvent thrift into an existing thrift; and (3) dismantling the thrift by selling deposits to other S&Ls or banks.<sup>62</sup> The problem faced by the RTC—and all would-be resolvers—was that it was instructed to balance speed and the maximization of value, on the one hand, and to resolve the S&L crisis quickly, on the other. Such rapid resolution was often at odds with the maximization of the value of the failed thrifts, which counseled for a degree of forbearance and for a holding of the thrifts' assets until the crisis blew over. Its ability to balance the threat of getting fire-sale prices for the S&L assets against the risk that a failed institution would never sell made the RTC a generally praised financial regulator—but it engaged in mop-up effectiveness, rather than crisis-prevention effectiveness.<sup>63</sup>

Moreover, the dealings of the RTC and federal regulators with financial groups during the S&L crisis included resolutions that led to constitutional litigation, though ultimately upheld by the courts.<sup>64</sup> These resolutions foreshadowed the problems with financial conglomerates that have made reform of the resolution system such a high priority.

In the wake of the S&L crisis, Congress passed a statute designed to ensure that regulators, and especially the FDIC, would not again exercise regulatory forbearance while insolvent institutions pursued risky lending strategies. Congress designed the Federal Deposit Insurance Corporation Improvement

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<sup>59</sup> Lisa L. Bonner, Student Work, *Developments in Banking Law: 1995—VII: Updating FDICIA/RTC*, 15 ANN. REV. BANKING L. 81, 81 (1996) (“The RTC went out of business on December 31, 1995.”).

<sup>60</sup> Timothy Curry & Lynn Shibus, *The Cost of the Savings and Loan Crisis: Truth and Consequences*, 13 FDIC BANKING REV. 26, 26 (2000).

<sup>61</sup> *Id.* at 33.

<sup>62</sup> Stein, *supra* note 56, at 67–68.

<sup>63</sup> *Id.*

<sup>64</sup> See, e.g., Christopher T. Curtis, *The Takings Clause and Regulatory Takeovers of Banks and Thrifts*, 27 HARV. J. ON LEGIS. 367, 385–89 (1990) (describing the takeovers of First Republic and MCorp).

Act (FDICIA) to “capitalize and protect the bank insurance funds, reform the deposit insurance system, and improve supervision of federally insured depository institutions, including foreign banks.”<sup>65</sup> The centerpiece of improved supervision was to be PCA—to force government action *before* resolution.<sup>66</sup> However, this new authority reached only banks, thrifts, and to some degree, their holding companies, which could be relied on as “sources of strength” for the tottering bank or thrift.<sup>67</sup>

The action-forcing aspects of the FDICIA require the FDIC to regularly review each institution governed by its deposit insurance and assess the adequacy of the institution’s capitalization on a scale ranging from well capitalized to critically undercapitalized.<sup>68</sup> The Act also requires regulators to follow a variety of specified procedures whenever institutions fall below the well-capitalized threshold: for instance, placing limitations on the sorts of deposits they can accept, requiring the development of a capital restoration plan, insisting that the institution raise more capital, requiring divestitures, and changing the board. Institutions that remain critically undercapitalized for ninety days must be placed into receivership or conservatorship.<sup>69</sup> In this sense, PCA is meant to prepare both the board of the bank and the regulator for resolution. Other requirements imposed on the agency were designed to force the FDIC to resolve economically. Although difficult to enforce, §1823 of the FDICIA requires the FDIC to use the least costly methods possible in resolving failing financial institutions and prohibited the agency from overinsuring depositors.<sup>70</sup>

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<sup>65</sup> Stephen K. Huber, *The Federal Deposit Insurance Corporation Improvement Act of 1991*, 109 BANKING L.J. 300, 300 (1992).

<sup>66</sup> The FDICIA gave the FDIC new PCA powers that were as much designed to require the FDIC to act as to expand the role of the agency. See, e.g., Frederic S. Mishkin, *Evaluating FDICIA*, in 9 FDICIA: BANK REFORM FIVE YEARS LATER AND FIVE YEARS AHEAD 23 (George Kaufman ed., 1997) (“Among the most important features of FDICIA is its prompt corrective action provisions, which require the FDIC to intervene earlier and more vigorously when a bank gets into trouble.”).

<sup>67</sup> This is a well-known provision of the federal Bank Holding Company Act, 12 U.S.C. §§ 1841–1850 (2006). See Policy Statement on the Responsibility of Bank Holding Companies to Act as Sources of Strength to Their Subsidiary Banks, 52 Fed. Reg. 15,707 (Apr. 30, 1987). FDICIA’s adoption, however, did not mean that all holding companies would always be dunned. See generally *Wachtel v. OTS*, 982 F.2d 581 (D.C. Cir. 1993) (ruling that the government must prove reckless disregard of legal obligations or unjust enrichment to require a holding company to pay for losses incurred by a savings bank subsidiary). The resolution authority granted by the FDICIA did not reach shadow banks and non-banks—even systemically significant ones like investment banks and insurance companies. And if the holding company itself is insolvent, it obviously cannot serve as a source of strength and cannot be resolved under the FDIC’s ordinary statutory powers.

<sup>68</sup> See Huber, *supra* note 65.

<sup>69</sup> 12 U.S.C. § 1831o (2006).

<sup>70</sup> 12 U.S.C. § 1823(c)(4) (2006).

When it exercises its authority under the Act, the FDIC takes over a failing bank as either a conservator or a receiver.<sup>71</sup> A receiver simply winds up the bank. It acts no differently than would a bankruptcy court liquidating the assets of a failed firm, though it does so with some expertise about the implications of failure for both individual banks and the financial system as a whole. The difference from bankruptcy, from the FDIC's perspective, is that once the failed company is liquidated, it may use its insurance funds to pay the deposit-insurance-covered creditors of the failed institution.

A conservator, on the other hand, either continues to manage the bank until the bank is sold to a solvent institution, or creates a federally chartered bridge financial company to hold some or all of its assets until such time as net asset value is maximized.<sup>72</sup> The bridge financial company is a technical innovation, but one that the agency views as critical to the success of its resolution program.<sup>73</sup> Its purpose is straightforward: it is a vehicle designed to buy the FDIC time before it is forced to dispose of an insolvent institution's assets at a particularly low price.<sup>74</sup>

Conservators that wind up the debts of the seized bank need not heed *ipso facto* clauses in contracts (which are accelerated if the institution ever goes bankrupt), can make the government a supercreditor, can disaffirm "burdensome contracts" (but must pay compensation), and may generally provide what might be called unequal treatment. That is, the conservator can treat different creditors differently if that is deemed best for the failing company.<sup>75</sup> The FDIC can also provide financial assistance to these

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<sup>71</sup> 12 U.S.C. § 1821(c) (2006).

<sup>72</sup> The new rules limit the receivership to three years, with the possibility of obtaining two more upon a showing of necessity, as defined by the statute. See Stuart Stock et al., *Dodd-Frank Act: Systemic Risk Regulation and Orderly Liquidation of Systemically Important Firms*, COVINGTON & BURLING LLP 6 (July 21, 2009), <http://www.cov.com/> (follow "Publications" hyperlink; then follow "Covington E-Alert & Advisory" hyperlink; then follow "Dodd-Frank Act: Systemic Risk Regulation and Orderly Liquidation of Systemically Important Firms" hyperlink).

<sup>73</sup> Bridge financial companies are an interesting legal development in their own right—the federal government charters few corporations outside of the financial sector, and even then, it does not handle some of the basics of the corporate form. Bridge companies are created without many formalities. Christopher Stoakes, *Marrying Venture Capital and High Yield*, EUROMONEY, July 1998, at 28.

<sup>74</sup> *Id.*

<sup>75</sup> See 18 U.S.C. § 1821(d) (2006); Seth Grosshandler, *Securities, Forward and Commodity Contracts and Repurchase, Swap and Master Netting Agreements Under U.S. Insolvency Laws*, in *ADVANCED SWAPS AND OTHER DERIVATIVES 2009*, at 181, 241 (PLI Corp. L. & Prac., Course Handbook Ser. No. 11839) (detailing a "Conservator's . . . Right to Disaffirm or Repudiate Contracts"). This is not the case for special-treatment contracts. Qualified financial contracts include securities contracts, commodities contracts, forward contracts, repurchase agreements, swap agreements, and master agreements for any of the foregoing. Mark

institutions through the conservatorship, a loan, or almost any other mechanism.<sup>76</sup> In these cases there is little room for judicial review, except for some protest by the seized bank and its managers and owners.<sup>77</sup> That review is handled on a fast track, and it has found little success.<sup>78</sup>

To handle its resolutions, the FDIC has created a Division of Resolutions and Receiverships; its *raison d'être* is closing and selling banks and thrifts.<sup>79</sup> Since 1980, approximately half of the over 3,000 occasions on which the FDIC has offered some form of assistance to a failing bank or thrift have been purchase-and-assumption arrangements, in which an acquiring bank purchases the assets of an insolvent bank and assumes its obligations.<sup>80</sup> In only about 250 of these cases has the FDIC simply closed the bank and paid the insured depositors the value of their deposits. Bank failures, in sum, are a matter of

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Roe thinks that conferring superpriority on derivatives and swaps “warp[s] the financial industry’s incentives to avoid problems.” Mark Roe, *End Bankruptcy Priority for Derivatives, Repos and Swaps*, FT.COM (Dec. 15, 2009, 11:44 PM), <http://www.ft.com/cms/s/0/16da702e-ea41-11de-aeb6-00144feab49a.html>.

<sup>76</sup> See 12 U.S.C. § 1823(c) (2006).

<sup>77</sup> See *id.* § 1821(j).

<sup>78</sup> See *id.* § 1821(c)(7).

<sup>79</sup> See *Resolutions and Receivership Specialist Intern Program*, FED. DEPOSIT INS. CORP., <http://www.fdic.gov/about/jobs/drr/drrintern.html> (last visited Aug. 28, 2010) (“Within FDIC, the Division of Resolutions & Receiverships (DRR) is charged with resolving failing and failed financial institutions, which includes, among other important responsibilities, ensuring depositors’ have prompt access to their insured funds.”).

<sup>80</sup> The following chart summarizes the types of assistance offered by the FDIC:

| Transaction Type | Description of Transaction Type                                                                                                                                                                                                                                                                                                      | Frequency of Use |
|------------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|------------------|
| A/A              | Assistance Transactions.                                                                                                                                                                                                                                                                                                             | 588              |
| REP              | Reprivatization; management takeover with or without assistance at takeover, followed by a sale with or without additional assistance.                                                                                                                                                                                               | 3                |
| P&A              | Some or all of the deposits, certain other liabilities, and a portion of the assets (sometimes all of the assets) were sold to an acquirer. It was not determined if all of the deposits were assumed (PA) or only the insured deposits were assumed (PI).                                                                           | 178              |
| PA               | Purchase and Assumption, where the insured and uninsured deposits, certain other liabilities, and a portion of the assets were sold to an acquirer.                                                                                                                                                                                  | 1673             |
| PI               | Purchase and Assumption of the insured deposits only, where the traditional P&A was modified so that only the insured deposits were assumed by the acquiring institution.                                                                                                                                                            | 143              |
| IDT              | Insured Deposit Transfer, where the acquiring institution served as a paying agent for the insurer, established accounts on their books for depositors, and often acquired some assets as well. Includes asset-backed transfer, a Federal Savings and Loan Insurance Corporation (FSLIC) transaction that is very similar to an IDT. | 403              |
| MGR              | An institution where FSLIC took over management and generally provided financial assistance. FSLIC closed down before the institution was sold.                                                                                                                                                                                      | 37               |
| PO               | Payout, where the insurer paid the depositors directly and placed the assets in a liquidating receivership.                                                                                                                                                                                                                          | 264              |
| Total:           |                                                                                                                                                                                                                                                                                                                                      | 3289             |

*Federal Deposit Insurance Corporation Failures and Assistance Transactions*, FED. DEPOSIT INS. CORP., <http://www2.fdic.gov/hsob/HSOBSummaryRpt.asp?BegYear=2010&EndYear=1980&State=1> (last visited Sept. 10, 2010); *H SOB Help*, FED. DEPOSIT INS. CORP., <http://www2.fdic.gov/hsob/Help.asp?EntryTyp=60> (last visited Sept. 10, 2010).

mergers and acquisitions substantially more than they are simply a matter of insurance claims adjustment.<sup>81</sup>

## 2. *Resolution Authority and the Financial Crisis*

The government has always followed a boom and bust, rather procyclical approach to bank failures, despite the best efforts of Congress to encourage the contrary. Its response to the recent financial crisis has been no exception. That is, it has tended to fail institutions when times are bad, such as during the S&L crisis of the 1980s and during the recent financial crisis, but not when they are good. As Table 1 illustrates, the FDIC's resolution authority bureau all but closed up shop between 1995 and 2005, in two of those years failing no institutions at all, and over that decade failing fewer than it did in the year 1993 alone. The slow times have changed since 2007. Although most often evoked to deal with small banks—which were failing at a rate of about one to nine per week during the height of the recent financial crisis<sup>82</sup>—the current FDIC authority has worked when applied to large institutions like Washington Mutual, which would have been the largest financial institution failure ever, were it not for the collapses of AIG and Lehman Brothers.<sup>83</sup>

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<sup>81</sup> The recent financial crisis has tested the FDIC's capacity for damage control. In one case, the FDIC was forced to create a thirty-day bridge bank when it could not find a buyer. Jake Bernstein, *The 30-Day Bank*, PROPUBLICA (Apr. 14, 2009, 4:04 PM), <http://www.propublica.org/article/the-30-day-bank-414>. In another case, it simply mailed checks to depositors in the amount of their insured funds. Paul Kiel, *Bank Failure Friday: 7 Banks Go Down, 3 with No Buyer*, PROPUBLICA (Dec. 19, 2009, 2:12 PM), <http://www.propublica.org/ion/bailout/item/bank-failure-friday-7-banks-go-down-3-with-no-buyer-1219>.

<sup>82</sup> See *Failed Bank List*, FED. DEPOSIT INS. CORP., <http://www.fdic.gov/bank/individual/failed/banklist.html> (last visited Aug. 28, 2010).

<sup>83</sup> Yalman Onaran & Christopher Scinta, *Lehman Files Biggest Bankruptcy After Suitors Balk (Update 1)*, BLOOMBERG, Sept. 15, 2008, <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=a6cDDYU5QYyw>; Robin Sidel et al., *WaMu Is Seized, Sold Off to J.P. Morgan, in Largest Failure in U.S. Banking History*, WALL ST. J., Sept. 26, 2008, at A1.

