BANKRUPTCY'S LORELEI: THE DANGEROUS ALLURE OF FINANCIAL INSTITUTION BANKRUPTCY*

(FORTHCOMING 97 NORTH CAROLINA LAW REVIEW (2019))

ADAM J. LEVITIN**

The idea of a bankruptcy procedure for large, systemically important financial institutions exercises an irresistible draw for some policymakers and academics. Financial institution bankruptcy promises to be a transparent, law-based process in which resolution of failed financial institutions is navigated in the courts. Financial institution bankruptcy presents itself as the antithesis of an arbitrary and discretionary bailout regime. It promises to eliminate the moral hazard of too-big-to-fail by ensuring that creditors will incur losses, rather than being bailed out. Financial institutions bankruptcy holds out the possibility of market discipline instead of an extensive bureaucratic regulatory system.

This Article argues that financial institution bankruptcy is a dangerous siren song that lures with false promises. Instead of instilling market discipline and avoiding the favoritism of bailouts, financial institution bankruptcy is likely to simply result in bailouts in bankruptcy garb. It would encourage bank deregulation without the elimination of moral hazard that produces financial crises. A successful bankruptcy is not possible for a large financial institution absent massive financing for operations while in bankruptcy, and that financing can only reliably be obtained on short notice and in distressed credit markets from one source: the United States government. Government financing of a bankruptcy will inevitably come with strings attached, including favorable treatment for certain

** Agnes N. Williams Research Professor of Law, Georgetown University Law Center. This Article draws on Congressional testimony I gave in July 2015 before the House Financial Services Committee regarding the CHOICE Act, which would amend the Bankruptcy Code to include a financial institutions bankruptcy subchapter. The Article has also benefitted from comments from Don Bernstein, Anna Gelpern, Edward Janger, Richard Levin, and the participants at the 2018 Jay Westbrook Symposium. Thank you to Julia Dimitriadis and David Frey for research assistance.

creditor groups, resulting in bankruptcies that resemble those of Chrysler and General Motors, which are much decried by proponents of financial institution bankruptcy as having been disguised bailouts.

The central flaw with the idea of financial institution bankruptcy is that it fails to address the political nature of systemic risk. What makes a financial crisis systemically important is whether its social costs are politically acceptable. When they are not, bailouts will occur in some form; crisis containment inevitably trumps rule of law. Resolution of systemic risk is a political question, and its weight will warp the judicial process. Financial institution bankruptcy will merely produce bailouts in the guise of bankruptcy while undermining judicial legitimacy and the rule of law.

INTRODUCTION

Financial institution bankruptcy is the Lorelei of the restructuring world.[1] The idea of financial institution bankruptcy calls out in a golden voice, singing "I am Law, I am Law. I brook no favoritism or cronyism, I permit no bailout. My rules are neutral, predictable, and generally applicable. I answer not to the whim of unaccountable bureaucrats, but am Law." With this siren song, the tempting concept of financial institution bankruptcy ("FIB")—the use of federal bankruptcy courts as a forum for resolving large, failed financial institutions—lures unwitting policymakers to the rocky shoals of a financial crisis, for FIB is a fib. It is not workable as a restructuring system, and to the extent the restructuring of large, systemically important financial institutions is attempted in bankruptcy, it will undermine the credibility of the bankruptcy system writ large.

The lure of the FIB Lorelei comes not from her inherent beauty, but from her comparative attractiveness relative to the alternative method of dealing with the failure of large financial institutions—bailouts. Nobody likes a bailout. Bailouts are messy by nature. They do not follow rules or law. Instead, they are ad hoc, improvised, and unpredictable responses to crises. Bailouts are messy mainly because they have a singular goal to which all other concerns, including rule of law, are temporarily subordinated—containing financial crises so they do not wreak broader havoc on the economy. Implicit in bailouts is the idea that the rule of law is a means to social welfare, not an end in itself. In a bailout, if rule of law impedes social welfare, the law will be stretched, changed, ignored, or jettisoned, at least temporarily.[2]

Revulsion toward bailouts is not just a function of their lawlessness. It is also because bailouts create opportunities for government favoritism, as has been alleged regarding the GM and Chrysler bankruptcies.[3] By deciding

1. Heinrich Heine, *Die Lorelei* (1824) (poem naming the siren who, from her perch atop a mountain overlooking the River Rhine, draws the gazes of sailors upwards and away from the treacherous rocks in their course).

2. Anna Gelpern, *Financial Crisis Containment*, 41 CONN. L. REV. 1051, 1057 (2009) ("[C]ontainment may call for measures . . . that are legally and politically fraught."); Adam J. Levitin, *The Politics of Financial Regulation and the Regulation of Financial Politics: A Review Essay,* 127 HARV. L. REV. 1991, 2017 (2014).

3. *See, e.g.*, Todd J. Zywicki, *Economic Uncertainty, Courts, and the Rule of Law*, 35 HARV. J.L. & PUB. POL'Y 195, 200 (2011) ("When politicians are not constrained they take advantage of that freedom of opportunity to benefit themselves. The General Motors and Chrysler bailouts might

whom to bailout and on what terms, the government is not just picking winners and losers in the economy, but also potentially enriching particular parties at taxpayer expense.[4] Given that bailouts are often undertaken through independent regulatory agencies, such as the Board of Governors of the Federal Reserve, that are not directly answerable at the ballot box, such cronyism is all the more distressing because there is not even an ex post disciplinary mechanism.

Moreover, to the extent creditors of large financial institutions believe ex ante they will be bailed out if a large financial institution fails, they will be more reckless in their lending to large financial institutions and extend too much underpriced credit.[5] The expectation of bailouts not only creates a moral hazard for lenders, but it incentivizes financial institutions to grow to be too big to fail—that is, to grow to a size and importance where their creditors are likely to be bailed out if they fail because the social costs and disruption from not doing so would be so large as to be politically unacceptable.[6] The result of anticipated bailouts is a downward spiral of reckless lending and bailouts.

A. Orderly Liquidation Authority as a Response to the 2008 Bailouts

Congress responded to the bailouts that marked the financial crisis of 2008 with the Dodd-Frank Wall Street Reform and Consumer Protection Act.[7] The Dodd-Frank Act imposes a wide array of additional prudential regulations designed to prevent financial institutions from failing in the first place. But it also includes as title II of the Act, an "Orderly Liquidation Authority," ("OLA") that gives federal regulators broad powers to place

be the most obvious and egregious examples of this dynamic from the financial crisis."); Paul Roderick Gregory, *American Airlines Shows the Corruption of Obama's GM Bailout*, FORBES (Feb. 6, 2012, 2:16 PM), https://www.forbes.com/sites/paulroderickgregory/2012/02/06/american-airlines-shows-the-corruption-of-obamas-gm-bailout/#48a8730d5eb8 [https://perma.cc/MTD3-UCP7] (arguing that the Obama Administration's bailout of General Motors was the result of political favoritism toward the United Auto Workers labor union).

4. *See* Zywicki, *supra* note 3, at 200 ("With Chrysler, the government intervened to take money from the company's creditors—which included the pension funds for teachers and policemen—and give it to the retirement and health care funds of the politically powerful United Auto Workers, who had an unsecured claim in the case.").

5. *See, e.g.*, *Financial Institution Bankruptcy Act of 2017: Hearing on H.R. 1667 Before the Subcomm. on Regulatory Reform, Commercial and Antitrust Law of the H. Comm. on the Judiciary*, 115th Cong. 9 (2017) (statement of John B. Taylor) (arguing that the expectation of bailouts reduces creditor incentive to monitor loans). The concern about creditors expecting bailouts sits in tension with another frequent criticism of bailouts—namely, their unpredictability. *See, e.g.*, David A. Skeel, Jr., *Single Point of Entry and the Bankruptcy Alternative*, *in* ACROSS THE GREAT DIVIDE: NEW PERSPECTIVES ON THE FINANCIAL CRISIS 311, 320 (Martin Neil Baily & John B. Taylor eds. 2014) (noting the problem of unpredictability for bailouts).

6. Adam J. Levitin, *In Defense of Bailouts*, 99 GEO. L.J. 435, 439-40 (2011).

7. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified as amended in scattered sections of 7, 12, 15, 22, 31, and 42 U.S.C.).

failing "financial companies"—not just depositories—that pose systemic risk into a receivership administered by the Federal Deposit Insurance Corporation ("FDIC").[8]

The OLA, which has not been used to date, has numerous statutory limitations upon it,[9] but it also gives federal regulators substantial discretion in whether to trigger the authority. Triggering OLA requires the turning of "three keys" by various regulators: (1) the Treasury Secretary, in consultation with the President, must determine that the firm is in default or danger of default, that its resolution outside of OLA would have "serious adverse effects on the financial stability of the United States, and the effect on creditors is "appropriate" given the threat to financial stability; (2) two-thirds of the Federal Reserve Board must approve the receivership; and (3) two-thirds of the FDIC Board (or two-thirds of the SEC for broker-dealers or the Director of the Federal Insurance Office for insurance companies) must approve the receivership.[10] The requirement of the three keys ensures that OLA will not be triggered without broad buy-in from both a politically accountable party and from politically-insulated independent agencies. In other words, OLA is designed to be a consensus-based procedure.