Table 1: FDIC Failures and Assistance Transactions Over Last Thirty Years<sup>84</sup>

| Year | Institutions | Failures | Assistance |
|------|--------------|----------|------------|
| 2010 | 118          | 118      | 0          |
| 2009 | 148          | 140      | 8          |
| 2008 | 30           | 25       | 5          |
| 2007 | 3            | 3        | 0          |
| 2006 | 0            | 0        | 0          |
| 2005 | 0            | 0        | 0          |
| 2004 | 4            | 4        | 0          |
| 2003 | 3            | 3        | 0          |
| 2002 | 11           | 11       | 0          |
| 2001 | 4            | 4        | 0          |
| 2000 | 7            | 7        | 0          |
| 1999 | 8            | 8        | 0          |
| 1998 | 3            | 3        | 0          |
| 1997 | 1            | 1        | 0          |
| 1996 | 6            | 6        | 0          |
| 1995 | 8            | 8        | 0          |
| 1994 | 15           | 15       | 0          |
| 1993 | 50           | 50       | 0          |
| 1992 | 181          | 179      | 2          |
| 1991 | 271          | 268      | 3          |
| 1990 | 382          | 381      | 1          |
| 1989 | 534          | 531      | 3          |
| 1988 | 470          | 232      | 238        |
| 1987 | 262          | 217      | 45         |
| 1986 | 204          | 162      | 42         |
| 1985 | 180          | 139      | 41         |
| 1984 | 106          | 83       | 23         |
| 1983 | 99           | 50       | 49         |
| 1982 | 119          | 34       | 85         |
| 1981 | 40           | 9        | 31         |
| 1980 | 22           | 10       | 12         |

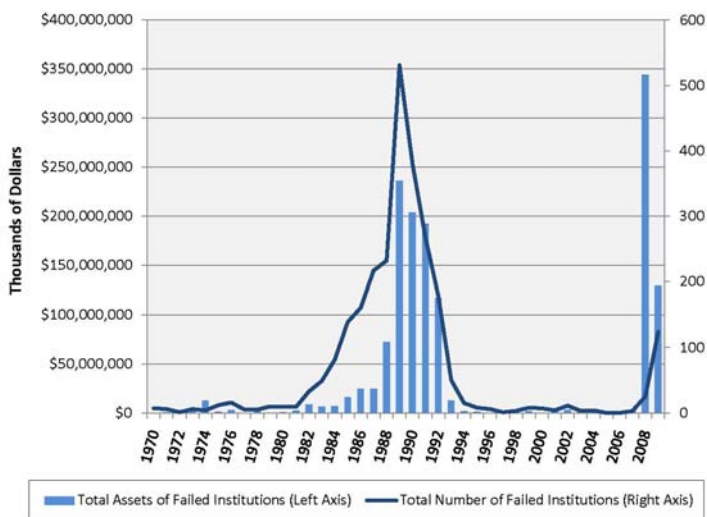
As Table 1 indicates, and as Figure 1, which covers a roughly contemporaneous period, also suggests, the FDIC fails institutions almost

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<sup>84</sup> *H SOB Bank & Thrift Failures—Summary Report*, FED. DEPOSIT INS. CORP., <http://www2.fdic.gov/hsob/HSOBSummaryRpt.asp?BegYear=2010&EndYear=1980&State=1> (last visited Sept. 10, 2010).

exclusively when times are bad for the banking system. The S&L crisis of the 1980s and the recent crisis account for most of these failures.

Figure 1: Bank Failures 1970 to November 30, 2009 (in 2005 Dollars)<sup>85</sup>

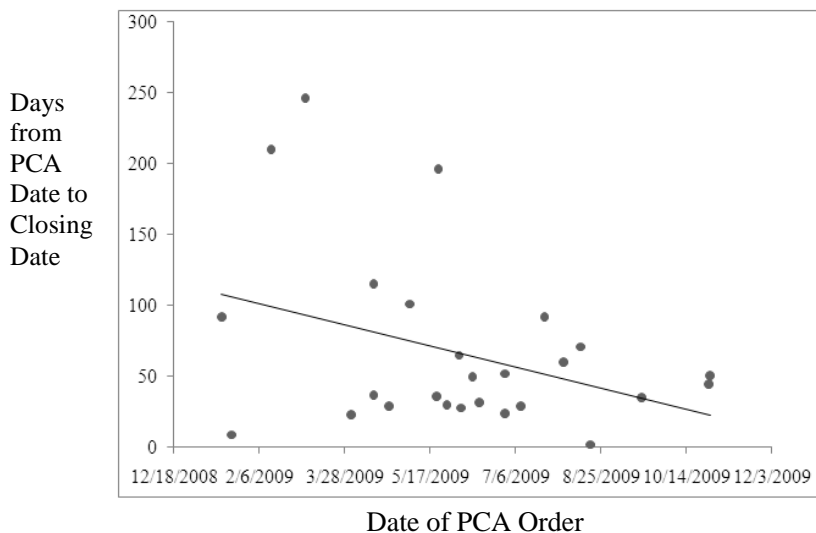


Neither the FDICIA nor PCA has mitigated this procyclical story. Indeed, during 2009, in the depths of the crisis, the agency never subjected most of the institutions that it failed to PCA orders. In fact, only 27 out of 140, or about 19%, of the failed banks received them. Twenty-one of these institutions were closed without any prior notice by the agency. As Figure 2 demonstrates, while the FDIC took an average of 66.37 days to notify those institutions that they were in trouble through the PCA discipline, the number of days between a PCA order and closure declined over the course of the year.

<sup>85</sup> Figure 1 comes courtesy of the Congressional Oversight Panel. See CONG. OVERSIGHT PANEL, DECEMBER OVERSIGHT REPORT: TAKING STOCK: WHAT HAS THE TROUBLED ASSET RELIEF FUND ACHIEVED 45 (2009).



Figure 2: The Decline in PCA Notice During the 2009 Crisis<sup>86</sup>



The import of this record is clear enough: the FDIC did not use its PCA authority frequently and, as the crisis deepened, increasingly elected to shrink the time between PCA notice and seizure.

This record, which reveals that the government resolves less than Congress hoped it would and, perhaps, too much during crises, poses some questions. Does expanded resolution authority do any good?<sup>87</sup> When the government did clearly have resolution authority—most notably in its supervision of Fannie Mae and Freddie Mac—the process was unable to forestall cataclysm.<sup>88</sup> For other resolvable banks, the FDIC has tended to act harshly when banks are at their most vulnerable—an unsurprising fact, but one totally at odds with what Congress and commentators have urged the agency to do.

<sup>86</sup> The source of the data used to generate Figure 2 comes from ProPublica's failed bank database. See *Failed Bank List*, PROPUBLICA, <http://projects.propublica.org/tables/failed-banks/> (last visited Aug. 28, 2010).

<sup>87</sup> This question was considered in a short editorial by the author. See David Zaring, *Why Congress Should Not Fix 'Too Big to Fail,'* WASH. POST (Apr. 23, 2009, 6:06 AM), [http://voices.washingtonpost.com/hearing/2009/04/should\\_congress\\_fix\\_too\\_big\\_to.html](http://voices.washingtonpost.com/hearing/2009/04/should_congress_fix_too_big_to.html).

<sup>88</sup> See Louise Story, *New Aid for Fannie and Freddie*, N.Y. TIMES, Dec. 25, 2009, at B4 (summarizing briefly the post-crisis experience of Fannie Mae and Freddie Mac); Chris Isidore, *Fannie & Freddie: The Most Expensive Bailout*, CNNMONEY.COM (July 27, 2009, 1:48 PM), [http://money.cnn.com/2009/07/22/news/companies/fannie\\_freddie\\_bailout/index.htm](http://money.cnn.com/2009/07/22/news/companies/fannie_freddie_bailout/index.htm).

### B. *The Dodd-Frank Approach*

One way to deal with the problem of resolving financial conglomerates is to broaden the reach of such authority, while simultaneously making a seizure harder to authorize—for instance, by requiring a number of different officials to sign off before it could be exercised. A broader authority would allow the government to take over the types of conglomerates it failed to resolve during the recent financial crisis, while the requirements of consultation would check against the rash use of that authority. These sorts of changes appeared in the Executive Branch’s proposals for financial reform shortly after the crisis began, and they made their way into the final legislation.<sup>89</sup> To check overhasty decisions to resolve, the Dodd-Frank Act adds a sign-off from a court in addition to internal Executive Branch consultation.<sup>90</sup> Such proposals do not reduce the risk of government overreach or underreach enough, as it is unlikely that various political appointees in the same branch of government, appointed by the same party and president, will disagree about whether to bail out institutions. Nor does the addition of a late, fast-paced sign-off by the district court in D.C. resolve this problem.<sup>91</sup> Neither approach precludes rash decisionmaking or insulates the decision to resolve from the political and lobbying pressures that apparently have made it so difficult to exercise.

Nonetheless, the statute has many useful resolution authority features. Importantly, it requires the government to make a list of the companies that will be subject to resolution authority.<sup>92</sup> As the list is only limited to the rather broadly defined category of “financial companies,” the government reserves the power to address new sorts of systemically important players in the financial world.<sup>93</sup> Thus, such a list provides flexibility while preserving a form

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<sup>89</sup> See *supra* Part I.A.

<sup>90</sup> At the same time, the Dodd-Frank Act does not require judicial review if the resolved firm’s board consents to the appointment of the FDIC in a resolution process. See Dodd-Frank Act § 202(a)(1)(A)(i); see also *Summary of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Enacted into Law on July 21, 2010*, DAVIS POLK (July 21, 2010), [http://www.davispolk.com/files/Publication/7084f9fe-6580-413b-b870-b7c025ed2ecf/Presentation/PublicationAttachment/1d4495c7-0be0-4e9a-ba77-f786fb90464a/070910\\_Financial\\_Reform\\_Summary.pdf](http://www.davispolk.com/files/Publication/7084f9fe-6580-413b-b870-b7c025ed2ecf/Presentation/PublicationAttachment/1d4495c7-0be0-4e9a-ba77-f786fb90464a/070910_Financial_Reform_Summary.pdf) (“Because the statute protects directors against any liability for acquiescing or consenting to the FDIC’s appointment in ‘good faith,’ it is likely that the Treasury Secretary will put intense pressure on boards to acquiesce or consent in order to avoid judicial review of the appointment decision.”).

<sup>91</sup> Dodd-Frank Act § 202 (providing for this sort of judicial review).

<sup>92</sup> *Id.* § 102(a)(4)(D) (creating a category of “Nonbank financial compan[ies] supervised by the board of governors”); § 113 (authorizing the designation of a list of such companies).

<sup>93</sup> Dodd-Frank’s resolution powers are couched in terms of financial companies; these companies are defined somewhat complicatedly as having activities that are “financial in nature.” For more details, see *id.* § 163(b).

of notice and contestation for those companies that the government brands as systemically significant and, therefore, subject to resolution.<sup>94</sup> A review of the Dodd-Frank approach to fixing resolution authority both offers insights into different ways to conceptualize the power and provides a basis for the evaluation of the proposal herein. Thus, this Article reviews this approach—both as it was first articulated by the Executive Branch in its request for new resolution authority from Congress and in its final form in the Dodd-Frank Act. This Article also discusses the so-called “living wills” requirement of banks, which has also found its way into the statute.

### 1. *Broader Authority, More Sign-Offs*

The Obama Administration proposed, and Congress passed, legislation broadening federal resolution powers to “financial companies,” including non-banks “predominantly engaged in financial activities,” holding companies of insurers, broker-dealers, and financial holding companies as defined by the Bank Holding Company Act (BHCA).<sup>95</sup> Some of these companies are automatically subject to the new resolution authority—for instance, bank holding companies with more than \$50 billion in assets—while other financial companies would be designated by a two-thirds vote of the members of the newly created Financial Oversight Council, comprised of the heads of the federal financial regulators.<sup>96</sup> Congress has also permitted the government to raise an “orderly liquidation fund” from large banks to cover the shortfalls possible in the event of a large insolvency.<sup>97</sup>

The new approach could—controversially—include hedge funds and private equity shops if their equity interests qualify them as holding

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<sup>94</sup> *Id.* §§ 202–203 (describing the listing and review process).

<sup>95</sup> *Id.* §§ 102(a), 113 (setting forth the considerations for making a determination that non-bank financial companies should be overseen by the Federal Reserve, which in turn makes them eligible for resolution). For some of the initial efforts to create a category of systemically significant institutions, see Press Release, U.S. Dep’t of the Treasury, Treasury Proposes Legislation for Resolution Authority (Mar. 25, 2009), available at <http://www.ustreas.gov/press/releases/tg70.htm> [hereinafter Press Release, Dep’t of Treasury]. Congress concluded that financial companies would be defined by a number of factors, including leverage, interconnectedness, size, and the like. See Dodd-Frank Act § 113(a)(2) (defining, *inter alia*, the categories of institution that may be subject to resolution authority); see also Shasha Dai, *Still Unclear What Tier-1 FHC Is, but at Least We Know What It Isn’t*, WALL ST. J. PRIVATE EQUITY BEAT BLOG (July 23, 2009, 6:53 PM), <http://blogs.wsj.com/privateequity/2009/07/23/still-unclear-what-tier-1-fhc-is-but-at-least-we-know-what-it-isnt/tab/article/>; U.S. Regulatory Reform Would Impose Strict Limits on Investments and Activities of Systemically Significant Financial Firms, CLIFFORD CHANCE, (June 18, 2009), [http://www.cliffordchance.com/publicationviews/publications/2009/06/u\\_s\\_regulatory\\_reformwouldimposestrictlimit.html](http://www.cliffordchance.com/publicationviews/publications/2009/06/u_s_regulatory_reformwouldimposestrictlimit.html).

<sup>96</sup> Dodd-Frank Act § 113 (providing for a designation of “systemically significant” institutions).

<sup>97</sup> *Id.* § 210(n).

companies, though the Dodd-Frank Act provides a number of safe harbors for various kinds of sophisticated or foreign investors.<sup>98</sup> By moving away from banks and thrifts toward a more inclusive view that encompasses companies that own banks and bank-like institutions that serve a crucial financial role, the proposal will, it is hoped, solve the problems created by the lack of coverage of financial conglomerates like Lehman and AIG.

Because commercial banks and thrifts are already subject to the FDIC resolution authority, which works differently and usually faster than the Bankruptcy Code, the FDIC has figured prominently into the Act as the administrator of the new resolution.<sup>99</sup> Congress's new grant of resolution authority largely extends the FDIC's resolution procedures to bank holding companies and other designated financial companies.<sup>100</sup> The Administration has the power, following the FDICIA rating system described earlier, to require more action when financial companies appear to be undercapitalized.<sup>101</sup> The combination of some limitations on leverage, more prudential oversight of a broader category of financial companies, and stronger resolution authority that can be used on such companies, would, in theory, prevent chaotic failures

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<sup>98</sup> *Id.* § 413 (adjusting the “accredited investor” standard, the standard that exempts wealthy investors from various sorts of SEC regulation); § 170 (permitting the Federal Reserve to pass regulations exempting certain foreign banks from the reach of the statute). For a discussion, see “*Too Big to Fail*” Policy (Warning: Long), ECONOMICS OF CONTEMPT (Oct. 20, 2009, 3:05 AM), <http://economicsofcontempt.blogspot.com/2009/10/too-big-to-fail-policy-warning-long.html>. It would not apply to subsidiaries of holding companies that are registered broker-dealers covered by their insurance scheme and insurance companies. *FDIC and Capital Financial Regulatory Reform*, FED. DEPOSIT INS. CORP., <http://www.fdic.gov/regulations/reform/role.html> (last updated July 21, 2010).

<sup>99</sup> See *supra* Part I.A. Indeed, commercial banks and thrifts are not subject to the Bankruptcy Code by definition. See 11 U.S.C. §§ 101(41), 109 (2006) (defining who is a person and who may be a debtor, respectively).

<sup>100</sup> Dodd-Frank Act §§ 204, 210.

<sup>101</sup> *Id.* §§ 165, 171. Section 171 refers to the PCA requirements when devising “leverage requirements.” Although the Federal Reserve will devise many of the relevant details through regulation, those requirements, if they track the FDIC’s, would particularly affect systemically significant institutions deemed “undercapitalized,” which would largely involve more scrutiny by regulators. “Significantly undercapitalized” institutions would receive further scrutiny; they might be sold, management might be replaced, and the compensation of senior executive officers might change. “Critically undercapitalized” institutions would be forced to file for bankruptcy within ninety days. These terms were devised by Congress, see 12 U.S.C. § 1831o(b) (2006), and have been implemented by regulation by the FDIC, see 12 C.F.R. § 303.200 (2008). The idea is that the tiers of undercapitalization, which require regulators to initiate PCA, will set up the bank for a non-chaotic failure.

like that of Lehman Brothers by forcing regulators into action via an ordered evaluative process.<sup>102</sup>

Resolution powers can only be deployed after an elaborate consultation process that would eventually reach the President himself. First, the Secretary of the Treasury would have to make a “systemic risk determination” that (1) a financial company is in default or in danger of default, (2) the failure of the financial company and its resolution under the Bankruptcy Code or other applicable law would have serious adverse effects on financial stability or national economic conditions, and (3) any actions or assistance under the proposed legislation would avoid or mitigate such adverse effects.<sup>103</sup> Second, this final determination can only be made upon recommendation by the Board of Governors of the Federal Reserve System (the “Federal Reserve Board”) and the FDIC or the other primary regulator of the systemically significant financial institution.<sup>104</sup> Third, the Secretary must consult with no less than the President himself before acting.<sup>105</sup> And finally, the systemic risk determination is also subject to a quick review by the D.C. district court.<sup>106</sup>

Upon making the necessary determination, the Treasury Department could then deploy its powers of conservatorship or receivership, or employ some of the tools used so often during the bailout: injections, asset purchases, loans, debt assumption, and a variety of other approaches that essentially untie the hands of the government agency. These actions would be funded by a special assessment from the Treasury’s general funds and by special assessments on

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<sup>102</sup> As this Article emphasizes elsewhere, however, it is difficult to persuade regulators to use their early warning system, and the recent financial crisis has been no exception. In this connection, consider the following account:

At bank after bank, the examiners are discovering that state and federal regulators knew lenders were engaging in hazardous business practices but failed to act until it was too late. . . . In many instances, the financial overseers failed to act quickly and forcefully to rein in runaway banks, according to reports compiled by the inspectors general of the four major federal banking regulators.

Eric Dash, *Post-Mortems Reveal Obvious Risk at Banks*, N.Y. TIMES, Nov. 19, 2009, at B1.

<sup>103</sup> Press Release, Dep’t of Treasury, *supra* note 95, at 2.

<sup>104</sup> Dodd-Frank Act § 203. The recommendation would advise whether the FDIC should appoint itself as conservator or receiver of the financial company, whether and to what extent to provide the company with assistance, and whether to take any other action. *Id.* The recommendation would also require the consent of no less than two-thirds of the Federal Reserve Board and two-thirds of the board or commission of the appropriate federal regulatory agency. *Id.*

<sup>105</sup> *Id.*

<sup>106</sup> Indeed, the review must be concluded within twenty-four hours. *Id.* § 202.

the relevant industry sector.<sup>107</sup> The Treasury Department may assign the FDIC, with its considerable experience, to assist in the winding-down process.<sup>108</sup>

All of these processes are limited by certain instructions from Congress, designed—somewhat hopefully given the government’s track record—to ensure that creditors and shareholders will bear the company’s losses, that management will be replaced, and that, ideally, tax revenues will not be used to bail out the firm.<sup>109</sup> The government faces other restrictions as well; it cannot take an equity interest in firms that it is inclined to resolve, for example.<sup>110</sup>

But the fundamental strategy for resolution in the Dodd-Frank Act is clear enough. It broadens most of the FDIC’s resolution powers to apply to a new category of financial companies, most of which will be large bank holding companies or financial companies designated as “systemically significant.”

## 2. *How Broad Is Broad?*

Identifying precisely where systemic risk begins is a particularly difficult task for any proposal for financial reform. The Treasury Department has suggested that resolution authority must be better able to reach the bank and thrift holding companies, and that large financial services conglomerates like AIG must face at least the theoretical prospect of seizure.<sup>111</sup> However, Congress has tried to keep that power canalized within the banks of relatively formal concepts like “holding” and “financial” companies; while the latter category is new, the Federal Reserve has long had some authority for defining what is “financial in nature.”<sup>112</sup> In this sense, the new authority will not only

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<sup>107</sup> *Id.* § 203.

<sup>108</sup> There is, however, some evidence that the FDIC’s resolution authority is not working perfectly. During the recent financial crisis, some banks failed under supervision of an FDIC program designed to streamline the process and be less intrusive for regulated institutions. James Sterngold, *FDIC’s 20% Shorter ‘Merit’ Reviews Preceded Failures (Update1)*, BLOOMBERG (Nov. 10, 2009, 12:57 PM), <http://www.bloomberg.com/apps/news?pid=20601109&sid=a3auv.3nhk.A&pos=10>. Such a program is unlikely to have a perfect record, of course, but the point is that imperfection inheres in the regulatory plan.

<sup>109</sup> Dodd-Frank Act § 214.

<sup>110</sup> *Id.* § 206.

<sup>111</sup> See Press Release, Dep’t of Treasury, *supra* note 95.

<sup>112</sup> The “canalized within banks” language is that of Justice Cardozo. See *A.L.A. Schechter Poultry Corp. v. United States*, 295 U.S. 495, 551 (1935) (Cardozo, J., concurring). The “financial in nature” language is based on a reference to § 4(k) of the Bank Holding Company Act, 12 U.S.C. § 1843(k) (2006), which provides a laundry list of the activities in which financial holding companies may engage. Dodd-Frank Act, § 102(a)(6). Accordingly, there would be no ability to seize and resolve hedge funds or other players in the

create a *list* of potentially nationalizable institutions, but also a *class* of them, including any institutions that meet the definition of a bank holding company with assets over \$50 billion.

Other observers have taken a broader view, one that might be characterized as discretionary resolution authority. As the government has assumed an increasingly active role in ensuring systemic economic stability through resolution, it may need to consider exercising that authority not just over banks and bank-like institutions, but also over other large and interconnected firms, such as automakers. In other words, once important financial institutions are potentially resolvable, it is unclear why other interconnected firms—albeit in some respects differently interconnected—might not be similarly treated.<sup>113</sup>

And while much of the legislation following the financial crisis has been justified by claims that the present financial situation is unique and uniquely threatens domestic economic stability, much of the government's *action* during the crisis—bailing out the automakers, most notably—suggests that a broader resolution tool would enable the government to avoid the bailout-or-bankruptcy dilemma in other contexts.<sup>114</sup> Moreover, in the past, many of the government's most expensive bailouts have gone not to financial institutions, but to other businesses—again, most notably the automakers, but also large defense manufacturers and the like.<sup>115</sup>

The problem with these sorts of proposals is that pure discretion to resolve if necessary gives the government little guidance and fails to limit those institutions that might be covered by the nationalization power. This broad

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shadow financial system that are too big or interconnected to fail, unless they own federally insured thrifts or banks and meet a certain size level.

<sup>113</sup> They may be dissimilar for Takings Clause purposes. As Christopher T. Curtis has pointed out, “[t]he Supreme Court has suggested that a physical occupation of private property constitutes a *per se* taking to which the *ad hoc*, multifactor approach used in most cases of so-called regulatory takings does not apply. But that proposition cannot apply to regulatory takeovers of banks and thrift institutions, because they are not physical property.” Curtis, *supra* note 64, at 375. Automakers and other businesses that consist of plants, parts, machinery, etc., may be subject to more careful Takings Clause scrutiny should the government care to step in.

<sup>114</sup> For a discussion of the auto bailouts, see *University of Rochester Roundtable on Bankruptcy and Bailouts: The Case of the US Auto Industry*, J. APPLIED FIN., Fall/Winter 2008, at 97 (2009); see also Randy Picker, *Can You Put Cars Under the Tarp?*, U. CHI. FACULTY BLOG (Dec. 12, 2008, 10:06:52 AM), <http://uchicagolaw.typepad.com/faculty/2008/12/can-you-put-cars-under-the-tarp.html>; David Zaring, *Can the TARP Be Pulled over Detroit?*, THE CONGLOMERATE (Dec. 14, 2008), <http://www.theconglomerate.org/2008/12/can-the-tarp-be.html> [hereinafter Zaring, THE CONGLOMERATE].

<sup>115</sup> See, e.g., Tara Branum & Susanna Dokupil, *Security Takeovers and Bailouts: Aviation and the Return of Big Government*, 6 TEX. REV. L. & POL. 431 (2002); Longman, *supra* note 32, at 14–18.

delegation of power might even implicate separation of powers problems like those posed by the rarely invoked, but often in the background, nondelegation doctrine.<sup>116</sup> As such a proposal would broaden the power to destroy to a truly wide ambit, the constraints imposed by the government are first definitional—a class of institutions are to be affected, and no more—and second, internally procedural—sign-offs must be obtained before power is exercised.

But by implementing procedural hurdles to constrain exercise of resolution authority, this authority relies on internal deliberations—to which outsiders are rarely privy—among political appointees who often have every reason to follow the will of the administration’s leadership. Further, the very short, and circumventable, window of review by the D.C. district court is unlikely to change the essential nature of this inquiry. In other words, the procedural limitations likely will not be particularly constraining.

### 3. *Living Wills*

In addition, Congress has embraced the possibility of requiring banks to come up with so-called living wills or, as termed by Dodd-Frank, “resolution plans.”<sup>117</sup> This provision requires systemically significant financial companies and bank holding companies to “report. . .the plan. . .for rapid and orderly resolution in the event of material financial distress or failure,” including how such a failure would affect any parts of the financial conglomerate that enjoy

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<sup>116</sup> For the canonical statements of the extent of the nondelegation doctrine and the only two cases in the history of the Supreme Court to use it to strike down legislation, see *A.L.A. Schechter Poultry Corp. v. United States*, 295 U.S. 495 (1935); *Pan. Refining Co. v. Ryan*, 293 U.S. 388 (1935).

<sup>117</sup> See *The Causes and Current State of the Financial Crisis: Hearing Before the Fin. Crisis Inquiry Comm.*, 111th Cong. 1–2, 40 (2010) (statement of Sheila C. Bair, Chairman, Federal Deposit Insurance Corporation) (“Large interconnected firms should also be required to develop their own liquidation plan—a living will so to speak—which would demonstrate that they could be broken apart and sold in an orderly manner.”); Roshni Banker, Note, *Glass-Steagall Through the Back Door: Creating a Divide in Banking Functions Through the Use of Corporate Living Wills*, 2010 COLUM. BUS. L. REV. 424 (arguing that living wills offer a preferable alternative to regulation of the scope of banking activities); Emilius Avgouleas et al., *Living Wills as a Catalyst for Action 13* (DSF Policy Paper Series, DSF Policy Paper No. 4, 2010), available at <http://ssrn.com/abstract=1533808> (discussing living wills extensively and arguing that they could make resolution of “cross-border financial institution[s]” easier). In theory, living wills seem to serve the dual purposes of clarification and simplification. First, they enable easy government takeover and disassembly, as well as force corporate transparency to facilitate earlier detection of risk. Second, they reduce what Financial Services Authority (FSA) Chairman Adair Turner describes as “complex legal structures designed to maximize regulatory and tax arbitrage.” Chris Giles et al., *Living Wills “to Be Forced on UK Banks,”* FT.COM (Sept. 14, 2009, 11:35 PM), <http://www.ft.com/cms/s/0/4bb9fd1e-a17b-11de-a88d-00144feabdc0.html> (describing resistance from banks and suggesting that U.S. banks have assumed a more conciliatory attitude toward the living wills issue).



deposit insurance.<sup>118</sup> It further requires “full descriptions of the ownership structure, assets, liability, and contractual obligations of the company.”<sup>119</sup> Regulations by the Federal Reserve and FDIC will set the precise content of the wills; companies that fail to develop “credible” living wills are subject to sanctions including, potentially, the divestiture of assets and units.<sup>120</sup>

Living wills force banks to confront their own mortality and, at their best, can create a sort of ex ante timetable and organization chart to smooth the ultimate task of resolution in the case of insolvency.<sup>121</sup> Congress has required large institutions both to make these sorts of wills and to update them periodically.<sup>122</sup> By requiring banks to identify their various subsidiaries to regulators and to suggest a process that might be used to wind up those subsidiaries, living wills could transform the real complexity that financial institutions have utilized in the past to engage in tax arbitrage and regulatory avoidance.<sup>123</sup>

All of this is usefully cautious, but it is also imperfect. Living wills may make banks more risk averse—or they may not. Planning for one’s death looks like it would have psychological ramifications, but, of course, financial intermediaries are not people.<sup>124</sup> The Treasury Department would actually impose a profitability hit on those covered by the living will requirement by

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<sup>118</sup> Dodd-Frank Act § 165(d)(1).

<sup>119</sup> *Id.*

<sup>120</sup> *Id.*

<sup>121</sup> Perhaps for this reason, British regulators and academics appear to be particularly enamored of them. See, e.g., Alistair Darling, *A Strong City Is Not Just in Britain’s Interests*, TIMES (London), Dec. 2, 2009, at 20 (“Living wills are now the agreed tool for ensuring that banks, not taxpayers, meet the cost of any future failures.”); Avgouleas et al., *supra* note 117, at 8–9; Giles et al., *supra* note 117.

<sup>122</sup> Dodd-Frank Act § 165(d)(1).

<sup>123</sup> However, as Gillian Tett points out:

The issue at stake revolves around a matter that often bedevils personal wills—namely, the tricky question of transparency. In order to make it easy to wind down a large bank, it is crucial to have structures that are relatively simple and streamlined. However, in the past few decades, the largest banks in the world have stealthily built corporate structures that are fiendishly complex, straddling numerous borders and plagued with offshore entities. Lehman Brothers was but one example of that. The pattern, of course, is no accident. After all, large investment banks excel in regulatory and tax arbitrage, and all that cross-border complexity and opacity enables them to exploit such loopholes with ease. The pattern is also one reason that the living will idea could be very controversial, if regulators ever try to push it through.

Gillian Tett, *Idea of “Living Wills” Is Likely to Die a Quiet Death*, FT.COM (Aug. 13, 2009, 7:50 PM), <http://www.ft.com/cms/s/0/098ac1ec-882d-11de-82e4-00144feabdc0.html>.