Once OLA is triggered, the FDIC has substantial discretion in implementing a receivership.[11] For example, while the FDIC is directed to "ensure that unsecured creditors bear losses in accordance with" a statutory order of priority,[12] the FDIC is also authorized to sell some or all the assets of the failed financial institution.[13] Such a sale may be to a third-party buyer or to a "bridge" financial institution formed by the FDIC, the stock of which

8. *See* 12 U.S.C. §§ 5381–5394 (2012). OLA is not the sole authority in the Dodd-Frank Act dealing with the resolution of failed financial institutions. The largest U.S. financial institutions—bank holding companies with total consolidated assets over $50 billion and nonbank financial companies supervised by the Board of Governors of the Federal Reserve—are required to periodically submit resolution plans to federal regulators. 12 U.S.C. § 5365(a), (d). These resolution plans, known as "living wills," must demonstrate that they are "credible and would result in an orderly resolution under title 11." 12 U.S.C. § 5365(d)(4). Failure to do so can result in more stringent capital, leverage, and liquidity requirements, restrictions on growth, activities, and operations, or even divestiture orders. 12 U.S.C. § 5365(d)(5).

9. *E.g.*, *id.* § 5386 (imposing mandatory terms on all orderly liquidation actions, including a priority of distributions).

10. *Id.* § 5383(a)(1).

11. *Id.* §§ 5384, 5386, 5390.

12. *Id.* §§ 5386(3). The order of priority for creditor claims is set out in § 5390(b).

13. *Id.* §§ 5390(a)(1)(A) (giving FDIC as receiver all powers of failed financial institution); *id.* § 5390(a)(1)(G) (authorizing transfer of any asset or liability or merger of the failed financial institution); *id.* § 5390(a)(9)(E) (providing directions for the disposition of assets of failed financial institution); *id.* § 5390(h)(5) (authorizing bridge company to acquire assets or assume liabilities of the failed financial institution).

could then be sold to a third-party purchaser, thereby enabling a stock sale rather than an asset sale.[14]

An asset sale may be accompanied by an assumption of select liabilities as a form of consideration from the buyer.[15] Greater assumption of liabilities will reduce the purchase price paid in other forms of consideration. To illustrate, a purchaser might pay $50 billion in cash and stock for the assets of a failed financial institution, or it could pay only $40 billion in cash and stock and assume liabilities of $10 billion. A creditor whose obligation is assumed by a buyer or by the bridge financial institution will get paid in full by the buyer or bridge institution (unless it too fails) and no longer has a claim in the receivership. That creditor, therefore, would not be subject to the distributional priority limitation on the FDIC in the receivership.[16]

The only generally applicable material limitation on the FDIC's ability to transfer liabilities of the failed financial institution to a bridge company is that "similarly situated creditors"—an undefined phrase with several statutory exceptions—must be treated the same in most situations.[17] However the phrase "similarly situated creditors" is interpreted, no such limitation applies to assumption of liabilities in sales to third-party buyers.

The federal government is also authorized to provide financing to continue operating the failed financial institution in OLA.[18] Notably, there are no detailed statutory restrictions within the OLA on the terms of the financing beyond a provision detailing the priority of the government's funding claim on the failed firm's assets.[19] This means that the government could set the terms on which it would provide financing simply as a matter of contract, not statute.

14. *Id.* §§ 5390(a)(1)(F) (authorizing FDIC to create a "bridge company"); § 5390(h)(3)(A) (permitting bridge financial company to assume or acquire assets and liabilities of failed financial institution); *id.* § 5390(h)(5)(A) (authorizing the FDIC as receiver to merge the failed financial institution with another company or "transfer any assets and liabilities" of the failed financial institution). A stock sale is a simpler and cheaper transaction because the only asset that needs to be transferred is ownership of the stock. In contrast, an asset sale might require separate formal deed recordings and transfer taxes to be paid on individual assets, particularly in the case of real estate transfers.

15. *Id.* § 5390(h)(3)(A).

16. *Id.* § 5390(a)(1)(G) (authorizing merger or transfer of any asset or liability of the failed financial institution); *id.* § 5390(b) (setting forth priority of claims).

17. *Id.* § 5390(b)(4) (requiring claims of similarly situated creditors to be treated similarly); *id.* § 5390(h)(5)(E) (requiring similarly situated creditors to be treated in a similar manner when assets or liabilities are transferred to a bridge company). Other limitations apply to particular types of asset transfers. *See, e.g.*, *id.* § 5390(c)(9) (requiring qualified financial contracts with a counterparty, if transferred at all, to be transferred as a complete book of business).

18. *Id.* § 5384(d) (authorizing funding for OLA); *id.* § 5390(b)(2) (providing priority for debtor-in-possession financing); *id.* § 5390(n) (creating an "Orderly Liquidation Fund); *id.* § 5390(o) (providing for assessments on financial institutions to fund an Orderly Liquidation Fund).

19. *Id.* § 5384(d).

Indeed, given that the enormous situational leverage the government will have over a failed firm in an OLA proceeding, the government will get whatever terms it wants—the government's offer is one that the failed firm cannot refuse. As such, the terms of government financing in an OLA will likely be at least as onerous as "debtor-in-possession" ("DIP") financing agreements in Chapter 11 bankruptcy. Government-provided financing in OLA will therefore come with various contractually negotiated provisions that determine the shape of any restructuring and which may effectively benefit certain creditor constituencies.[20] Not surprisingly, the discretion vested in federal regulators has led to criticisms that the OLA is nothing more than a codified bailout regime.[21]

B. Calls for a Financial Institution Bankruptcy Process

Aversion to the capricious and cronyistic nature of the bailouts has prompted calls to revise the Bankruptcy Code to provide for the resolution of large financial institutions in bankruptcy rather than through an administrative process. The Dodd-Frank Act itself called for a study of bankruptcy alternatives for resolving large financial institution failures.[22] The House of Representatives has thrice passed a version of a "Financial Institutions Bankruptcy Act."[23] A financial institutions bankruptcy procedure has also appeared in both versions of the CHOICE Act,[24] the Republican Dodd-Frank Act alternative, the second iteration of which passed the House.[25] A new financial institutions bankruptcy bill was introduced in the Senate in 2018, while this Article was in the editorial process.[26] Likewise, various conservative-leaning academics and the Hoover Institute have called

20. ADAM J. LEVITIN, BUSINESS BANKRUPTCY: FINANCIAL RESTRUCTURING AND MODERN COMMERCIAL MARKETS 397, 409–12 (2d ed. 2018).

21. *See, e.g.*, *Examining How the Dodd-Frank Act Could Result in More Taxpayer-Funded Bailouts: Hearing on H.R. 34 Before the H. Comm. on Fin. Servs.*, 113th Cong. 2 (2013) (opening remarks of Jeb Hensarling, Chairman, H. Comm. on Financial Services) ("Regrettably, Dodd-Frank not only fails to end too-big-to-fail and its attendant taxpayer bailouts; it actually codifies them into law . . . . Title II, Section 210, notwithstanding its ex post funding language, clearly creates a taxpayer-funded bailout system that the CBO estimates will cost taxpayers over $20 billion."); *see also* Evan Weinberger, *Trump Orders Review of 2 Key Dodd-Frank Act Powers*, LAW360 (Apr. 21, 2017, 1:31 PM), https://www.law360.com/articles/915818/trump-orders-review-of-2-key-dodd-frank-powers [https://perma.cc/7DJS-2BP6 (staff-uploaded archive)].

22. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 216, 124 Stat. 1376, 1519 (2010).

23. Financial Institutions Bankruptcy Act of 2014, H.R. 5421, 113th Cong. (2014) (passed House); Financial Institutions Bankruptcy Act of 2016, H.R. 2947, 114th Cong. (2016) (passed House); Financial Institutions Bankruptcy Act of 2017, H.R. 1667, 115th Cong. (2017) (passed House).

24. Financial CHOICE Act of 2016, H.R. 5983, 114th Cong. §§ 231–32 (2016); Financial CHOICE Act of 2017, H.R. 10, 115th Cong. §§ 121–23 (2017) (passed House).