<sup>124</sup> This is one reason why the living will idea seems attractive in theory but would raise many problems in practice. What if the bank is wrong? Or if it makes little real effort to come up with a workable living will, an eminently likely possibility?

uncovering tax ploys, which will make them, if anything, *less* safe and sound, at least in the near term.<sup>125</sup> And just because an institution has outlined all of its activities and set forth a way to wind up each one does not mean that regulators will have the guts to actually follow the will (and pronounce the death sentence that must precede it). For these reasons, living wills, though interesting ideas, should be deemed ancillary aspects of regulatory reform and resolution authority itself; the wills make that authority more easily exercisable, but do little to identify where and when such authority should be exercised.

None of this is meant as a comprehensive summary of Dodd-Frank's resolution procedures; they are quite detailed, and the focus here is on the heart of resolution rather than the ancillary issues that accompany any comprehensive financial reform. The Dodd-Frank Act includes many of these accompanying provisions.<sup>126</sup> In addition, Congress has also enacted high-minded nostrums like "taxpayers shall bear no losses from the exercise of" resolution authority.<sup>127</sup> But it is these sorts of fundamental values that expanded resolution authority risks traducing, as the next Part makes clear.

## II. ANTI-SEIZURE PROTECTIONS FOR FINANCIAL INSTITUTIONS

Resolution authority's legitimacy turns on a bargain that its expansion will largely undo. The bargain offered by the FDIC is unprecedented powers of nationalization in exchange for the federally insured bank charter, which offers its holders cheap capital and willing depositors.<sup>128</sup>

However, the expansion of resolution authority is by its very terms the right to seize an institution that does not enjoy, in exchange, the benefit of the bank charter and the low cost of capital that comes with it. Instead, the benefit granted by the government is the right to play in the waters of American finance at scale, including through the ownership of a bank or thrift subsidiary, and to profit accordingly. While that right is a valuable one, it is very different

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<sup>125</sup> See Zaring, *THE CONGLOMERATE*, *supra* note 114.

<sup>126</sup> For example, the Act provides the government with the power to claw back compensation from executives during a two-year period before resolution, as well as the ability to levy a fee on large financial institutions to cover the costs of supervising them. Dodd-Frank Act § 318(c).

<sup>127</sup> *Id.* § 214(c).

<sup>128</sup> See Ilan Moscovitz, *The Coming Financial Meltdown*, *MOTLEY FOOL* (June 15, 2010), <http://www.fool.com/investing/general/2010/06/15/the-coming-financial-meltdown.aspx> (noting that FDIC insurance creates a "cheap source of funding" for banks); *cf.* Sam Zuckerman, *Turning Bankers into Entrepreneurs*, *U.S. BANKER*, Jan. 1, 1997, at 46, 46–48.

from the corporate form offered to banks and thrifts. Nor is that right paired with formal deposit insurance or the worry-free capital that it attracts,<sup>129</sup> hence the fact that various of the proposals for resolution authority would permit the FDIC to act to take over and shut down institutions *that it does not insure or regulate*.

But exactly which institutions? Unless resolution authority's reach is limited to a very carefully defined set of institutions, the scope of those affected by the exchange of a government guarantee for the extra-strong government imposition will remain unclear, making for uncertain markets and potentially skittish shareholders.

What is needed, and what this Article hopes to provide, is a case for the legitimacy of the practice of resolution authority that puts any new expansion of that authority onto a firmer base.

While it is difficult to feel sympathy for the financial institutions facing an expanded threat of the government's death penalty, neither is it always clear that this kind of authority will be used for good.<sup>130</sup> Although Washington Mutual's shareholders had few options after the FDIC concluded that there was a case for seizing and closing the bank and selling its assets to J.P. Morgan Chase, some observers think that the agency's hasty resolution of what was then the nation's largest thrift severely exacerbated the financial crisis.<sup>131</sup> If

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<sup>129</sup> See GARY B. GORTON, *SLAPPED BY THE INVISIBLE HAND: THE PANIC OF 2007* (2010).

<sup>130</sup> It is not always obvious that these varieties of resolution authority are wholly threatening to the owners of the assets seized by the government, to be sure. Insolvent institutions, after all, are pretty much by definition not likely to be totally valuable. See, e.g., *In re Penn Central Transp. Co.*, 384 F. Supp. 895, 917 (Reg'l Rail Reorg. Ct. 1974) ("[T]here is a certain incongruity between the high demands which the investors make of the [Regional Rail Reorganization] Act and the unhappy position they, or in any event most of them, occupied when it was enacted. The idea that billions of dollars of liquidation proceeds of these bankrupt railroads are lurking just around the corner is unrealistic in the last degree.").

<sup>131</sup> See Felix Salmon, *One Question for Sheila Bair*, REUTERS BLOG (Nov. 12, 2009, 2:11 PM), <http://blogs.reuters.com/felix-salmon/2009/11/12/one-question-for-sheila-bair/> ("If I could ask her just one question, it would be about her actions taking over WaMu and wiping out all its senior unsecured debt. That's the wholesale interbank market right there, and in the wake of the WaMu collapse, banks pretty much stopped lending to each other, fearful that at any point Bair could step in and wipe out billions of dollars in assets. The ensuing credit crunch was responsible for trillions of dollars in stock and bond-market losses, and Tim Geithner, for one, was furious at Bair for her precipitous decision."). This resolution also probably undermined the existence of the Office of Thrift Supervision (OTS) (which will be eliminated under Dodd-Frank), as the agency depended on Washington Mutual for an extremely large proportion of its revenues because it was the most likely agency to be folded into another one. See Dain C. Donelson & David Zaring, *Charter Switching and the Financial Crisis: Evidence from the Office of Thrift Supervision* (Oct. 13, 2009) (unpublished manuscript), available at [http://www.law.uiuc.edu/\\_shared/pdfs/thrift%20chartering%20draft%2010%20dz.docx](http://www.law.uiuc.edu/_shared/pdfs/thrift%20chartering%20draft%2010%20dz.docx).

resolution authority is to expand, there is good reason to want some limitations on its scope.

This is not merely a policy question; the case for a successful constitutional challenge of the expanded authority given the FDIC by Congress is a close one. In what follows, this Article reviews how the Takings Clause, the Due Process Clause, and the constitutional protections against arbitrary and biased decisionmaking threaten the resolution authority passed by Congress. This Article further suggests that an imperfectly defined category of institutions in peril and a number of Executive Branch sign-offs with one expedited district court check might not be able to provide the necessary constitutional basis for resolution authority.

### A. *Takings*

Before the Dodd-Frank Act, angry shareholders failed to convince the courts that the seizure of banks during the recent financial crisis amounted to a taking.<sup>132</sup> But the case for a takings claim is much closer than it would appear. These claims failed in part due to long practice and in part due to the potentially vast consequences of permitting them in these sorts of contexts. Yet seizing a bank and wiping out shareholders without compensation resembles any understanding of a taking. It therefore must be managed carefully if expanded resolution authority is to survive the first attempt to use it.

In fact, under current doctrine, it is not that regulatory seizures could not possibly amount to a taking or that resolved financial institutions in particular could not play this role. A regulatory imposition may result in a compensable taking in either of two ways: through a physical invasion or through a regulatory act that largely destroys a property's value.

First, when a regulatory scheme results in a physical invasion or permanent occupation of property, such invasions are "compensable without case-specific inquiry into the public interest advanced in support of the restraint."<sup>133</sup> In general, in the case of physical invasions, the Supreme Court pointed out that "no matter how minute the intrusion, and no matter how weighty the public

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<sup>132</sup> See *Thykkuttathil v. United States*, 88 Fed. Cl. 293, 296 (2009) ("A takings claim will not lie for the seizure of a bank by federal regulators, even if an allegation is made that the seized bank had not yet failed when it was seized."), *aff'd*, No. 2010-17109, 2010 U.S. App. LEXIS 17109 (Fed. Cir. Aug. 12, 2010).

<sup>133</sup> *Lucas v. S.C. Coastal Council*, 505 U.S. 1003, 1015 (1992).

purpose behind it, we have required compensation.”<sup>134</sup> Of course, a resolution involves just this type of a physical invasion: FDIC officials ordinarily show up and instruct the employees of the insolvent institution as to what they must do over the weekend.<sup>135</sup> They also tend to take the books and records of the failed institutions.<sup>136</sup>

In cases where a regulatory scheme does not involve a physical invasion or occupation of property, the Supreme Court “has generally ‘been unable to develop any “set formula” for determining when “justice and fairness” require that economic injuries caused by public action’” result in a compensable taking.<sup>137</sup> The Court, however, has identified three factors to consider when determining whether a governmental action has exceeded “regulation” to become a “taking.” Those factors are “the character of the governmental action, its economic impact, and its interference with reasonable investment-backed expectations.”<sup>138</sup>

Here too the case for a taking is not, on its face, ludicrous: the character of the government action is severe, its economic impact, from the perspectives of the shareholders, is awesome, and their investment-backed expectations—their shares—are, of course, wiped out. It is also worth noting that, in other contexts, the United States has taken the international position that the expropriation of private property must be paired with full and fair compensation for the owners of that property.<sup>139</sup>

To be sure, banks have never had much luck arguing that seizures of their assets via the FDIC’s resolution authority implicate the Takings Clause. The Federal Circuit has held that “[g]iven the highly regulated nature of the

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<sup>134</sup> *Id.*; see also *Loretto v. Teleprompter Manhattan CATV Corp.*, 458 U.S. 419, 426 (1982) (“[A] permanent physical occupation authorized by [the] government is a taking without regard to the public interests that it may serve.”).

<sup>135</sup> See Mary Gordon, *Bank Failure Friday Is Back as Feds Shut Down Four More Banks Last Week*, BUS. INSIDER (Feb. 22, 2010, 9:01 AM), <http://www.businessinsider.com/bank-failure-friday-is-back-as-feds-shut-down-four-more-banks-last-week-2010-2> (noting that the FDIC tends to fail banks on Fridays).

<sup>136</sup> *Financial Markets in Crisis: Overview of FDIC’s Authority with Respect to Bank Failures*, GIBSON DUNN (Sept. 30, 2008), <http://www.gibsondunn.com/publications/Pages/FinancialMarketsCrisis-FDICAuthority-BankFailures.aspx> (“The FDIC’s first step as conservator or receiver is to take possession of all of the closed institution’s books and records and assets and loans.”).

<sup>137</sup> *Kaiser Aetna v. United States*, 444 U.S. 164, 175 (1979) (quoting *Penn Cent. Transp. Co. v. New York City*, 438 U.S. 104, 124 (1978)); *accord Hodel v. Va. Surface Mining & Reclamation Ass’n*, 452 U.S. 264, 295 (1981) (applying the “economically viable use” test in determining the existence of a regulatory taking).

<sup>138</sup> *PruneYard Shopping Ctr. v. Robins*, 447 U.S. 74, 83 (1980).

<sup>139</sup> See generally Curtis, *supra* note 64 (discussing the compensation required by the Takings Clause during government takeovers of banks).

banking industry,. . .the [federal regulators’ seizure of the bank] could not possibly have interfered with a reasonable investment-backed expectation on the part of [the owners of a bank].”<sup>140</sup> It has further observed that “[i]t is well known that ‘[b]anking is one of the longest regulated and most closely supervised of public callings.’”<sup>141</sup> Accordingly, “[t]he Federal Circuit has never upheld a claim that a seizure of a financial institution under the statutes and regulations designed to insure safe and secure banking institutions constituted a taking.”<sup>142</sup>

Moreover, these recent results are consistent with long established Supreme Court precedent. Decades ago, in *Fahey v. Mallone*,<sup>143</sup> the Court observed that:

Banking is one of the longest regulated and most closely supervised of public callings. It is one in which accumulated experience of supervisors, acting for many states under various statutes, has established well-defined practices for the appointment of conservators, receivers and liquidators. . . .A discretion to make regulations to guide supervisory action in such matters may be constitutionally permissible while it might not be allowable to authorize creation of new crimes in uncharted fields.<sup>144</sup>

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<sup>140</sup> *Golden Pac. Bancorp v. United States*, 15 F.3d 1066, 1074 (Fed. Cir. 1994).

<sup>141</sup> *Cal. Hous. Sec., Inc. v. United States*, 959 F.2d 955, 958 (Fed. Cir. 1992) (quoting *Fahey v. Mallone*, 332 U.S. 245, 250 (1947)); *see also* *Castle v. United States*, 48 Fed. Cl. 187, 220 (2000) (“The law is clear that the seizure of a bank that fails to meet regulatory capital requirements does not constitute a taking.”), *aff’d in relevant part*, 301 F.3d 1328, 1341–42 (Fed. Cir. 2002); *Branch v. United States*, 69 F.3d 1571, 1575 (Fed. Cir. 1996) (“Banking is a highly regulated industry, and an individual engaged in that industry is deemed to understand if his bank becomes insolvent or is operated in violation of law or regulations, the federal government may ‘take possession of its premises and holdings’ and no compensation for that governmental action will be due.” (quoting *Cal. Hous. Sec.*, 959 F.2d at 958)); *Am. Cont’l Corp. v. United States*, 22 Cl. Ct. 692, 698 (1991) (“[I]t was hardly contrary to reasonable expectations of an investor in the highly regulated, federally insured banking industry when the federal government buttressed the then-existing regulatory scheme by authorizing appointment of a conservator or receiver when a federally insured bank is in [trouble].”). A bank seizure must be presumed to be lawful when considering a takings claim based on that federal action. *See Acadia Tech., Inc. v. United States*, 458 F.3d 1327, 1331 (Fed. Cir. 2006) (“For takings purposes, we therefore must assume the government conduct at issue . . . was not unlawful.”).

<sup>142</sup> *Franklin Sav. Corp. v. United States*, 46 Fed. Cl. 533, 535 (2000), *aff’d*, 97 F. App’x. 331 (Fed. Cir. 2004). Similar rules appear to apply in other jurisdictions, which are also unlikely to compensate failed bank shareholders. Northern Rock shareholders lost on their claim that the statutory scheme establishing how much the British government has to compensate shareholders violated Article 1 of the First Protocol of the European Convention of Human Rights. *See SRM Global Master Fund v. Comm’rs of Her Majesty’s Treasury*, [2009] EWCA (Civ) 788, [2009] W.L.R. [267] (Eng.). There was much more debate about this question, however, in Europe.

<sup>143</sup> 332 U.S. 245 (1947).

<sup>144</sup> *Id.* at 250.

And the problem is not merely one of doctrine, but of a culture lacking sympathy for the owners of federally insured banks. Foreign shareholders frequently have more protection than American shareholders in the case of a takeover by banking regulators, for instance as in Europe, which is exceedingly worried about the prospect of unwarranted resolution of still-valuable financial enterprises.<sup>145</sup> But those European financial intermediaries generally do not have formal depositor protections in place—the benefit of the bargain for which resolution authority is a cost.

### B. *Due Process*

The point of resolution authority is both to give the regulators the power to act quickly and to encourage them, almost to the point of requiring them, to use it. A problem then arises regarding predeprivation notice and the opportunity to a fair hearing, rights usually guaranteed under due process.<sup>146</sup> This then requires a look at the oft-invoked three-factor test in *Mathews v. Eldridge*:

First, the private interest that will be affected by the official action; second, the risk of an erroneous deprivation of such interest through the procedures used, and the probable value, if any, of additional or substitute procedural safeguards; and finally, the Government's interest, including the function involved and the fiscal and administrative burdens that the additional or substitute procedural requirement would entail.<sup>147</sup>

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<sup>145</sup> Nor is this only a matter for the United States. One private equity fund has sued the German government over its seizure of a bank in which the equity fund was heavily invested. *Germany Defends Hypo Real Squeeze-Out After Lawsuit*, REUTERS, Oct. 12, 2009, available at <http://www.reuters.com/article/idUSL18214220091012>. The central problem has been described as follows: "Governments forced to step in to save the financial system would prefer to close or merge weak banks to revive lending as quickly as possible. But shareholders . . . angling to make lemonade out of lemons, want to eke out the best return they can, even if it delays an economic recovery." Carter Dougherty, *Holding His Ground*, N.Y. TIMES, Apr. 28, 2009, at B4. J.C. Flowers bought about 25% of Hypo Real Estate in 2008 (approximately \$1.8 billion), but that has now been reduced to a less than 3% stake. See *JC Flowers Seeks to Block Soffin Forcing Hypo Minority Sales*, IRISH INDEP. (Oct. 13, 2009), <http://www.independent.ie/business/european/jc-flowers-seeks-to-block-soffin-forcing-hypo-minority-sales-1911446.html>. The reduction in stake is presumably due to dilution. The uncertainty, of course, can be telling. It is difficult to plan for the future in a financial institution that can go from well-earned to resolved in a matter of days. Bear Stearns, after all, was deemed solvent by its regulator up to the moment of its resolution by contract orchestrated by the Treasury Department. Davidoff & Zaring, *supra* note 11, at 476 (discussing the SEC's assessment that Bear Stearns was adequately capitalized up until the moment of collapse).

<sup>146</sup> See *Goldberg v. Kelly*, 397 U.S. 254 (1970).

<sup>147</sup> 424 U.S. 319, 335 (1976).

The *Mathews* regime clearly applies to financial regulation.<sup>148</sup> But this does not mean that lengthy predeprivation notice and an opportunity to be heard is always required when federal agencies seize failing banks. In *FDIC v. Mallen*, the Supreme Court identified three factors that typically are present in cases in which a postdeprivation hearing is sufficient to satisfy due process: (1) the action is necessary to further an important governmental interest; (2) there is a need for prompt action; and (3) there is a substantial assurance that the deprivation is not baseless or unwarranted.<sup>149</sup> The Court concluded that the FDIC's seizure powers passed this test, as applied to banks and thrifts.<sup>150</sup>

Is due process implicated by a broad new resolution authority regime, extending beyond insured banks? The *Mathews* test obviously involves strong private and strong governmental interests, so it appears that the critical issues are the procedures offered by resolution and its alternatives. It is here that the expansion of resolution authority risks denying the seized institution an opportunity to be heard "at a meaningful time and in a meaningful manner."<sup>151</sup> As the risks of a wrongful seizure are dramatic, additional procedures, such as an auction in addition to the carefully articulated *ex ante* list, would ensure that financial institutions have an adequate opportunity to be heard.

Moreover, the seizure of a bank will, in many cases, involve the dismissal of the board and principals (and Congress has, as it has enhanced resolution authority, urged the FDIC to exercise this power), which presents its own due process concerns. The Supreme Court has established that the discharge of an employee by a governmental entity interferes with the employee's liberty interest under the procedural Due Process Clause if combined with "any charge against him that might seriously damage his standing and associations in his community," although the discharge must be severely stigmatizing to implicate constitutional rights.<sup>152</sup> But, in an era of intense banker hatred, it is not impossible to imagine the seizure of a bank and the firing of its employees resulting in this sort of stigmatization.<sup>153</sup>

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<sup>148</sup> *FDIC v. Mallen*, 486 U.S. 230, 242 (1988).

<sup>149</sup> *Id.* at 240–41; *see also* *Bd. of Governors of Fed. Reserve Sys. v. DLG Fin. Corp.*, 29 F.3d 993, 1001–02 (5th Cir. 1994) (using the *Mallen* factors to evaluate the sufficiency of due process in an FDIC takeover).

<sup>150</sup> *Mallen*, 486 U.S. at 240.

<sup>151</sup> *Armstrong v. Manzo*, 380 U.S. 545, 552 (1965).

<sup>152</sup> *Bd. of Regents of State Colls. v. Roth*, 408 U.S. 564, 573 (1972).

<sup>153</sup> *See, e.g.*, Matt Taibbi, *The Great American Bubble Machine*, *ROLLING STONE*, July 9, 2009, at 52 ("The world's most powerful investment bank is a great vampire squid wrapped around the face of humanity, relentlessly jamming its blood funnel into anything that smells like money.").



Moreover, there are property interests at stake in these kinds of terminations. The Court has held that “the right to continue to serve as president of the bank and to participate in the conduct of its affairs is a property right protected by the Fifth Amendment Due Process Clause. . . . It is also undisputed that the FDIC’s order of suspension affected a deprivation of this property interest.”<sup>154</sup>

Also, while certain limited rights of judicial review are generally available in resolution authority statutes, and “the existence of post-termination procedures is relevant to the necessary scope of pre-termination procedures,”<sup>155</sup> the scope of procedures offered to banks and thrifts post-seizure is limited, and they have rarely resulted in successful claims, making the adequacy of the process offered now questionable.<sup>156</sup>

One may sense this not only by reviewing the FDIC’s strong won–lost record in nationalization claims, but also by looking at how the courts have reviewed the claims of those dispossessed by bailouts and their attendant processes. While courts have not said that banking regulator decisions are unreviewable as a matter of law, they have avoided in-depth scrutiny of both monetary policy decisions and bailouts. In *Raichle v. Federal Reserve Bank*, Augustus Hand refrained from assessing whether a legally constituted bank may make loans to other banks and set interest rates for those loans in forming a basis for bailouts with Federal Reserve money during the financial crisis of 1929.<sup>157</sup> And as for bailouts, after the Franklin National Bank failed and was bailed out by the Federal Reserve, the Second Circuit concluded that:

Absent clear evidence of grossly arbitrary or capricious action on the part of [the Federal Reserve or the Treasury Department,]. . . it is not for the courts to say whether or not the actions taken were justified in the public interest, particularly where it vitally concerned the operation and stability of the nation’s banking system.<sup>158</sup>

In sum, because it is very difficult to get judicial review *ex post* over the decision whether to resolve or bail out—as the recent financial crisis, with few judicial proceedings, has illustrated—it is not unreasonable to ask whether the postdeprivation rules in place are an adequate substitute for more

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<sup>154</sup> *Mallen*, 486 U.S. at 240.

<sup>155</sup> *Cleveland Bd. of Educ. v. Loudermill*, 470 U.S. 532, 547 n.12 (1985).

<sup>156</sup> See David Zaring, *Administration by Treasury*, 94 MINN. L. REV. (forthcoming 2010).

<sup>157</sup> 34 F.2d 910 (2d Cir. 1929).

<sup>158</sup> *Huntington Towers, Ltd. v. Franklin Nat’l Bank*, 559 F.2d 863, 868 (2d Cir. 1977).

predeprivation process. Indeed, the current rules and their amendments leave no room for such process at all.

Worrying about the due process implications of expanded seizure powers is hardly crazy.<sup>159</sup> The Fifth Circuit has applied the *Mathews* test to the issuance of a capital directive by the FDIC.<sup>160</sup> Further, the FDIC itself has conceded that it is subject to constitutional review in administering its PCA powers.<sup>161</sup> And although the FDIC's procedures have generally withstood constitutional scrutiny in the past—*FDIC v. Mallen* upheld a removal procedure that affords an indicted bank official a post-termination hearing but neither a full evidentiary hearing nor a right to judicial review<sup>162</sup>—that process occurred in the context of the regulated banks and thrifts. The seizure of real property pursuant to drug arrests, for example, has been held by the Court to be inconsistent with due process.<sup>163</sup> One wonders if the seizure of noninsured banking assets would present a similar problem.

### C. Bias

Lastly, the prospect of the federal banking agencies serving as the prosecutor, judge, and executioner of these banks raises at least the specter of biased decisionmaking. Due process also affords some constitutional protections in relief of biased decisionmaking,<sup>164</sup> and although the combination of investigator and decisionmaker in a single agency alone is not enough to

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<sup>159</sup> Other lawyers have expressed their concerns about the due process implications of resolution authority as it currently exists. See, e.g., Howard N. Cayne & Michael Caglioti, *FDICIA's New D&O Dismissal Authority: What Process is Due?*, 14 BANKING POL'Y REP. 1 (1995) (expressing doubt regarding the propriety of the method by which the PCA processes the removal rights of the directors of seized banks and its compliance with due process related notions of notice and opportunity to be heard).

<sup>160</sup> *FDIC v. Bank of Coushatta*, 930 F.2d 1122, 1130–31 (5th Cir. 1991).

<sup>161</sup> *Id.* at 1130 (“[T]he FDIC concedes that unreviewability does not extend to the issue of whether there is a ‘constitutional right to a full hearing on the record prior to issuance of a directive,’ and instead asserts that the procedures provide due process.”).

<sup>162</sup> *Mallen*, 486 U.S. at 248 (1988).

<sup>163</sup> See *United States v. James Daniel Good Real Prop.*, 510 U.S. 43, 53–54 (1993) (employing the *Mathews* test in determining that the seizure of real property without notice and hearing did not, under the circumstances of the case, comport with due process).

<sup>164</sup> *Stivers v. Pierce*, 71 F.3d 732, 741 (9th Cir. 1995) (“It is well-settled that the Due Process Clause prevents the state from depriving a plaintiff of a protected property interest without ‘a fair trial in a fair tribunal.’” (quoting *In re Murchison*, 349 U.S. 133, 136 (1955))).

offend due process,<sup>165</sup> the question, when exemplified by the draconian act of resolution authority, is at least worth a bit of thought.<sup>166</sup>

Biased decisionmaking usually requires a showing of particular prejudice, rather than the combination of prosecutorial and adjudicative functions within a single agency in general, which has been permitted ever since the Supreme Court decided *Withrow v. Larkin*.<sup>167</sup> But putting the judge and the jury together and allowing both to make decisions in a procedure-free environment raises the possibility of prejudice and other problems that, surely, regulators would prefer to avoid.

Bias claims have been leveled before against the FDIC for seizing financial institutions; one banking lawyer believes that the entire PCA process, as it eschews so many other procedures, is shot through with an unacceptable risk of bias and has pursued litigation to that end.<sup>168</sup> The possibility of a bias claim, let alone a larger notice-before-deprivation claim, makes even more sense given the problems associated with the expansion of resolution authority beyond the confines of the federally insured bank charter.

### III. CONSTITUTIONAL, AND EXERCISABLE, RESOLUTION AUTHORITY

If an expanded construct of resolution authority could make takings, due process, and bias claims viable, the question is how to structure a new regime to deal with these problems—as well as the problem of “too big to fail”—while incentivizing the government to act when necessary, which it frequently fails to do.

Dealing with the first problem requires both a commonsense solution and a creative one. The commonsense rule is to make clear, *ex ante*, the financial institutions subject to resolution authority. Publishing a list of these institutions, rather than providing guidelines to identify institutions that may be subject to nationalization in the future, is better because the *ex ante* approach provides more certainty. This Part of the Article celebrates the Dodd-Frank Act for providing a list and a dispute resolution process, rather than, for

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<sup>165</sup> *Withrow v. Larkin*, 421 U.S. 35, 52 (1975) (rejecting a due process challenge to the combination of the roles of investigator and decisionmaker in a state medical examiners' board).

<sup>166</sup> See generally Thomas M.L. Metzger, *FDIC Capital Directive Procedures: The Unacceptable Risk of Bias*, 110 *BANKING L.J.* 237 (1993) (examining procedural due process concerns in the context of FDIC decisionmaking).

<sup>167</sup> 421 U.S. at 52.

<sup>168</sup> For a description of his approach, see Metzger, *supra* note 166.

instance, the alternative originally proposed by the Treasury Department. The Treasury Department's proposal would have created a class of potentially nationalizable institutions, and it would have been difficult to tell precisely who belonged to the class and who did not. The owners of banks should have a short window after seizure during which to buy back their institutions from the government. In this way, overreaction by regulators can be countered sensibly after a seizure without relying on the so-far toothless mechanism of judicial review. And in this way the problem of regulatory overload can be mitigated to address due process—and also plain regulatory capacity—concerns.

Incentivizing more action by regulators, however, instead of deterring bad decisions, is not easy, although a better form of regulation may lie in international relationships instead of domestic ones. I have often touted, along with others, the technocratic potential of international networks of regulators; particularly in financial regulation, those networks are extremely well-developed.<sup>169</sup> They offer peer support for and review of the decision to resolve, as well as distance from the hurly-burly of domestic lobbying. This Part outlines and justifies a way to handle resolution that might better serve both the government and the public.

#### *A. Protection Against Government Overreach*

No matter how limited the resolution authority, in certain cases, there is little hope that the government will be able to act in any way other than precipitously. Emergencies arise, after all, and the recent financial crisis was full of momentous decisions rendered overnight, or “before the Asian markets open[ed].”<sup>170</sup> Moreover, the exact nature of the institution subject to such precipitous action could be unclear if resolution authority is delegated poorly. Is there some way to use procedure to counteract the possibility of arbitrariness in these cases?

Most likely, there is. As an initial matter, more sensible procedural protections for seizable banks would further the important project of incentivizing a resolution system to make good decisions. Moreover, these protections would also address the constitutional concerns presented by the abandonment of the bargain of resolution authority for deposit insurance,

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<sup>169</sup> See, e.g., ANNE-MARIE SLAUGHTER, *A NEW WORLD ORDER* 36–64 (2004).

<sup>170</sup> Charles Babington & Alan Fram, *Deal Reached on Financial Market Bailout*, N.Y. SUN, Sept. 28, 2008, <http://www.nysun.com/national/deal-reached-on-financial-markets-bailout/86725/>.

which would follow any extension of resolution authority to larger financial, or other systemically significant, conglomerates. The protections would identify and give notice to the “regulated industry” for Takings Clause purposes, provide the additional procedures necessary to solve *Mathews* test problems, and mitigate the concerns of biased decisionmaking by offering a market check on the decisionmaker.