25. Financial CHOICE Act of 2017, H.R. 10, 115th Cong. §§ 121-23 (passed House).

26. Taxpayer Protection and Responsible Resolution Act, S. ___ (2018).

for the creation of a "Chapter 14" in the Bankruptcy Code for a FIB procedure.[27]

Bankruptcy, according to the logic behind such proposals, ensures the rule of law.[28] It is a transparent, judicially supervised process, with public court filings and hearings in open court. All transactions outside of the ordinary course of business require judicial approval in bankruptcy,[29] and bankruptcy law gives all parties in interest a general right to be heard and to challenge proposed transactions in court.[30] Any sort of financial institution bankruptcy regime would draw on well-established rules from corporate bankruptcy.[31] Bankruptcy, it is supposed, will prevent discretionary, cronyistic intervention by government and will allow for the restructuring of failed financial institutions without disruptions to the wider economy.[32] Any resolution of a failed financial institution, FIB backers argue, would be determined efficiently by private ordering in the context of bankruptcy, not by government fiat.[33] At the same time, FIB proponents believe that

27. *See, e.g.*, Thomas H. Jackson, *Resolving Financial Institution: A Proposed Bankruptcy Code Alternative,* 2 BANKING PERSPECTIVES ___ (2014), *at* http://bit.ly/2rQWAac [hererinafter Jackson, *Resolving*]; Skeel, Jr., *supra* note 5, at 329–33; Thomas H. Jackson, *Bankruptcy Code Chapter 14: A Proposal*, *in* BANKRUPTCY NOT BAILOUT 25, 26 (Kenneth E. Scott & John B. Taylor eds., 2012); *see generally* THE HOOVER INSTITUTION, MAKING FAILURE FEASIBLE: HOW BANKRUPTCY REFORM CAN END "TOO BIG TO FAIL" (Kenneth E. Scott, Thomas H. Jackson & John B. Taylor eds., 2015) (proposing a version of Chapter 14 that responds to criticisms of FIB).

28. *See, e.g.*, *Financial Institution Bankruptcy Act of 2015: Hearing on H.R. 2947 Before the Subcomm. On Regulatory Reform, Commercial and Antitrust Law*, 114th Cong. 2 (opening remarks of Tom Marinoo, Chairman, Subcomm. On Regulatory Reform, Commercial and Antitrust Law) ("The bankruptcy process has long been favored as the primary mechanism for dealing with distressed and failing companies. This is due to its impartial nature, adherence to established precedent, judiciary oversight, and grounding in the principles of due process and the rule of law."); Jackson, *Resolving*, *supra* note 27, at ___.

29. 11 U.S.C. §§ 363(c), 364(b)–(d), 365(a) (2012).

30. *Id.* § 1109(b).

31. *See, e.g.*, Financial CHOICE Act of 2016, H.R. 5983, 114th Cong. §§ 231–232 (2016); Financial CHOICE Act of 2017, H.R. 10, 115th Cong. §§ 121–123 (2017) (passed House) (incorporating Chapter 11 bankruptcy provisions for a financial institutions bankruptcy procedure).

32. *See, e.g.*, *Financial Institution Bankruptcy Act of 2017: Hearing on H.R. 1667 Before the Subcomm. on Regulatory Reform, Commercial and Antitrust Law of the H. Comm. on the Judiciary*, 115th Cong. 3 (2017) (written statement of John B. Taylor), https://judiciary.house.gov/wp-content/uploads/2017/03/Taylor-Testimony.pdf [https://perma.cc/7BJU-2NMW] ("The goal of these provisions is to let a failing financial firm go into bankruptcy in a predictable, rules-based manner without causing disruptive spillovers in the economy while permitting people to continue to use its financial services without running.").

33. *See, e.g.*, Thomas H. Jackson, *Resolving Financial Institutions: A Proposed Bankruptcy Code Alternative*, BANKING PERSPS. (FIRST QUARTER 2014), *at* https://bit.ly/2MsAjt9 ("In bankruptcy, it is market-discipline first and foremost; in Title II, there inevitably is a heavier layer of regulatory overlay and control."); John B. Taylor, *It's Time to Pass the Financial Institutions Bankruptcy Act*, ECON. ONE (Mar. 23, 2017), https://economicsone.com/2017/03/23/its-time-to-pass-the-financial-institutions-bankruptcy-act/ [http://perma.cc/N6PM-PGD9] (noting that in contrast to government decision making in an OLA resolution, "under bankruptcy reorganization,

bankruptcy will ensure that failed financial institutions' creditors will internalize their losses, and the credible threat of this loss internalization will incentivize creditors to demand that financial institutions assume less risk.[34] Thus, financial institution bankruptcy legislation was paired with the proposed repeal of OLA and of various prudential regulatory safeguards.[35]

With FIB proposals, however, comes an important subtext: a proper bankruptcy system vitiates the need for prudential regulation of financial institutions. In theory, the threat of ex post losses for creditors in bankruptcy will create ex ante incentives for them to lend prudently and thereby reduce risk within the financial system in general: market discipline can substitute for government regulation as a mode of reducing systemic risk.[36]

Indeed, the political attraction of FIB may be less in its inherent benefits as a resolution mechanism than in its collateral effect of undermining the case for ex ante prudential bank regulation. Advocates of FIB never explicitly tie FIB to bank deregulation, but the connection may be seen in the inclusion of a FIB proposal as part of the first title in the major House Republican-sponsored bank deregulation bill, which would have repealed OLA along with various prudential regulatory tools.[37] FIB may in fact be a deregulatory Trojan Horse.

More recent FIB legislation has not included a repeal of OLA, and have even expressly confirmed the power in OLA to take over other insolvency proceedings.[38] This raises the question of what FIB accomplishes if it co-exists with OLA. It is hard to imagine regulators preferring the FIB process in which they have less control than OLA, so if regulators have the choice they are likely to either trigger OLA or take over a FIB and convert it to OLA. The pointlessness of having OLA and FIB co-exist suggests that eschewing the repeal of OLA is a tactical move by FIB advocates—enacting FIB will get the camel's nose under the tent, and OLA can be separately repealed latter, as FIB would render it superfluous.

---

private parties, motivated and incentivized by profit and loss considerations, make key decisions about the direction of the new firm").

34. *See, e.g.*, *Hearing on H.R. 1667*, *supra* note 29, at 2 (written statement of John B. Taylor) ("Chapter 11 ensures that creditors bear losses and this reduces moral hazard and excessive risk-taking.").

35. *See, e.g.*, Financial CHOICE Act of 2017, H.R. 10, 115th Cong. § 111 (2017) (passed House) (repealing OLA); *id.* § 131–52 (repealing various prudential regulatory tools provided by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2011).

36. Ironically, this market discipline is imposed through government regulation in the form of bankruptcy law.

37. *See* Financial CHOICE Act of 2017, H.R. 10, 115th Cong. § 111 (2017) (passed House) (repealing OLA); *id.* § 131–152 (repealing various prudential regulatory tools provided by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2011).

38 Taxpayer Protection and Responsible Resolution Act, § 6(a).

At the very least, however, the presence of a FIB procedure would undermine the Dodd-Frank Act requirement that the certain very large financial institutions prepare resolution plans known as "living wills" that must be approved by regulators. These living wills require financial institutions to demonstrate that they could be resolved in Chapter 11 bankruptcy.[39] Failure to do so can result in more stringent capital, leverage, and liquidity requirements, restrictions on growth, activities, and operations, or even divestiture orders.[40]

The point of living wills is not to be actual resolution plans—it is not credible to resolve a large financial institution in Chapter 11 or any bankruptcy process like it, for the various reasons discussed below.[41] Instead, living wills are a tool that allows federal regulators discretion to force large financial institutions to simplify their structures and operations or to impose greater regulatory requirements on these institutions.[42] Having a simplified FIB process would enable large financial institutions to argue for the elimination of living wills because a specialized FIB process should be inherently able to resolve their failure.

Unfortunately, a private FIB regime is an ideological pipedream that has become an unhealthy distraction in financial regulatory policy debates. This Article argues that the idea of FIB functioning without extensive government involvement is a pernicious market fantasy, a siren song that is not workable because of a number of insurmountable practical obstacles and irreconcilable policy goals, most notably the inability of a large failed financial institution to obtain the DIP financing required to preserve the value of its assets during bankruptcy. Attempting to resolve a large financial institution's failure via FIB without DIP lending would result in a value-destroying disaster that would exacerbate the spillover effects from the institution's failure.