Specifically, this Article agrees, with some caveats, that the list of non-FDIC insured institutions that could be subject to resolution authority, as provided by the Dodd-Frank Act, is a good idea. It is important, however, that the list be published in advance and revised as the government concludes that some institutions belong on the list, or that some have shrunk or otherwise limited themselves sufficiently to be removed. It is also slightly alarming that the Act includes a class of financial companies that become subject to resolution authority without any listmaking by the regulators—namely, those firms deemed bank holding companies with \$50 billion of assets do not get the benefit of an individualized assessment of whether they belong on the list, along with the notice and comment and the assorted benefits accompanying this sort of ventilation.<sup>171</sup>

A list alone, however, is improvable. This Article suggests that resolution authority would be even more legitimate if it provided the institution’s owners an opportunity to purchase back the institution shortly after its nationalization. This opportunity may not be realistic in every case, but in at least some imaginable cases, it may cause the government to pause before committing its own funds to clean up an institution rather than offer that institution back to its owners. It also formalizes, after resolution, the informal process the government undergoes before resolution, where so-called “problem banks” are shopped by the FDIC to potential buyers, without a clear role for the input of the institution’s management. This ad hoc process is not terrible, but would be even better if it was clearly part of the resolution process as a requirement imposed on the government before nationalization. Furthermore, the prospect of a required auction, though rare in the annals of administrative law, is hardly

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<sup>171</sup> The Dodd-Frank Act allows a financial institution to contest the decision to be labeled systemically significant before the agency. The right to judicial review of that decision is somewhat less clear, however. Judicial review of decisions to exercise resolution authority are to be made through closed proceedings, however, so the publicity permitted by the statute is not entirely clear. *See* Dodd-Frank Act § 202.

outside the realm of conjecture—Lucian Bebchuk and Jesse Fried proposed just such an auction process for valuing secured claims in bankruptcy.<sup>172</sup>

The following subsections consider the advantages and disadvantages of such an approach and conclude that it offers more predictability, certainty, and flexibility than would the broader, Executive-Branch-and-financial conglomerates-only alternative that Congress passed.

### *1. Making a List*

There is much to recommend in providing a list of companies that are bigger than banks and thrifts that would be covered by the expanded power of resolution authority. This subsection of the Article presents a theoretical justification for Dodd-Frank's list requirement, along with an expression of modest concern over its class of covered entities: bank holding companies with over \$50 billion in assets. A revisable list is more flexible and more certain than is resolution authority limited to financial companies, if that term were defined only by the statute, rather than also by a designation of the Financial Oversight Council.<sup>173</sup> While a "financial company" is a definition, its coverage is not always clear. For example, consider controlling investors in financial intermediaries and holders of single thrift charters, which include some very idiosyncratic companies, such as a department store and a maker of funeral caskets. There is little doubt that future mergers will create large conglomerates, with some arms having activities "financial in nature," such as providing consumers with credit to purchase the conglomerate's other products.<sup>174</sup> If other non-holding (or possibly even financial) institutions belong in that list—as suggested by the bailouts of the hedge fund Long-Term Capital Management in 1999<sup>175</sup> and the auto companies in 2008—they should be identified specifically.

In addition, many observers have suggested that the ability to predict whether a particular institution can be resolved is important both because it limits the government's choices to a defined set of institutions, and it allows investors to price the possibility of a government takeover. For example, it is

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<sup>172</sup> See Lucian Arye Bebchuk & Jesse M. Fried, *A New Approach to Valuing Secured Claims in Bankruptcy*, 114 HARV. L. REV. 2386, 2409–23 (2001) (outlining the auction method).

<sup>173</sup> For a discussion of other proposals regarding resolution authority, such as the proposal to extend the power to cover financial holding companies, see *supra* Part II.

<sup>174</sup> Donelson & Zaring, *supra* note 131.

<sup>175</sup> See ROGER LOWENSTEIN, *WHEN GENIUS FAILED: THE RISE AND FALL OF LONG-TERM CAPITAL MANAGEMENT* (2002) (recounting the fall of Long-Term Capital Management).

suggested that if we know who is subject to a government guarantee we will be able to order our affairs accordingly and with more certainty.<sup>176</sup> It is, to be sure, difficult to predict whether the ability to be seized will be seen as an advantage by the market (because of an implicit government guarantee for some creditors, such as the depositors in banks covered by the FDIC), or a disadvantage (because of the threat of seizure). But one chief advantage of resolution authority—that creditors as well as shareholders can suffer losses—suggests that the certainty of resolvableness may increase the cost of capital for the institutions on the list, and many observers worried about the problem of too big to fail institutions welcoming higher capital costs for large conglomerates not yet covered by FDIC insurance.<sup>177</sup>

Finally, another advantage to obligating the government to name the institutions that it might nationalize is that it might encourage the government to limit the number of institutions that are in fact too big to fail through other means. The exercise of naming the new and big institutions that might be subject to expanded resolution powers may help to solve a problem that Art Wilmarth has identified as particularly salient and problematic for banks. He has observed that institutions clearly deemed to be too big to fail might also be “too big to discipline adequately” because the government is unable to threaten the institutions with serious sanctions.<sup>178</sup> Since defining the threatened institution is a precondition for outlining a credible threat of discipline, publishing a list of businesses subject to resolution authority and revising that list as necessary, may provide some initial steps toward solving the “too big to discipline adequately” problem. By forcing the government to commit to certain institutions that might be on it, such a list can perhaps incentivize the government to consider ways to shrink it.<sup>179</sup> But creating a category of institutions that automatically join this list problematizes this otherwise useful approach.

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<sup>176</sup> See GARY H. STERN & RON J. FELDMAN, *TOO BIG TO FAIL: THE HAZARDS OF BANK BAILOUTS* (2004).

<sup>177</sup> Moreover, the owners and shareholders of institutions that the government identifies as subject to potential taking might strive to get off of that list, possibly by shrinking in size and, accordingly, in systemic importance.

<sup>178</sup> Arthur E. Wilmarth, Jr., *The Transformation of the U.S. Financial Services Industry, 1975–2000: Competition, Consolidation and Increased Risks*, 2002 U. ILL. L. REV. 215, 304.

<sup>179</sup> *Id.*

## 2. *The Market Out*

A list especially helps to solve the *Mathews* predeprivation process problems, and the Dodd-Frank legislation is commendable to the extent that it adopts the list requirement. But the gold standard for constitutional administrative procedure is *postdeprivation* process (such as judicial review), and simply making a list does not offer postdeprivation process. One way to address this concern is to offer to the owners and managers of systemically significant financial institutions an opportunity to buy their way out of resolution conservatorships. When banks look like they may be insolvent, the government frequently, but quietly, cajoles them to consider a sale that can get them out of trouble. But these informal efforts are not required of the government; the last clear chance for owners to do something about a financial institution that they feel is valuable, but wrongly used by regulators, comes after the seizure itself. However, there is no procedure in place to make use of the last clear chance.<sup>180</sup> When a seizure occurs, the posturing of the slow-motion failure is over and a formal resolution process has begun. At this point, the remedies to owners are restricted to judicial review of the terms they receive from the FDIC, and in a limited way at that. This Article has already discussed the difficulties faced by owners pursuing post-resolution litigation against the FDIC. Owners would benefit from a final formalized opportunity to take back control of the institution from the government: a right of first refusal.

Administrative scholars and Congress rarely urge these sorts of market solutions.<sup>181</sup> But markets are nowhere deeper than they are for American financial intermediaries, the most likely targets of any reformed resolution procedure. In the instance that the regulators erred and seized the institution unwisely, then its owners will likely be able to raise the money to buy back the institution.<sup>182</sup>

In this way, a market out for resolved financial institutions would serve as a useful safeguard against the government's reaching too quickly to nationalize viable institutions. Further, a buy-back window would, if exercised, likely

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<sup>180</sup> The last clear chance doctrine in tort is designed to deal with these sorts of games of chicken. See RESTATEMENT (SECOND) OF TORTS §§ 479, 480 (1974).

<sup>181</sup> For an example where Congress did, in fact, urge such a solution, see Ellen P. Goodman, *Spectrum Equity*, 4 J. ON TELECOMM. & HIGH TECH. L. 218–20 (2005) (discussing the FCC's slow willingness to turn to an auction model for its spectrum space after Congress ordered it to conduct auctions).

<sup>182</sup> Moreover, a guaranteed ex post buy-back opportunity may help both parties avoid posturing about the possibility of a seizure before the fact.



influence government regulators loath to spend dollars from the fisc to make up differences between the obligations of systemically significant institutions and those of their many counterparties.<sup>183</sup> The buy-back window thus concentrates the minds of both the regulators and the regulated after the critical decision has been made, but before all of those obligations are unwound. Use of the buy-back will be rare, and is thus no panacea, but there is no better way to check an economically significant decision by the government than to see if a market-driven alternative exists. Only a formal ex post auction can do this. Nor is the possibility of an auction implausible. Bebchuk and Fried have already recognized the potential power of auctions in valuing secured claims in bankruptcy, when, occasionally, secured creditors find that looking to their security does not satisfy their claims against the debtor.<sup>184</sup> Although the details of Bebchuk and Fried's scheme are complicated, the point for the purposes of this Article is that they have devised a plausible approach to auctions initiated following government action. If it can work in the context of bankruptcy, it can work in resolution as well.

Nor should the general prohibition against equity owners retaining a stake in a company reorganized following Chapter 11 bankruptcies without contributing additional value (the "absolute priority rule" and "new value corollary," respectively) present an insuperable legal problem.<sup>185</sup> As a matter of law, these bankruptcy rules need not constrain resolutions, which have been carved out of the Bankruptcy Code.<sup>186</sup> And as a matter of policy, this market-out offer *would* turn on the contribution of new value by the owners and managers of the resolved institution—it is that new value that would form the basis of the price paid to the government. Regulators particularly worried about the possibility of self-dealing by the owners during this market check could, of course, broaden the formal auction to include outsiders as well as insiders.<sup>187</sup>

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<sup>183</sup> Although economists like the idea of valuing government assets by auctioning them on occasion, the government looks to these sorts of auctions rarely.

<sup>184</sup> See Bebchuk & Fried, *supra* note 172.

<sup>185</sup> For a discussion of these rules, see *Bank of Am. Nat'l Trust & Sav. Ass'n v. 203 N. LaSalle St. P'ship*, 526 U.S. 434, 444–50 (1999).

<sup>186</sup> See *supra* note 99 and accompanying text.

<sup>187</sup> Indeed, the Supreme Court in *203 North LaSalle* suggested that a broader opportunity to participate could cure problems with the participation of equity holders in reorganized companies taken through Chapter 11. See *203 N. LaSalle*, 526 U.S. at 458 (“[S]ome form of market valuation may be available to test the adequacy of an old equity holder’s proposed contribution.”); see also Hieu T. Hoang, Comment, *The New Value Exception to the Absolute Priority Rule After In re 203 N. LaSalle Street Partnership: What Should Bankruptcy Courts Do, and How Can Congress Help?*, 149 U. PA. L. REV. 581 (2000).

### B. *Prevention from Underreach*

New resolution authority does not merely raise concerns about the prospect of executive excess. Executive modesty is an equally serious problem. Any administrative scheme that relies on the exercise of regulatory discretion at the right moment expects a lot out of its publicly employed factotums.<sup>188</sup> Regulators, no less than businesspeople, are prone to making mistakes; it would be naïve to pretend that, even at its technocratic best, the government always gets it right.<sup>189</sup> Many scholars, ranging from the Nobel-Prize-winning public choice economist James Buchanan,<sup>190</sup> to other observers such as Clifford Winston, have argued that the government's economic regulation is subject to many systematic pressures that can impinge upon its ability to make wise decisions—or any decisions at all.<sup>191</sup>

This is the problem of underreach, and this section focuses on that possibility. Having resolution authority, the government still may not exercise that authority to the degree that it should. In fact, past financial crises are replete with examples suggesting that regulators consistently forbear in the worst cases—relaxing the safety and soundness standards for failing, or downright insolvent, institutions in lieu of resolving them.<sup>192</sup> Forbearance occurred during the S&L crisis of the 1980s.<sup>193</sup> There was probably forbearance for likely insolvent institutions like Citibank and Bank of America during the recent crisis.<sup>194</sup> And cynics have noted that Citibank alone arguably

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<sup>188</sup> Ron Feldman, *Interview with Raghuram Rajan*, REGION, Dec. 2009, at 19, 23 (“There is always some amount of regulatory capture. The people the regulators interact with are people they get to know. They see the world from their perspective, and, you know, they want to make sure they’re in their good books.”).

<sup>189</sup> David Zaring, *The Post-Crisis and Its Critics*, 12 U. PA. J. BUS. L. (forthcoming 2010) [hereinafter Zaring, *The Post-Crisis*] (discussing some of the often overblown, but hardly baseless fears about government intervention in the economy that have shaped many evaluations of the post-crisis).

<sup>190</sup> Thomas Romer, *Nobel Laureate: On James Buchanan’s Contributions to Public Economics*, 1988 J. ECON. PERSP. 165.

<sup>191</sup> See CLIFFORD WINSTON, *GOVERNMENT FAILURE VERSUS MARKET FAILURE: MICROECONOMIC POLICY RESEARCH AND GOVERNMENT PERFORMANCE* (2006).

<sup>192</sup> See Charles W. Calomiris et al., *Financial Crisis Policies and Resolution Mechanisms: A Taxonomy from Cross-Country Experience*, in SYSTEMIC FINANCIAL CRISES: CONTAINMENT AND RESOLUTION 25–75 (Patrick Honohan & Luc Laeven eds., 2005). For an analysis of the competing concerns behind secrecy in bank regulation, see Heidi Schooner, *The Secrets of Bank Regulation: A Reply to Professor Cohen*, 6 GREEN BAG 2D 389, 392 (2003) (“Bank regulators generally insist on sound accounting practices. However, . . . it is not always clear that bank regulators should so insist when disclosure of a loss might threaten the solvency of a bank, or worse, the financial system.”).

<sup>193</sup> See CALAVITA ET AL., *supra* note 57, at 9–15; Calomiris et al., *supra* note 192, at 32, 73.

<sup>194</sup> See Yves Smith, *Citi and Bank of America “Encouraged” to Get More Capital as Result of Stress Tests*, NAKED CAPITALISM (Apr. 27, 2009, 11:19 PM), <http://www.nakedcapitalism.com/2009/04/citi-and-bank-of-america-e.html>.

has been insolvent—and enjoyed forbearance—three times in the past forty years, once due to sovereign debt exposure, once due to emerging markets exposure, and most recently, again, due to housing market exposure.<sup>195</sup> As Citibank costs the government more and more money, Americans might be forgiven for wishing that the bank had been nationalized and sold off or broken up much earlier.

A government that is given the strong tool of resolution authority must be encouraged to use it. But how can it be so encouraged? The answer offered here lies in the internationalization of the exercise of resolution authority. The underlying theory is that a government with broad resolution authority can be encouraged to actually utilize its tools by making its decision in an international context, subject to a beneficial sort of peer pressure and removed, to a degree, from the problems of agency interference. One international institution has already indicated its concern about cross-border resolutions of financial intermediaries.<sup>196</sup> That institution is the Basel Committee, which is an imperfect but available, active, and fully formed resource on which governments have relied since 1974 to deal with difficult problems of bank supervision.<sup>197</sup> The Committee, and other international regulatory networks like it, are increasingly essential to any coherent regulation of the ever more global financial system. Because resolution authority is one of the most important aspects of any regulatory regime, it makes sense to think about it in a global context. What follows will expand on the advantages of an international solution to the problem of resolution authority by considering the international nature of the problem, the capacity of the international system, the way such an approach would work, and the alternatives to it.

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<sup>195</sup> See *Citigroup VIEs Raise Question of Solvency*, MISH'S GLOBAL ECONOMIC TREND ANALYSIS (Feb. 26, 2008, 4:52 AM), <http://globaleconomicanalysis.blogspot.com/2008/02/citigroup-vies-raise-question-of.html>. For a podcast on this issue criticizing Citi's three bailouts, see *Chicago Booth Podcast: The Future of Markets*, U. CHI. BOOTH SCH. BUS. (June 29, 2009, 10:00 AM), <http://www.chicagobooth.edu/multimedia/podcast/?play=http://chicagobooth.edu/multimedia/audio/2009-05-29-ManConKeynote.mp3#02:07:32> (featuring six Chicago Booth faculty members including Gary Becker, Kevin Murphy, Anil Kashyap, and Steve Kaplan, as well as moderator Ray Suarez, a veteran journalist, reexamining the role of government in the economy at a special forum at the 57th annual Management Conference in Chicago).

<sup>196</sup> See BASEL COMM. ON BANKING SUPERVISION, REPORT AND RECOMMENDATIONS OF THE CROSS-BORDER BANK RESOLUTION GROUP 15 (Mar. 2010) [hereinafter BASEL COMMITTEE].

<sup>197</sup> Zaring, *The Post-Crisis*, *supra* note 189.

### 1. *International Nature of the Problem*

Cross-border strategies to resolution authority are a necessary part of any serious resolution of a big financial firm. Indeed, such institutions could not possibly be more international. All of the large financial holding companies ply their trades in, and spread their risks across, various foreign environments.<sup>198</sup> The catastrophic failures of Lehman Brothers, and the Franklin National Bank and Bank Herstatt before it, are examples of the cross-border difficulties presented by insolvency.<sup>199</sup> A quick and orderly dissolution and resolution of a multinational bank in the United States is of little worth if the institution collapses in London and Tokyo, and the creditors race to those courthouses and pick over the bank's assets while American regulators attempt to figure out exactly what the bank does and does not own.<sup>200</sup> Indeed, Lehman Brothers was shipping capital to London in vast quantities in its last days in a desperate effort to survive the financial crisis.<sup>201</sup> Another example is AIG, which sold most of its credit default protection—the business that laid it low—through London.<sup>202</sup>

Perhaps unsurprisingly, then, American regulators have threatened to include certain large foreign institutions in their definition of financial companies that would be subject to resolution, and in fact, the Dodd-Frank Act provides for their regulation.<sup>203</sup> But these regulators also have recognized that

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<sup>198</sup> See, e.g., *id.* (suggesting coordinated resolution of financial institutions in light of their increasingly global nature).

<sup>199</sup> See *supra* notes 38–42 and accompanying text.

<sup>200</sup> See BASEL COMMITTEE, *supra* note 196, at 15 (“In the event of the failure of a cross-border financial institution, once the relevant component entities enter into insolvency proceedings, the insolvency regimes applicable to the major entities are likely to be separate proceedings . . . .”); see also *id.* at 18 (“The concepts of universality and territoriality strictly only describe the way in which national authorities will apply their insolvency and related resolution processes to individual institutions (a financial institution with branches and assets located in other jurisdictions). These concepts are not determinative in the situation of financial groups consisting of multiple legal entities. Accordingly whether a jurisdiction follows the universal approach or territorial approach in relation to branches does not govern the resolution of subsidiaries of foreign institutions. In both cases, the subsidiary is subject to separate, local insolvency proceedings.”).

<sup>201</sup> *Left in Limbo—or Worse—by Lehman*, N.Y. TIMES DEALBOOK BLOG (Oct. 1, 2008, 12:08 PM), <http://dealbook.blogs.nytimes.com/2008/10/01/left-in-limbo-or-worse-by-lehman/> (“The fallout appears to be rooted in Lehman’s London unit, where the firm handled billions of dollars in transaction from hedge fund clients from all over the world. Many funds chose to clear trades through London because of regulatory rules that allowed firms to borrow more money than they could from brokers in New York.”).

<sup>202</sup> See Mary Williams Walsh, *Risky Trading Wasn’t Just on the Fringe at A.I.G.*, N.Y. TIMES, Jan. 31, 2010, at B1; see also Langley et al., *supra* note 12.

<sup>203</sup> See *infra* notes 205–10 and accompanying text.

unilateral efforts to take over a big European or Japanese bank with a substantial American presence is likely to be exceedingly difficult.<sup>204</sup>

The result in the past has often been a race to the courthouse when financial intermediaries fail. The American approach to cross-border insolvencies exemplifies the problem, though the courts and Congress have tried to improve their global footprint. The question of how a United States court should act in the context of a cross-border insolvency has been the subject of a historical debate between two competing theories: territorialism and universalism.<sup>205</sup> Under the territorial approach, American courts and regulators have failed institutions without foreign consultation; the universal approach contemplates a more coordinated process.

An example of the difference between territorialism and universalism is found in bankruptcy: under its territorial approach, “the court in each jurisdiction where the debtor has assets distributes the assets located in that jurisdiction pursuant to local rules.”<sup>206</sup> This approach “is often referred to derogatorily as ‘the grab rule’ because each court takes control of the estate of a debtor and tends to distribute them in a way that favors local creditors.”<sup>207</sup>

By contrast, the universal approach contemplates “a primary insolvency proceeding. . . in the debtor’s domiciliary country” with courts in other jurisdictions where the debtor has assets “defer[ring] to the foreign proceeding. . . to facilitate the centralized liquidation of the debtor’s estate according to the rules of the debtor’s home country.”<sup>208</sup> The United States has moved toward the universal approach, but the problem becomes finding the right country in which to centralize resolution or liquidation. In bankruptcy, the American approach contemplates a number of factors in deciding whether an American court should coordinate its efforts to deal with a bankrupt firm that has a presence in other countries—and that has filed for bankruptcy in those

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<sup>204</sup> See *infra* notes 205–09 and accompanying text.

<sup>205</sup> See, e.g., Nigel John Howcroft, *Universal vs. Territorial Models for Cross-Border Insolvency: The Theory, the Practice, and the Reality That Universalism Prevails*, 8 U.C. DAVIS BUS. L.J. 366, 368 (2008) (“[T]wo trends have emerged: the ‘universal’ approach and the ‘territorial’ approach.”).

<sup>206</sup> *In re Treco*, 240 F.3d 148, 153 (2d Cir. 2001).

<sup>207</sup> Howcroft, *supra* note 205, at 371.

<sup>208</sup> *Treco*, 240 F.3d at 153; see also Howcroft, *supra* note 205, at 370 (“In its pure form, a universal approach dictates that other jurisdictions recognize the orders of the court overseeing the main jurisdictional proceedings. This means that each time a jurisdiction embracing universalism is (a) implicated in a case and (b) is not the main jurisdiction, that jurisdiction must recognize the world-wide reach of the proceeding on foot in the main jurisdiction.”).

countries as well.<sup>209</sup> These factors include comity, but particularly focus on the principle place of business of the insolvent institution. The suggestion of this Article is only that regulators forcing resolutions ought to move in the same direction that courts are already headed in matters of bankruptcy. Congress also has insisted that the government, in resolving an institution, “shall coordinate, to the maximum extent possible, with the appropriate foreign financial authority regarding the orderly liquidation of any covered financial company that has assets or operations in a country other than the United States.”<sup>210</sup>

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<sup>209</sup> Section 304 of the Bankruptcy Code (now superseded by Chapter 15 of the Code), “enacted as part of the Bankruptcy Reform Act of 1978, ‘was intended to deal with the complex and increasingly important problems involving the legal effect the United States courts will give to foreign bankruptcy proceedings.’” *Treco*, 240 F.3d at 153 (quoting *Cunard S.S. Co. v. Salen Reefer Servs.* AB, 773 F.2d 452, 454 (2d Cir. 1985)). As the *Treco* court noted, § 304’s enactment was “a step toward the universality approach.” *Id.* at 154; see also Andrew B. Dawson, *Offshore Bankruptcies*, 88 NEB. L. REV. 317, 325 (2009) (“Since its enactment in 1978, the United States Bankruptcy Code has endorsed a universalist-type treatment of cross-border insolvencies by encouraging cooperation with foreign bankruptcy courts.”). It allowed “a foreign representative [to] commence an ancillary proceeding to assist the foreign proceeding” and “provid[ed] that a foreign representative may request injunctive relief, turnover, or ‘other appropriate relief’ in connection with a foreign proceeding.” Francisco Vazquez, *Cross-Border Bankruptcy Developments: The Movement Towards Universality in the United States*, 2005 ANN. SURV. BANKR. L. 633, 636. However, § 304 did “not require an extension of comity to all foreign proceedings or foreign countries” and was therefore characterized as adopting a “‘modified’ form of universality.” *Id.* Indeed, before relief would be deemed appropriate under § 304, a foreign representative would have to establish that relief would:

assure an economical and expeditious [sic] administration of such estate, consistent with—

- (1) just treatment of all holders of claims against or interests in such estate;
- (2) protection of claim holders in the United States against prejudice and inconvenience in the processing of claims in such foreign proceeding;
- (3) prevention of preferential or fraudulent disposition of property of such estate;
- (4) distribution of proceeds of such estate substantially in accordance with the order prescribed by [the Bankruptcy Code];
- (5) comity; and
- (6) if appropriate, the provision of an opportunity for a fresh start for the individual that such foreign proceeding concerns.

*Id.* (quoting 11 U.S.C. § 304(c) (2000)).

Although comity was a consideration under § 304, its hodgepodge of factors—along with the subjective nature of the term “comity” itself—stymied predictability. See Kevin J. Beckering, *United States Cross-Border Corporate Insolvency: The Impact of Chapter 15 on Comity and the New Legal Environment*, 14 L. & BUS. REV. AM. 281, 296 (2008) (“[S]ection 304(c) cannot yield certain, or even predictable, results.”). After all, “[o]ne judge’s balance of the interests of different States to achieve his/her understanding of justice will differ from the balance of another judge, and such variance is amplified by broad authority and flexibility.” *Id.*

<sup>210</sup> Dodd-Frank Act § 201(a)(N).

## 2. *Capacity of the International System*

Prompted by three large international bank failures in 1974,<sup>211</sup> the Central Bank Governors of the Group of Ten Countries (G-10), Luxembourg, and Switzerland agreed to establish the Basel Committee on Banking Supervision that year.<sup>212</sup> The members declared that the primary purpose of the Committee would be to provide its members with a regular forum for airing cooperative approaches to the supervision of multinational banks.<sup>213</sup> In addition to simply recognizing the need to coordinate supervision over multinational financial institutions, the Committee has been a model of insulated technocratic expertise, pursuing policies internationally that individual regulators might find impossible to implement domestically. It also offers a system of monitoring to ensure that its members and other banking supervisors are actually implementing at home what they represented they would do in the Committee. This prospect of peer review and international technocratic insulation, in an already extant committee, is likely to provide the most realistic mechanism for stiffening the spine of would-be bureaucratic resolvers.

Since its founding, the Basel Committee has served both as the venue for the exchange of information about supervisory practices and as the mechanism for the promulgation of hard standards to which all members of the Committee must subscribe. It rotates its chairmanship and operates through consensus.<sup>214</sup> If limitations on leverage are instituted for the largest international players, they will probably come from Basel.<sup>215</sup> And Basel has indicated that it wants to play a role in cross-border transactions.<sup>216</sup>

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<sup>211</sup> See *supra* note 38 and accompanying text.

<sup>212</sup> The Committee's members come from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Spain, Sweden, Switzerland, the United Kingdom, and the United States. See *About the Basel Committee*, BANK FOR INT'L SETTLEMENTS, <http://www.bis.org/bcbs/aboutbcbs.htm> (last visited Aug. 29, 2010).

<sup>213</sup> See Press Communiqué, Bank for Int'l Settlements (Feb. 12, 1975) [hereinafter Press Communiqué] (on file with author); see also Joseph J. Norton, *Trends in International Bank Supervision and the Basel Committee on Banking Supervision*, 48 CONSUMER FIN. L.Q. REP. 415, 415 n.1 (1994).

<sup>214</sup> See TONY PORTER, STATES, MARKETS, AND REGIMES IN GLOBAL FINANCE 66 (1993); Joseph J. Norton, *Privatization of Public Pension Systems in Developing Nations: A Call for International Standards*, 64 BROOK. L. REV. 817, 857 (1998).

<sup>215</sup> Not least because the American leverage requirements are, while not nothing, statutorily required only at a ratio of 15:1. See Dodd-Frank Act §§ 113(a), 716.

<sup>216</sup> This concern is emphasized in the Basel Committee's Report and Recommendations of the Cross-Border Bank Resolution Group, which was prepared in anticipation of the G-20 Summit Meeting. See BASEL COMMITTEE, *supra* note 196.

In fact, financial regulators have already devised a robust international process to deal with the problems of financial market globalization. This process has been called upon to support existing G-20 and other international initiatives.<sup>217</sup> It has addressed capital requirements, increased regulation of credit rating agencies, convergence of regulations, OTC derivatives markets, cross-border supervisory colleges, and various other aspects of commonplace financial regulation.

Moreover, the international networks of regulators offer something more than soft, easily avoidable rules (though they certainly do offer such rules). They also offer a respite from domestic politics and a competence-based international organization in which domestic regulators can focus on better rulemaking outside of the ambit of political control.<sup>218</sup> In the domestic arena, congressmen may agitate for regulatory forbearance, and the politics facing regulators make it difficult for those regulators to pull the trigger.<sup>219</sup>

In fact, there is already some sense that operating through Basel may offer a wider range of possibilities for revising financial regulation than would pursuing domestic reform: on the too big to fail problem, the Committee has suggested, for example, introducing leverage caps on banks. American regulators have failed to propose a domestic cognate, despite the appeal of such caps.<sup>220</sup>

With regard to resolution, moreover, the Basel Committee has already had something to say.<sup>221</sup> It has proposed a “middle ground approach that

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<sup>217</sup> See Zaring, *Crisis Performance*, supra note 39, at 495–500 (discussing the G-20’s development as a priority-setting mechanism as one of the effects of the crisis).

<sup>218</sup> And of course, the opportunity to avoid political pressures is one of the motivating reasons to create an agency. See Eben Albert-Knopp, Note, *The California Gas Charge and Beyond: Taxes and Fees in a Changing Climate*, 32 VT. L. REV. 217, 222 (2007) (“[A]gencies are not directly beholden to any particular constituency and may thereby avoid some of the political pressure brought to bear on legislatures.”).

<sup>219</sup> See supra notes 41–42 and accompanying text.