If FIB were ever actually pursued, it could only operate effectively with massive government assistance in the form of DIP financing. Failed financial institutions would require enormous liquidity support while in bankruptcy, and that level of liquidity support on short notice in distressed markets could come from one source and one source only: the U.S. government. As DIP lender, the U.S. government would get to call the shots in the bankruptcy—

[39] 12 U.S.C. § 5365(a), (d).

[40] 12 U.S.C. § 5365(d)(5).

[41] *See infra* Part II.

[42] Notably, while resolution plans are to be evaluated against a baseline of a hypothetical Chapter 11 bankruptcy, such resolution plans could generally be implemented through OLA. The use of Chapter 11 as an evaluative baseline increases federal regulators' leverage over financial institutions subject to the resolution plans requirement because the institutions must grapple with the problems of DIP financing in Chapter 11 and valuation uncertainty and cannot plan on federal assistance.

that is what DIP lenders do. For example, DIP lenders routinely dictate detailed timelines for asset sales with bidding procedures to their liking and impose corporate officers of their choosing on debtors.[43]

This scenario is exactly what occurred in the Chrysler and General Motors bankruptcies. In both cases, the U.S. government, as DIP lender, required fast asset sales that complied with acceptable terms,[44] and the assets were sold to entities partially owned by the U.S. government. Moreover, in both cases, the asset sales were conditioned upon the buyer assuming certain favored liabilities of the debtor, particularly obligations owed to the firms' unionized employees and retirees who would have received nothing in a liquidation. Ironically, proponents of FIB have been among the leading critics of those bankruptcies, but Chrysler and General Motors are the template for what can be expected with a FIB process. FIB will result in precisely what its proponents despise—a bailout that rewards some favored creditors (here, the unionized employees)—albeit in the form of bankruptcy.

Because of financial institutions' massive liquidity needs, the only way FIB could realistically function is with government involvement. Such government involvement would warp the bankruptcy process to produce results that are indistinguishable from bailouts. And it would do so with the added harm of being done under color of law, thereby undermining the very rule of law virtue that makes bankruptcy attractive in the first place. Yet that may not matter to FIB proponents if their real goal is bank deregulation. The problems with FIB will not become manifest until a large financial institution fails, and in the interim, FIB will be a cudgel to push for bank deregulation.

The failure of a systemically important financial institution is materially different from that of most nonfinancial businesses. The failure of a nonfinancial business is a private matter between the business and its creditors. The spillover effects from such nonfinancial bankruptcies are likely to be more limited in most situations. While there can be domino effects up and down supply chains and across an industry due to single-sourced suppliers,[45] the failure of nonfinancial firms do not pose a threat to the credit market and payment system that are the lifeblood and arteries of the economy.

Systemically important financial institutions are another matter. Their failure threatens disruption to the entire global financial system. It is, then, not simply a private matter but a matter of public policy concern, both because of its broad ranging economic effects and its likelihood of triggering

43. LEVITIN, *supra* note 20, at 376, 408-09.

44. *See, e.g.*, Douglas G. Baird, *Lessons from the Automobile Reorganizations*, 4 J. LEGAL ANALYSIS 271, 288–89 (2012).

45. Levitin, *supra* note 6, at 453-461 (explaining how nonfinancial firms can pose systemic risk).

federal government involvement in the form of DIP financing. Put another way, the public is affected by the distribution in the bankruptcy of a systemically important financial institution, even though it is not a "creditor." Resolution of systemically important financial institutions is thus a political question because it implicates the public fisc and general distributional questions, not simply firm-specific ones.[46]

The courts, however, are a poor venue for resolving political problems—as the political question doctrine recognizes—because political pressures can corrupt the judicial process and generally undermine its legitimacy.[47] FIB would turn bankruptcy into a political process for which it is wholly unsuited.[48]

Bankruptcy is a process suited for addressing the microconcerns of individual firms, not macropolicy concerns. It is not a transparent, participatory forum capable of giving effective voice to noncreditor constituencies who may nevertheless be significantly affected by the bankruptcy.[49] Furthermore, bankruptcy is not a democratic forum. Many key issues are decided solely by a non–Article III judge and are, as with many issues, effectively unreviewable on appeal.[50] To the extent there is a vote (which is only on a plan), it is a vote only of classes of impaired creditors and shareholders, not affected third parties.[51] Government involvement would be by contract through a court order approving a non-appealable DIP

46. Adam J. Levitin, *Safe Banking: Finance and Democracy*, 83 U. CHI. L. REV. 357, 443 (2016).

47. *See* Baker v. Carr, 369 U.S. 186, 267 (1962) (Frankfurter, J., dissenting); ALEXANDER M. BICKEL, THE LEAST DANGEROUS BRANCH: THE SUPREME COURT AT THE BAR OF POLITICS 69 (2d ed. 1986).

48. Given the dysfunction of the formal legislative process in Congress, one might reasonably argue that the courts are a preferable forum for addressing political issues, insofar as they are a forum that will in fact address issues, even if the process is less than democratic.

49. *See, e.g.*, *In re* Alpha Nat. Res. Inc., 544 B.R. 848, 856 (Bankr. E.D. Va. 2016) (denying standing to environmental groups to object to court approval of a settlement agreement between the debtor coal company and the state of West Virginia).

50. Some issues are effectively unreviewable because of statutory limitations on appellate remedies. *See, e.g.*, 11 U.S.C. § 363(m) (2012) (prohibiting review of consummated sale orders on appeal); *id.* § 364(e) (prohibiting review of consummated financing orders on appeal); *id.* § 1144 (allowing revocation of confirmation orders if procured by fraud). Other issues become functionally moot because they are not appealable—absent leave of the bankruptcy court—until the issuance of a final order. 28 U.S.C. § 158(a) (2012). Additionally, most circuits recognize some form of the doctrine of equitable mootness, which limits the appellate review. *See, e.g.*, *In re* Nica Holdings, Inc., 810 F.3d 781, 788–90 (11th Cir. 2015); *In re* Charter Communications, Inc., 691 F.3d 476, 481–82 (2d Cir. 2012); *In re* Continental Airlines, 91 F.3d 553, 559 (3d Cir. 1996). Further, critical questions such as valuation are appealed on a clear error basis, which means that the bankruptcy court receives deference for its valuation determination. *See* LEVITIN, *supra* note 20, at 325. All told, the effect is to make many key bankruptcy decisions effectively unreviewable on appeal.

51. 11 U.S.C. § 1126(a), (f) (2012) (providing the holders of claims and equity interests the right to vote on a bankruptcy plan, but conclusively deeming unimpaired classes of claims and interests to have voted to support the plan).

financing agreement.[52] The terms of such agreement are not subject to the normal procedural safeguards of Administrative Procedures Act rulemaking or to any constraints beyond some minimal requirements in the Bankruptcy Code.[53] Bankruptcy is thus a particularly non-transparent, non-participatory form of policy making.[54]

This does not mean that the politics disappear from bankruptcy, only that they function differently outside the legislative process. The distributional concerns that are so intense when dealing with systemic financial crises mean that political pressures will inevitably corrupt the FIB process and turn FIB into nothing more than a bailout in judicial garb.

This Article proceeds in four parts. Part I explains the basic form that FIB would likely take before addressing the fundamental tension between trying to reduce both moral hazard and systemic disruption through bankruptcy. Part II then turns to a discussion of the practical obstacles to using bankruptcy to restructure financial institutions: lack of DIP financing, international coordination difficulties, problems concerning derivatives and other financial contracts; and the lack of a mechanism for addressing the valuation uncertainty that will chill the market for buyers of the failed institution's assets. The only way to overcome these obstacles is through federal government intervention in a bankruptcy, turning bankruptcy into a bailout. Part III demonstrates how the resolution of systemically important financial institutions is a political question and therefore best avoided by the courts. Accordingly, the Article concludes by suggesting that rather than follow FIB's siren song onto jagged rocks, we would do better to devote our energies to crafting a procedural mechanism for bailouts that impose transparency, basic procedural checks, and ex post accountability on government and bailout recipients.

I. THE SIREN SONG OF BANKRUPTCY

A. *Imagining Financial Institution Bankruptcy: The Good Bank/Bad Bank Transaction*

A FIB process could take many forms, but there are certain features that are likely to be included in any FIB process, and which are the focus of this Article. The key feature of any FIB process would likely be an asset sale that partitions the assets of the failed financial institution between a new "good bank" and the old, failed "bad bank." In recent years the traditional form of

52. *See id.* § 364(a)–(e).

53. *See id.*

54. *See* Stephen M. Davidoff & David T. Zaring, *Regulation by Deal: The Government's Response to the Financial Crisis*, 61 ADMIN. L. REV. 463, 468 (2009).

Chapter 11 bankruptcy reorganization, in which the reorganization is undertaken pursuant to a plan subject to a creditor vote and various statutory requirements, has often been replaced with a sale-based reorganization.[55] In the sale-based reorganization, some or all of the failed firm's assets are sold, moving them into a new capital structure, with any remaining assets then liquidated in bankruptcy.[56] Unlike a plan, a sale is not subject to a creditor vote or to the other statutory requirements for plan confirmation.[57]

The sale-based reorganization method in bankruptcy is essentially the same as a long-standing bank resolution technique, known as a "good bank/bad bank" ("GB/BB") structure. Although the terminology originated in the bank resolution context,[58] the transaction structure is in no way specific to banks. Understanding the GB/BB structure is essential for understanding the practical difficulties with FIB as well as the policy tensions that lie within it.

Financial institutions often run into trouble with a particular type of debt overhang problem, that of uncertain asset valuation. If a financial institution has assets, such as a book of mortgages or mortgage-backed securities, whose value declined by an uncertain although material amount, the effect is a solvency problem for the institution. The valuation uncertainty means that the institution might be insolvent, and that will make it difficult for the institution to continue contracting—no one wants to assume the risk of trading with an insolvent financial institution.[59]

A common solution for the valuation uncertainty problem is to divide the failed firm's good assets from its bad ones using a GB/BB structure. While a GB/BB structure can be used even when there is no valuation uncertainty, a GB/BB structure can address valuation uncertainty by partitioning the assets of the financial institution through a sale that separates the assets of uncertain value from those of certain value: the "good" assets (those of certain value) are sold to a new entity, the "Good Bank" that serves as the acquisition vehicle for new equityholders.[60] The Good Bank will also assume certain favored liabilities of the financial institution. These liabilities might be favored because they are necessary for the Good Bank to maintain

55. LEVITIN, *supra* note 20, at 825–27.

56. *Id.*

57. *Id.*; *see also* 11 U.S.C. § 363 (2012).

58. *See* Edward D. Herlihy & Craig M. Wasserman, *Making the Good Bank/Bad Bank Structure Work*, 11 INT'L FIN. L. REV. 34, 34–37 (1992).

59. For example, a firm might have large contingent liabilities, such as a firm that used asbestos products in its manufacturing. The extent and timing of the firm's liability is currently unknown, but any potential liability diminishes the firm's ability to obtain unsecured debt because of the possibility of large competing tort claims.

60. *See* MORRISON & FOERSTER, GOOD BANK-BAD-BANK: A CLEAN BREAK AND A FRESH START 1–5 (Feb. 18, 2009), https://media2.mofo.com/documents/20090218goodbankbadbank.pdf [https://perma.cc/7U3X-3YXP] (describing variations of GB/BB structures).

the on-going good will of certain creditors, such as suppliers and employees, or because the creditors on the favored liabilities are simply preferred for personal reasons, such as insiders, or because of the favored creditors' political connections.

The failed financial institution thus becomes the "Bad Bank," as it is left with the "bad" assets of uncertain or negative value plus the proceeds of the sale transaction. The Bad Bank also remains obligated on the disfavored liabilities. The Bad Bank is still of uncertain solvency because of the uncertain valuation of the bad assets (and possibly of the disfavored liabilities), but the Good Bank is not, and that is critical. The assets of the Good Bank can be productively deployed because the Good Bank will not suffer from the debt overhang problem, so counterparties will not eschew doing business with it. Thus, the GB/BB format liberates the good assets from the bad assets and from disfavored liabilities.[61]

A GB/BB structure can be implemented in a variety of ways, including in bankruptcy. In bankruptcy, a GB/BB structure is implemented through a sale of the Good Bank assets under § 363(b) and (f) of the Bankruptcy Code,[62] presumably prior to the confirmation of any bankruptcy plan. The the Bad Bank assets are then subsequently liquidated pursuant to a plan of liquidation. Such a format capitalizes on the speed of bankruptcy sales, which must be held "after notice and a hearing," a phrase defined to mean only such notice and hearing as is appropriate under the circumstances, and which may mean that no notice or hearing is required if time is of the essence.[63] Thus, if the Good Bank assets are flighty customer relationships—the financial institution equivalent of melting ice cream—they can be preserved through a fast sale.[64] Moreover, the ultimate liquidation of the Bad Bank can largely be done automatically by adherence to the liquidation priorities in Chapter 7 bankruptcy.[65] Creditors have few grounds and even

61 Note that the single-point-of-entry (SPOE) mechanism that is frequently used in the resolution plans ("living wills") required of certain large financial institutions, 12 U.S.C. § 5365(d)(4), is a GB/BB structure. In SPOE the equity and certain debt obligations of the debtor holding company would be left behind with any undesirable assets, while the good assets are transferred to a new holding company, along with other (favored) liabilities. While SPOE often focuses on the equity and long-term debt of the debtor holding company getting "bailed-in"—that is left behind, the key to SPOE is really in the selective transfer of favored assets and liabilities to a new firm, which is just the GB/BB structure.

62. 11 U.S.C. § 363(b), (f) (2012).

63. *See id.* § 102(1).

64. Melissa B. Jacoby & Edward J. Janger, *Ice Cube Bonds: Allocating the Price of Process in Chapter 11 Bankruptcy*, 123 YALE L.J. 862, 866–67 (2014).

65. 11 U.S.C. §§ 725, 726 (2012).

less reason to attempt to hold up the post-sale liquidation, because they could not use it to unwind the prior asset sale.[66]

For the GB/BB structure to work, however, two conditions must hold. First, creditors must be prevented from undertaking collection actions while the asset sale is pending, or else the sale may fall apart as key assets may no longer be available for creditors. In bankruptcy the automatic stay will generally prevent such creditor actions, except in the case of certain financial contracts; swaps, repos, securities and commodities futures contracts, forward contracts, and master netting agreements may all be terminated, accelerated, and liquidated without running afoul of the automatic stay.[67] This presents little obstacle for most debtors, but is an issue for financial institution debtors as discussed below.

Second, the asset purchaser—the Good Bank—must have confidence in the valuation of the assets it purchases. If the assets' value is too uncertain, a buyer is unlikely to step forward. One way around this problem is by enabling prospective buyers to have sufficient time to diligence the assets, such that they can come up with a valuation on which to base a bid. But if time is of the essence with the GB/BB transaction—the ice cream is melting—then such diligence will not be possible. In such a case, either the purchase price will be severely depressed or the transaction will not happen, unless a third-party is willing to guaranty the purchased assets. The automatic stay generally provides the breathing room for the necessary diligence to occur. But, as noted above, the stay does much less work for financial institution debtors.

The result of a GB/BB structure is that the holders of the favored liabilities assumed by the Good Bank would be paid in full, assuming that the Good Bank remains solvent. The holders of the disfavored liabilities, however, recover in bankruptcy only from the bad assets and the sale proceeds from the good assets, meaning that the risk of loss on the bad assets, as well as the risk of underpricing the good assets, lie with the creditors who hold the disfavored liabilities. A GB/BB structure thus operates as a type of priority system that ensures 100% repayment for favored liabilities and does not guarantee any particular repayment for disfavored liabilities.

For example, suppose that a bankrupt company has \$150 of assets and \$300 in total liabilities as follows: \$100 to a class of unsecured bondholders, \$100 to a class of tort claimants, and \$100 to a class of employees. These three classes of claims are all general unsecured claims of equal priority and

66. *See id.* § 363(m) (providing that the "reversal or modification on appeal" of a sale order "does not affect the validity of a sale . . . to an entity that purchased . . . in good faith").

67. 11 U.S.C. §§ 362(b)(6), (7), (17), (27) (2012); *id.* §§ 555, 559-561 (2012).

should be paid out pro rata in a bankruptcy liquidation, with all three classes receiving 50¢ on the dollar.[68]

Now suppose that the assets were purchased by a third party. If the third party paid fair market value in cash for the assets—$150—there would be no effect on the distribution to the creditors. The old assets would simply have been transformed into cash from other forms of property. The plain asset sale does not change the distribution. The creditors do assume the risk, however, that the sale is underpriced. If the assets are really worth $200, then they should receive a 66.7% dividend. Of course, if the assets are really worth $200, then one would expect another buyer—perhaps a creditor—to bid more than $150 for them, but this presupposes no limitations on bidding procedures and other transactional and informational frictions.

Now, however, suppose that the purchaser wants to keep the existing workforce and wants to ensure labor peace. The purchaser therefore reduces its offer from $150 in cash to an offer of only $50 in cash and the assumption of the $100 in employee claims. If the purchase is approved, the debtor is left with $50 in assets and $200 in claims, so the bondholders and tort claimants are paid 25¢ on the dollar. In contrast, the employees' claims are assumed by a solvent third party purchaser, so they will be paid in full, 100¢ on the dollar. The assumption of liabilities in the asset purchase effectively gives the employees priority over the bondholders and tort claimants despite all parties formally having the same priority.