<sup>220</sup> See Press Release, Bank for Int’l Settlements, Initiatives in Response to the Crisis by the Basel Committee (Mar. 30, 2009) [hereinafter Press Release, Bank for Int’l Settlements, Initiatives], available at <http://www.bis.org/press/p090330.htm>; Press Release, Bank for Int’l Settlements, The Basel Committee Issues Papers on Operational Risk (July 28, 2009), available at <http://www.bis.org/press/p090728.htm>. The Federal Reserve has not been able to, on its own, come up with new rules to impose leverage caps on banks, increase their capital adequacy, or change the way that their various kinds of capital are accounted for, such as capital based on residential mortgages without this sort of international help. See David A. Moss, *Lowering the Boom on Financial Leverage*, HUFFINGTON POST (Feb. 22, 2010, 10:48 AM), [http://www.huffingtonpost.com/david-a-moss/lowering-the-boom-on-fina\\_b\\_471472.html](http://www.huffingtonpost.com/david-a-moss/lowering-the-boom-on-fina_b_471472.html) (discussing “[t]he struggle for financial regulatory reform in Washington”).

<sup>221</sup> James Hamilton, *Levit, Volcker Stress Need for Resolution Authority for Large Financial Institutions; Basel Urges Cross-Border Framework*, CCH FINANCIAL REFORM NEWS CENTER (Sept. 24, 2009, 4:23 PM),



recognizes the strong possibility of ring fencing in a crisis and helps ensure that home and host countries as well as financial institutions focus on needed resiliency within national borders.”<sup>222</sup> The recommendations are rooted in fostering cooperation through “[g]reater convergence in national laws, by promoting a common understanding, more predictability, and reliable frameworks for responsive actions.”<sup>223</sup> The Committee, to be sure, is by no means perfect, but the prescription in this Article does not depend upon perfect regulation from Basel.

### 3. *Operation of an International Approach*

The reason to resort to an international approach to resolution authority is not because the international institutions that would perform the task are so adept in matters of crisis response, whatever their merits as policymakers.<sup>224</sup> Indeed, as we saw during the last crisis, the Basel Committee decides and acts slowly, if at all, meaning that the Committee itself has little to say during fast-moving events.<sup>225</sup> Accordingly, as a Committee, although it may be relied upon to put some modest procedures in place for resolving *future* cross-border insolvencies (and, as it does so, this is the hook on which the internationalization of the resolution decision would lie),<sup>226</sup> the advantage of international organization—in this case, at least—does not lie in tasking the decision about what to do with any particular bank to Basel. That Committee, acting as a committee, is unlikely to be able to act; it is not itself a responsive, crisis-ready regulator, but rather a forum for the coordination of policymaking.

But coordinating resolution authority through Basel exploits the advantage of the international forum without depending on the forum itself to act. (Indeed, Basel itself purports to be nothing more than a coordinator of the interests of its members.)<sup>227</sup> It is also an insulator from domestic pressures, and as Robert Putnam has shown, that form of insulation can give regulators

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<http://www.financialcrisisupdate.com/2009/09/levitt-volcker-stress-need-for-resolution-authority-for-large-financial-institutions-basel-urges-cross-border-framework.html>.

<sup>222</sup> BASEL COMMITTEE, *supra* note 196, at 19.

<sup>223</sup> *Id.*

<sup>224</sup> Zaring, *Crisis Performance*, *supra* note 39, at 478 (“[I]nternational networks, such as the Basel Committee on Banking Supervision and the International Organization of Securities Commissions (IOSCO), have not been the loci of any serious response to the crisis.”).

<sup>225</sup> *Id.*

<sup>226</sup> Press Release, Bank for Int’l Settlements, Initiatives, *supra* note 220.

<sup>227</sup> Press Communiqué, *supra* note 213.

flexibility.<sup>228</sup> On this understanding, it is the independence of the global stage, rather than the strength of the global institution, that makes it a good place for American regulators to actually use the regulation authority that they hold.<sup>229</sup> And so, in a crisis, one might expect the Federal Reserve to announce in Basel a coordinated decision to resolve a cross-border institution (such as Bear Stearns), with operations in a number of the jurisdictions overseen by members of the Committee in conjunction with their international counterparts. The resolution could be guided by Basel's principles for cross-border action and announced by American regulators in coordination with European and Japanese counterparts. Basel here provides only substructure—the ability to coordinate and to hold regular meetings that ensure such coordination—that would remove the decision to resolve from the domestic context in which it has been exercised so rarely.

This approach posits Basel, and international institutions more generally, as a safe harbor, where regulators can contemplate their mandates somewhat removed from the domestic political pressures that would shape those mandates. It is not a perfect solution, but one that suggests that the technocratic basis for seizure of a large financial intermediary is best regarded not as a political and domestic decision, but an international one, requiring expert judgment and a degree of multinational coordination.

Finally, an international solution to resolution authority might surpass a unilateral American approach for other more tangential reasons. For instance, it might forestall the World Trade Organization from acting on the basis of a unilateral contribution of funds during the course of a resolution by coordinating it internationally. And it might more generally foster the recognition that financial regulation is increasingly an international matter.<sup>230</sup>

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<sup>228</sup> See Robert D. Putnam, *Diplomacy and Domestic Politics: The Logic of Two-Level Games*, 42 INT'L ORG. 427 (1988).

<sup>229</sup> Indeed, the history of Basel is replete with examples of regulators acting in ways arguably inconsistent with the interests of their domestic industries; Japan's willingness to accede to capital adequacy requirements that its banks did not meet is an example. See DAVID ANDREW SINGER, *REGULATING CAPITAL: SETTING STANDARDS FOR THE INTERNATIONAL FINANCIAL SYSTEM* 53, 60–61 (2007).

<sup>230</sup> The WTO law on subsidies governs any "financial contribution" made by or at the direction of "a government or any public body within the territory of a Member," where certain conditions are met. WTO Agreement on Subsidies and Countervailing Measures art. 1.1, Apr. 15, 1994, Marrakesh Agreement Establishing the World Trade Organization, Annex 1, 1867 U.N.T.S. 14. A resolution process directed only at domestic firms, if it enabled those institutions to acquire capital more cheaply than their competitors, might count as a financial contribution in violation of the WTO's subsidy disciplines, contingent upon, among other things, a showing of serious prejudice. *Id.* art. 6.2.

#### 4. *Theory and Alternatives*

Of course, there are other more theoretical ways to stiffen the spine of American financial bureaucrats in cases where large institutions become increasingly obviously insolvent. By positing that considered resolutions will most likely be made in the international arena, this Article suggests a doubling down on the merits of expertise and a turn away from straightforward reward- and punishment-based incentives that could also get regulators to act.

For example, regulators could be incentivized to exercise their regulatory authority through domestic benefits; money or leisure rewards offer the classical incentive-based approaches. Individual regulators could receive cash bonuses for implementing resolutions. Agencies could be awarded larger budgets for acting to resolve troubled institutions. Additional resources offer not just pecuniary benefits and a degree of prestige, but perhaps even the leisure of more employees to perform the same sort of job, and so on. But bonuses for bankrupting financial intermediaries are incentives that would have to be carefully managed, lest they backfire. Plus, they would probably depend on future congressional appropriations that are always uncertain. The carrot might appear unrealistic indeed to regulators, who are told that they might be compensated for acting against institutions that are thought to have lobbying machines with sufficient resources in place as it is.

The other similarly unrealistic way to persuade regulators to act involves punishment. In theory, budgets could shrink after failures to resolve, or the powers to resolve could transfer to other agencies in the future. There is little theoretical reason to believe that a credible threat of reorganization in the wake of a failure to resolve would not work on the principals of the financial regulatory agencies. But in practice, the fear of punishment meted out by Congress or anyone else is limited.

Instead, we usually see the opposite sorts of incentives in the real world for regulatory failure. Budgets tend to grow at institutions that have failed to catch wrongdoers in the act.<sup>231</sup> In the aftermath of the recent financial crisis, the Securities and Exchange Commission—notably the ineffective overseers of the large investment banks that either collapsed or reorganized during this time—

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<sup>231</sup> See, e.g., Mary K. Olson, *Managing Delegation in the FDA: Reducing Delay in New-Drug Review*, 29 J. HEALTH POL. POL'Y & L. 397, 403 (2004) (“[I]t is difficult for politicians to credibly commit to rewarding or punishing agency performance ex post.”).

has seen its budget increased.<sup>232</sup> And the problem is not just one at the agency level. Civil service and protections make it difficult to fire employees for failing to exercise their resolution authority, so threats of “if they are not resolved, you are fired” would be difficult to implement.<sup>233</sup> Accordingly, the firm-level examiners are unlikely to find the prospect of punishment particularly relevant should they fail to quickly and appropriately resolve insolvent institutions.

In sum, because the stick does not seem to be any more realistic than some of the more straightforward carrots of bonuses or budget increases for successful exercises of resolution authority, actual use of resolution authority will depend on a broader view of the matters that motivate agencies. One of the original bases for the exercise of political control is the value of independent and insulated expertise.<sup>234</sup> The Federal Reserve, like most of the central banks of developed countries, has been designed to exercise a strong degree of independence from the political pressures of ordinary domestic politics in setting monetary policy.<sup>235</sup> Further, the belief that independent expertise could matter is a traditional basis for bureaucratic regulation. Richard Stewart characterized this belief as coincident with the era of the founding of many regulatory agencies in administrative law.<sup>236</sup> To be sure, in Stewart’s view (and the views of others ranging from George Stigler to Ralph Nader), modern agencies are as likely to be captured by regulated industry as to adequately realize their regulator missions.<sup>237</sup> And despite the fact that stories about agency failure and capture are often more consistent with theory

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<sup>232</sup> SEC. & EXCH. COMM’N, IN BRIEF: FY 2011 CONGRESSIONAL JUSTIFICATION 2 (2010), available at <http://www.sec.gov/about/secfy11congbudgjust.pdf>.

<sup>233</sup> Federal employees may generally only be fired for cause, a difficult standard to meet. See *Humphrey’s Ex’r v. United States*, 295 U.S. 602, 626 (1934). This standard has been written into the charters of financial regulators like the SEC. Lisa Schultz Bressman & Robert B. Thompson, *The Future of Agency Independence*, 63 VAND. L. REV. 599, 600 n.2 (2010) (“Although the SEC statute lacks explicit removal language, it is ‘commonly understood’ to include a ‘for cause’ removal limitation.”).

<sup>234</sup> For examples of proponents of these views, see GARY LAWSON, *FEDERAL ADMINISTRATIVE LAW* 12–20 (4th ed. 2007).

<sup>235</sup> See Michael S. Barr & Geoffrey P. Miller, *Global Administrative Law: The View from Basel*, 17 EUR. J. INT’L L. 15, 18 (2006) (describing the insulation of central banks, including the Federal Reserve, from political pressures).

<sup>236</sup> See Richard B. Stewart, *The Reformation of American Administrative Law*, 88 HARV. L. REV. 1667 (1975) (discussing traditional model in which agencies were given independence and monitored to prevent illegal, rather than biased, actions).

<sup>237</sup> See Joshua Green, *Inside Man*, ATLANTIC, Apr. 2010, at 36 (describing the Stigler and Nader schools of capture theory).

than with practice,<sup>238</sup> it may be the case that the coziness of the relationship between the regulators and regulated, and the intensity of lobbying from Capitol Hill, have contributed to the unwillingness of regulators to act against insolvent financial intermediaries.<sup>239</sup> If this is the case, the insulation from those sorts of pressures that results from the removal of the decision-making process to the global scene is probably the best way to get some more authority in place. Indeed, Basel's implemented system of peer review only bolsters its advantages in this regard.

International interactions are no panacea, but they (1) can allow for the deployment of expertise, (2) can build capacity among domestic regulators, and (3) are somewhat isolated from the political process.<sup>240</sup> While few doubt, for example, that national champions are hard to curb by national regulators acting alone, the international context may curb them.<sup>241</sup> And more generally, Putnam's work on the flexibility afforded by international interaction holds particularly true for the regulation of contagious problems like international finance.<sup>242</sup>

## CONCLUSION

The goal of this Article is not only to offer technical solutions to problems of resolution authority but to think more generally about the systemic implications for governance and administration implicit in the power to destroy. The government faces two problems when tasked with using that power.

The first is that it will act destructively. This Article has focused on the problem of overreach: the broad grant of power raises the threat that the government may go too far and nationalize viable institutions, wiping out their shareholders and removing their executives instantly and opaquely. This sort of power—too much resolution authority—is daunting for regulated banks and

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<sup>238</sup> See Daryl J. Levinson, *Empire-Building Government in Constitutional Law*, 118 HARV. L. REV. 915, 916 (2005) ("The kind of rampant empire-building that courts and constitutional theorists imagine would seem to require government officials who care more about aggrandizing the institutions in which they work than about pursuing either the interests of the citizens they represent or their own self-interest. Democratic governments are unlikely to generate such officials.").

<sup>239</sup> See Simon Johnson, *The Quiet Coup*, ATLANTIC, May 2009, at 46.

<sup>240</sup> While networks like the Basel Committee are promising, they are not always effective in the face of crisis. See Zaring, *Three Challenges*, *supra* note 41, at 215–17 (analyzing the performance of the Basel Committee and the International Organization of Securities Commissions after the collapse of Bear Stearns).

<sup>241</sup> D.N. Ghosh, *National Champions in the Financial Sector*, 36 ECON. & POL. WKLY. 261 (2001).

<sup>242</sup> See Putnam, *supra* note 228.

thrifts, and if applied to a broader, less well-defined set of institutions, could scare a broad swath of investors. Corporate executives might worry about creating institutions that become so successful in the marketplace that they become systemically significant—and accordingly nationalizable. Hence this Article proposes addressing the overreach cases through market solutions and pre-seizure notice and publication.<sup>243</sup> The intuition is that if resolution authority is broadened beyond the limitations of the bank and thrift charters, some allowances must be made for the protection of those who risk overweening government intrusion on their nonetheless viable institutions.

The second potential problem is that the government will not act. And indeed, it has often failed to act in the past when it should have resolved insolvent institutions. It has instead pursued the opposite course, permitting them to continue to ignore the usual constraints and to take risks in a bid to make it back to solvency.<sup>244</sup> The failure to act is apparent from the government's eschewing of PCA in the most recent crisis, as this Article has demonstrated.

There is no ideal solution to the problem of getting the government to act when it must, but it may help to internationalize those questions of whether to resolve. Internationalization would both insulate regulators from some of the pressures that may prevent them from exercising their resolution powers, and place them in the context of a forum in which the expertise of numerous financial overseers can inform particularly serious problems. As Justice Brandeis recognized long ago, sometimes a technocratic approach is the best way to address particularly serious problems of government inaction because agencies can deploy skills that courts and legislatures cannot or will not use.<sup>245</sup>

Resolution authority is a dramatic government act. But a solution that embraces the values of international cooperation and the values of markets, in addition to commonsense domestic administrative procedures, would make for truly innovative financial regulation. In fact, resolution authority might become a model for other forms of important economic regulation. In this sense, it may act as a guide for other sorts of regulation in the future.

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<sup>243</sup> See *supra* Part II.

<sup>244</sup> See Calomiris et al., *supra* note 192.

<sup>245</sup> *Pennsylvania v. West Virginia*, 262 U.S. 553, 623 (1923) (Brandeis, J., dissenting) (noting the inability of courts to deal with highly technical subjects such as natural gas production and distribution).