Now assume that there is some uncertainty about the valuation of some of the assets. The buyer might be willing to assume the valuation risk on those assets, but if the buyer purchases only the good assets, then the remaining assets—and the valuation uncertainty—remain with the creditors whose claims were not assumed in the sale. In other words, the valuation risk not just of the sale price but also the valuation risk of the remaining assets is concentrated on the bondholders and tort claimants. The employees, whose claims were assumed by the buyer, have escaped the risk of an underpriced sale as well as the valuation risk of the assets left behind.

The GB/BB structure is already the preferred transactional form for many large, nonfinancial business bankruptcies. Many large bankruptcies now use an asset sale, rather than a plan, as their primary means of effectuating a reorganization.[69] Some version of a GB/BB structure would likely be used in a FIB for two reasons.

First, the GB/BB structure allows for the quick redeployment of the good assets, which is important to minimize disruptive spillover effects. A GB/BB transaction has both a sale and a subsequent liquidating plan, but the

68. *See id.* § 726(b).
69. LEVITIN, *supra* note 20, at 825–27.

key part of the transaction is the sale; it is not critical that the liquidating plan be achieved with particular alacrity. Indeed, the GB/BB approach effectively divides the bankruptcy process into two parts: an asset sale process followed by a separate, subsequent process for evaluating claims and distributing value to allowed claims. The former is a process that has little role for a judge, while the latter is an adjudicative process in terms of claims evaluation, but distribution may then be done robotically according to a statutory cashflow waterfall.

The alternative to a sale followed by a plan-based liquidation is a plan-based reorganization. The timeline for a plan in a FIB need not follow the current Federal Rules of Bankruptcy Procedure. Nonetheless, any sort of plan-based reorganization would necessarily be slower than the sale component of a GB/BB transaction because a plan-based reorganization must provide some time for dissemination and consideration of a disclosure statement,[70] as well as for voting (meaning dissemination of ballots and counting of ballots cast), a confirmation hearing, and a post-confirmation appellate period.[71]

Second, in contrast to a bankruptcy plan, a sale is not a procedure that is vulnerable to holdouts, at least under current bankruptcy law. Consensual confirmation of a bankruptcy plan requires obtaining consent of the majorities of all impaired classes of claims and interests,[72] as well as satisfaction of a number of other statutory requirements.[73] A bankruptcy plan may also be confirmed via the "cramdown" procedure with consent of only a single impaired class (excluding insiders),[74] but the speed issue remains. In contrast, the standards for a preplan asset sale are much looser; no creditor consent whatsoever is required, and the debtor merely has to show an "articulated business justification."[75]

B. *The Resolution Dilemma: Reducing Moral Hazard or Reducing Systemic Spillovers*

FIB proposals seek to simultaneously achieve two irreconcilable goals. On the one hand, FIB proposals seek to reduce moral hazard by forcing

70. *See* FED. R. BANKR. P. 3017(a) (requiring 28 days' notice before a disclosure statement hearing).

71. *See* FED. R. BANKR. P. 3020(e) (requiring a 14-day delay after a plan is confirmed before it is effective, which matches the 14-day window for filing an appeal under Federal Rule of Bankruptcy Procedure 8002(a)(1)).

72. 11 U.S.C. §§ 1126(c), 1129(a)(7) (2012).

73. *Id.* § 1129(a).

74. *Id.* § 1129(b).

75. *See In re* Lionel Corp., 722 F.2d 1063, 1070–71 (2d Cir. 1983).

creditor loss internalization.[76] If creditors incur losses as a result of poor lending decisions, they will be incentivized to take more care in the future; conversely, if they are bailed out of their bad deals, they have no incentive to take care, as they are left with a "heads I win, tails you lose" bargain. Thus, to reduce moral hazard, it is imperative that creditors (or at least adjusting ones) bear losses in a FIB (or at least that they credibly believe that they will bear losses). The whole point of the moral hazard reduction is to encourage better ex ante behavior by creditors; it is not meant to be punitive. In a GB/BB transaction, loss internalization can be achieved by leaving creditors' obligations behind in the Bad Bank.

At the same time, however, FIB seeks to ensure a "smooth landing" for the economy by minimizing the spillovers from the failure of a large financial institution.[77] The failure of a large financial institution can result in a domino chain of failures as questions of solvency metastasize throughout the financial system. A GB/BB transaction can be used to achieve such a smooth landing and head off spillovers by having the Good Bank assume creditors' obligations.

If the goal is to eliminate moral hazard, it is necessary for bankruptcy *to impose losses* on creditors that can adjust ex ante. Yet the most certain way to prevent such spillovers is to ensure that creditors *do not incur losses* in a bankruptcy. This means it is not possible to simultaneously prevent moral hazard and prevent spillovers in regard to the same creditor. Either the creditor will bear losses or it will not in a bankruptcy.

One way around this conundrum is to differentiate between types of creditors—some creditors will bear losses and provide the market discipline that will limit future bank risk-taking, while others will not bear losses and will be effectively bailed out because the Good Bank will assume their obligations. Such a differentiation of creditors is politically problematic. It means picking winners and losers, an issue FIB supporters avoid discussing entirely, because the moral hazard problem they seek to eliminate will persist if *any* creditors have their obligations assumed (or even think that they will have their obligations assumed).

Consumers, tax authorities, tort creditors, and vendors are basically nonadjusting creditors, so it makes no sense to place losses on them because they do not present a moral hazard problem. That leaves financial creditors—

76. *See, e.g.*, *Hearing on H.R. 1667*, *supra* note 29, at 2 (written statement of John B. Taylor) ("Chapter 11 ensures that creditors bear losses and this reduces moral hazard and excessive risk-taking.").

77. *See, e.g.*, *Hearing on H.R. 1667*, *supra* note 29, at 3 (written statement of John B. Taylor) ("The goal of these provisions is to let a failing financial firm go into bankruptcy in a predictable, rules-based manner without causing disruptive spillovers in the economy while permitting people to continue to use its financial services without running.").

unsecured bond debt, any secured debt, and repo and derivatives counterparties—as the adjusting creditors. Yet these financial creditors are exactly whom we are most worried about being the channel for a domino effect of failures throughout the economy. Protecting these financial creditors (or a subset of them) is exactly the type of crony capitalism problem that bailout critics raise. There is no way to both create market discipline and prevent domino effects that cascade throughout the economy. Ultimately, a choice must be made. This is the "resolution dilemma."

The choice should be easy: reduce the economic dislocation caused by the failure of a financial institution. Market discipline is a wonderful thing, but it should not become a fetish. It is not an end in and of itself but a means towards achieving greater economic stability. There are other tools available for reducing excessive risk-taking by financial institutions—namely, prudential regulation. Prudential regulatory regimes are not failsafe, and particular features may impose costs that outweigh their benefits. But given the difficulty in credibly committing ex ante to impose losses on creditors no matter the economic consequences, prudential regulation is the only realistic alternative. No matter how many laws proclaim "no bailouts," no one believes that government will follow through when doing so becomes an economic suicide pact.

Once we recognize the resolution dilemma, however, one has to ask: Why bother with the bankruptcy? To the extent that a bankruptcy system protects creditors from incurring losses, it is just another form of a bailout, hiding in bankruptcy's clothing. If the reluctant choice is to go with bailouts, why try to disguise them in the garb of bankruptcy? Let the wolf come as a wolf, not in sheep's garb.

One could make a more sophisticated argument that using a bankruptcy procedure will create the impression or at least uncertainty about the likelihood that there will be loss internalization even if there ultimately will not be, and this deke will improve market discipline. While this is not an argument actually made by FIB proponents, it has some virtue. The uncertainty would reduce moral hazard without having to surrender the smooth landing when a financial institution actually fails. Yet such an argument relies on sophisticated financial institutions being snookered by the system's design, and if they are not fooled, they will double down on reckless lending. Moreover, it is an argument for completely cynical legislation—for creating a FIB regime not intended for actual use but instead to scare bank counterparties that it could be used. This argument also runs against the concern about lack of transparency in bailouts: What is less transparent than disguising a bailout as a bankruptcy? The tension between reducing moral hazard and reducing spillover effects points to the pointlessness of financial institution bankruptcy.

II. THE IMPRACTICABILITY OF FINANCIAL INSTITUTION BANKRUPTCY

Beyond the conceptual problem inherent in a GB/BB framework for restructuring a financial institution in bankruptcy, there are also four core practical obstacles: the inability to obtain adequate financing for a restructuring; problems with international coordination; the difficulty of dealing with derivatives and other financial contracts; and the lack of a mechanism for addressing valuation uncertainty for potential Good Bank purchasers. Any one of these obstacles alone should throw cold water on dreams of FIB. Together, however, they show just what a fantasy a private FIB process truly is. FIB can only possibly work with massive government involvement, at which point its supposed virtues dissipate, and it compares less favorably to bailouts whether executed ad hoc or through a previously authorized administrative device like the OLA.

A. DIP Financing Is Not Feasible for Large Financial Institutions

1. Normal Sources of DIP Financing Will Not Be Available

For a debtor to have any chance of successfully restructuring itself in bankruptcy, it must have adequate liquidity to pay its operating costs. The debtor needs to have the cash to keep the lights on, retain employees, maintain insurance coverage, pay taxes, and more.

For a financial institution, such liquidity demands are even greater. Financial institutions trade on trust and confidence. Counterparties will enter into contracts with them only if they feel reasonably confident that the financial institution will meet its obligations. For a financial institution to operate, it must be able to constantly access the market. For example, if a bank is to make a fixed rate loan, it must also be able to access interest rate swap markets to hedge its interest rate risk, but if swap counterparties do not think the bank will be able to honor its commitment on the swap, they will not contract with it.

This means that, for a financial institution to continue operating in bankruptcy, it must have essentially the level of liquidity that it would have if it were not financially distressed. Anything less will result in a self-fulfilling prophecy of a run, as creditors will raise prices, demand more collateral, or refuse to rollover debts because of a lack of confidence in the survival of the debtor. This is precisely what occurred with Lehman Brothers in 2008—its clearing bank, JPMorgan, demanded that Lehman post more collateral.[78] And, as the 2008 crisis clearly demonstrated, the liquidity demands on a financial institution in bankruptcy will be extraordinary.[79]

Yet the nature of most debtor firms is that they lack liquidity when they file for bankruptcy. Most firms do not file for bankruptcy until they absolutely have to do so. They will only file when there is an acute liquidity crisis pending, such that they will not be able to make a debt payment or meet payroll.

There is every reason to think the same would be true with financial institutions. As long as a financial institution is liquid, it can keep operating, even if insolvent. Indeed, the financial institution's management would be strongly incentivized to do so, as management loses nothing by "gambling on resurrection."[80] If the company's fortunes turn around, everything is great, and if not, the managers have not lost shareholder funds but value that would otherwise go to creditors.[81] It is possible, of course, to conceive of a FIB regime that permits for the filing of an involuntary petition, perhaps triggered by regulatory action. But there is a real possibility that regulators will be reluctant to pull the trigger lest they do so prematurely, with the result that they pull it too late and face a worse crisis than otherwise.

Thus, by the time a financial institution ends up in bankruptcy, it is likely to have very little liquidity, probably not enough to keep operating. To the extent it still has enough liquidity to operate, it will assuredly evaporate as creditors (particularly those funding repo lines of credit) run rather than keep dealing with a debtor that might potentially lack the liquid funds to pay on its obligations as they come due.

The liquidity crisis a financial institution is likely to face when it files for bankruptcy necessitates a fresh source of liquidity. In this regard, a FIB is not materially different from any other business bankruptcy. In a typical

78. *See, e.g.*, Jonathan Stempel, *JPMorgan to Pay $1.42 Billion Cash to Settle Most Lehman Claims*, REUTERS (Jan. 25, 2016, 9:00 PM), https://www.reuters.com/article/us-jpmorgan-lehman-idUSKCN0V4049 [http://perma.cc/SNU5-ZMXS].

79. Large financial institutions are already subject to a "Liquidity Coverage Ratio" intended to ensure that they will not find themselves pressed for liquidity. 12 C.F.R. § 50.10 (2018) (covering national banks); *id.* § 329.10 (covering state member banks); *id.* § 249.10 (covering insured state banks). But if the liquidity coverage ratio is simply the financial regulatory equivalent of building a higher levy, it is always vulnerable to being wiped out by a strong enough hurricane, or here, financial crisis. *See* Adam J. Levitin, *Prioritization and Mutualization: Clearinghouses and the Redundancy of the Bankruptcy Safe Harbors*, 10 BROOK. J. CORP. FIN. & COM. L. 129, 139 (2015) [hereinafter Levitin, *Prioritization and Mutualization*].

80. *See* LEVITIN, *supra* note 20, at 315.

81. Notably, corporate law in most states imposes no liability on corporate directors and officers for gambling on resurrection. Directors do not bear fiduciary duties to creditors, *see* N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla, 930 A.2d 92, 99 (Del. 2007), and Delaware does not recognize tort of "deepening insolvency." Trenwick Am. Litig. Tr. v. Ernst & Young L.L.P., 906 A2d 168, 174 (Del. Ch. 2006), *aff'd sub nom.* Trenwick Am. Litig. Tr. v. Billett, 931 A.2d 438 (Del. 2007).

business bankruptcy, the debtor will address the liquidity problem by obtaining DIP financing—a new, post-petition financing facility that will provide the debtor with the funds to continue operations.[82]

Adequate DIP financing, however, is not possible for a financial institution of any size.[83] An enormous DIP financing facility would be required for a financial institution, far more than for a Main Street company such as a manufacturer. Moreover, particularly for a financial institution whose ability to do business depends on customers' confidence in its ability to honor its commitments, a DIP financing facility would need to be in place immediately, on day one of the case. Without a DIP facility in place on day one, counterparties would flee a financial institution, resulting in a self-fulfilling collapse. Both requirements present insurmountable problems.

A large financial institution would require a DIP facility of tens if not hundreds of billions of dollars. JPMorgan Chase, for example, has around $560 billion in high quality liquid assets that cover peak short-term cash outflows.[84] To maintain counterparty confidence to continue operations and not set off a creditor run, a firm like JPMorgan would need to keep up its nondistressed level of liquidity, in this case around $560 billion. Similarly, Bank of America and Citibank would each require around $425 billion in liquidity to maintain its nondistressed financial profile,[85] while Goldman Sachs would require $210 billion.[86] While a financial institution would not enter bankruptcy with zero liquidity, it would likely still need a liquidity source for a substantial portion of its pre-distressed liquidity level.

82. *See* LEVITIN, *supra* note 20, at 770, 781–82, 798.

83. This fact alone should call into question the credibility of all resolution plans filed under the Dodd-Frank Act's living wills provision, 12 U.S.C. § 5365(d). As noted above, however, the purpose of the living wills requirement may be less about ensuring that living wills are actually credible than about giving regulators extra discretion to impose additional regulatory requirements on the largest financial institutions. *See supra*, text accompanying notes 39-42.

84. JPMORGAN CHASE & CO., LIQUIDITY COVERAGE RATIO DISCLOSURE: FOR THE QUARTERLY PERIOD ENDED DECEMBER 31, 2017, at 1, http://files.shareholder.com/downloads/ONE/6370549969x0x972718/FE4E3462-AFE3-4342-8BD6-D0B039E84EA5/4Q17_Liquidity_Coverage_Ratio_Report_Final.pdf [http://perma.cc/P9A7-GE8H (staff-uploaded archive)].

85. BANK OF AMERICA, PILLAR 3 U.S. LIQUIDITY COVERAGE RATIO (LCR) DISCLOSURES: FOR THE QUARTER ENDED JUNE 30, 2017, at 4, http://phx.corporate-ir.net/External.File?item=UGFyZW50SUQ9Mzg3MTU1fENoaWxkSUQ9LTF8VHlwZT0z&t=1&cb=636391143557193311 [http://perma.cc/85XV-PQ3K]; CITIGROUP, INC., U.S. LCR DISCLOSURE: FOR THE QUARTERLY PERIOD ENDING 6/30/17, at 2, https://www.citigroup.com/citi/investor/data/lcr170630.pdf?ieNocache=165https://bit.ly/2Ms5Lra [http://perma.cc/X69Q-TG64].

86. THE GOLDMAN SACHS GROUP, INC., LIQUIDITY COVERAGE RATIO DISCLOSURE: FOR THE QUARTER ENDED JUNE 30, 2017, at 2, https://www.goldmansachs.com/investor-relations/financials/archived/other-information/2q-2017-liquidity-coverage-ratio.pdf [http://perma.cc/R3BM-4CHT].

Private lending markets are not capable of providing such large amounts of liquidity to a bankrupt firm, even for a very short period of time. The largest private syndicated loan in history was $75 billion, raised in November 2015, for AB InBev's takeover bid for SABMiller.[87] The largest private DIP financing ever assembled was a mere $9 billion loan for Energy Future Holdings in 2014.[88] Even the US government's DIP loan to General Motors, the largest DIP loan ever, was only $33 billion.[89] None come close to approaching the level of DIP financing a large financial institution would require to continue operating in bankruptcy. Furthermore, the emergency nature of DIP liquidity provision precludes syndication because of the time needed to market the loan (here, in secrecy) to potential syndicate members, each of which must conduct its own diligence.

DIP loans are also almost always first lien, superpriority loans. No DIP lender wants to lend on an unsecured basis because the borrower is, by definition, bankrupt and a serious credit risk. A bankrupt financial institution would be hard-pressed to offer a new DIP-lending consortium unencumbered collateral, as most valuable assets would likely already be pledged. Bankruptcy law contemplates the possibility of priming liens for DIP loans,[90] meaning that the DIP loans would get a lien with priority over existing liens. Such priming liens, however, would likely be bitterly contested. At the very least, they would require a lengthy valuation hearing, delaying the financing, as well as evidence that the debtor had tried and failed to find financing on other terms.[91]

Further complicating DIP financing for complex bankruptcies is that it must be arranged in advance to be available at the start of a case. Large, multibillion-dollar loans are never made by single institutions. Instead, they are syndicated facilities in which numerous financial institutions each provide the funding for a part of the facility.[92] Lining up a syndicate, much

87. Alasdair Reilly & Tessa Walsh, *AB InBev Backs SABMiller Buy with Record $75 Billion Loan*, REUTERS (Nov. 11, 2015, 6:42 AM), https://www.reuters.com/article/us-abinbev-loans/ab-inbev-backs-sabmiller-buy-with-record-75-billion-loan-idUSKCN0T019E20151111 [http://perma.cc/8BZW-CJGE].

88. Billy Cheung, *Energy Future Holdings Lining Up $9 Billion Bankruptcy Financing*, REUTERS (Mar. 27, 2014, 9:35 AM), https://www.reuters.com/article/us-energy-future-hd-loans/energy-future-holdings-lining-up-9-billion-bankruptcy-financing-idUSBREA2Q13020140327 [http://perma.cc/M7CN-RA6R].

89. *Id.*; Christine Caufield, *GM Gets OK to Tap $33.3B in DIP Financing*, LAW360 (June 25, 2009, 12:00 AM), https://lawlibproxy2.unc.edu:2147/articles/108332/gm-gets-ok-to-tap-33-3b-in-dip-financing [http://perma.cc/AE69-DAHV (staff-uploaded archive)].

90. 11 U.S.C. § 364(d)(1) (2012).

91. *See id.*

92. LEVITIN, *supra* note 20, at 71–75.

less one so large, takes time. The $75 billion loan for AB InBev took weeks to arrange for a solvent firm.[93]

A financial institution, however, does not have the luxury of time. First, it might be in trouble in part because of market-wide problems. If markets have frozen, DIP financing will not be available. And the failure of a large financial institution is itself likely to result in a market freeze. Second, DIP financing would likely come from other financial institutions—the failed institution's current counterparties because nearly all large financial institutions trade with each other. As soon as a firm begins to attempt securing DIP financing, it is advertising to its creditors that it will be filing for bankruptcy, which will precipitate a run on the firm, resulting in a bankruptcy before it is ready.

Private capital markets are simply incapable of coming up with enormous liquidity for a potentially insolvent company, much less overnight and when markets are in turmoil. Now consider the possibility that multiple financial institutions fail simultaneously, as occurred in 2008. There's simply no chance of adequate DIP financing from the private sector.

2. Alternative Sources of DIP Financing Are Problematic

The federal government could, in theory, provide the massive DIP financing required with the necessary limited notice to creditors, but the whole point of FIB proposals is to keep the government out of the process and let the restructuring be a private ordering. Once the government is involved, it will assuredly flex its muscles and insist on favorable terms for its loan or for favorable treatment for particular, politically favored creditors. If OLA is any guide, none of this would be restricted by statute, not least because no one wants to constrain the flexibility of a response ex ante without knowing the particular circumstances involved. Even if there were statutory restrictions, however, there would be strong pressure to figure out a way around them in the FIB procedure or else FIB simply would not be used for resolution. Instead, the terms of the DIP loan would be contractually determined and presented to the court for approval on a take-it-or-leave-it basis. The court's only option when faced with such terms is to approve them because denying the DIP loan means triggering a serious financial crisis, something no judge wants to do.[94] It is hard to see a FIB operating without government DIP lending, which undermines the entire point of FIB.

It is true that a FIB with a GB/BB structure could take the form of a very quick asset sale (and liability assumption) from the failed financial institution to some buyer, and that buyer might agree to supply liquidity

93. Reilly & Walsh, *supra* note 87.
94. *See, e.g.*, Baird, *supra* note 35, at 290.

during the interim before the sale's closing. But consider who the buyers might be. To swallow up the good assets of a large financial institution—an institution that might have tens of billions if not hundreds of billions or even trillions of dollars in assets—a buyer would need to be of similar or greater size. For example, as of the end of 2017, JPMorgan Chase Bank, N.A. reported assets of just more than $2.5 trillion,[95] while Citigroup, N.A. reported assets of around $1.8 trillion.[96] There are few such buyers around to begin with, and in a global financial crisis, the potential buyers are themselves possibly in financial difficulty or reluctant to assume additional risk, much less without the opportunity for serious diligence. Thus, in the 2008 crisis, Lehman Brothers was unable to find a buyer.[97] The shotgun marriages between Bank of America and Merrill Lynch, JPMorgan and Washington Mutual, JPMorgan and Bear Stearns, and Wells Fargo and Wachovia were all done with a heavy (and sometimes heavy-handed) dose of governmental involvement.[98] And those deals sometimes included government loss-sharing agreements,[99] which is presumably anathema to FIB proponents because of its supposed private-ordering virtues and lack of involvement of the public fisc.

Another possibility would be a stand-by DIP facility for financial institutions. No financial institution would willingly pay for such a facility

95. JPMORGAN CHASE & CO., 2017 ANNUAL REPORT 38 (2018), https://www.jpmorganchase.com/corporate/investor-relations/document/annualreport-2017.pdf [http://perma.cc/TCC8-2B94].

96. CITIGROUP, INC., 2017 ANNUAL REPORT 1 (2018), https://www.citigroup.com/citi/investor/quarterly/2018/ar17_en.pdf [https://perma.cc/P3SU-7HXZ].

97. .Robert J. Samuelson, *Lehman Brothers collapsed 10 years ago. Whose fault was it?*, THE WASHINGTON POST (Aug. 26, 2018), https://www.washingtonpost.com/opinions/lehman-brothers-collapsed-10-years-ago-whose-fault-was-it/2018/08/26/79137b2e-a7dd-11e8-a656-943eefab5daf_story.html?utm_term=.1d4386b06a93 [https://perma.cc/39P6-7LXC].

98. William D. Cohan, *The Final Days of Merrill Lynch*, THE ATLANTIC (Sept. 2009), https://www.theatlantic.com/magazine/archive/2009/09/the-final-days-of-merrill-lynch/307621/ [https://perma.cc/43C4-ZRKJ]; David Ellis & Jeanne Sahadi, *JPMorgan Buys WaMu*, CNN MONEY (Sept. 26, 2008, 12:18 PM), https://money.cnn.com/2008/09/25/news/companies/JPM_WaMu/ [https://perma.cc/Q7ZM-VAMD]; Sara Lepro & Jennifer Malloy Zonnas, *Wells Fargo Buys Wachovia for $15.1 Billion*, ABC NEWS (Oct. 3, 2008), https://abcnews.go.com/Business/SmartHome/story?id=5946486&page=1 [https://perma.cc/MU5K-VQVC]; Liz Moyer, *A Decade After its Fire-sale Deal for Bear, A Look at What JP Morgan Got in the Bargain*, CNBC (Mar. 16, 2018, 7:13 AM), https://www.cnbc.com/2018/03/14/a-decade-after-its-fire-sale-deal-for-bear-a-look-at-what-jp-morgan-got-in-the-bargain.html [https://perma.cc/AC62-G3VS].

99. *See, e.g.*, Press Release, JPMorgan Chase & Co., JPMorgan Chase and Bear Stearns Announce Amended Merger Agreement and Agreement for JPMorgan Chase to Purchase 39.5% of Bear Stearns (Mar. 24, 2008), https://www.sec.gov/Archives/edgar/data/19617/000089882208000320/pressrelease.htm [http://perma.cc/F4C9-NVXE] (noting that the Federal Reserve Bank of New York was assuming any losses on the $30 billion purchase beyond the first $1 billion of losses).

in part because the lack of one increases the likelihood of a bailout, so it would have to be required by regulation. Conceptually such a facility is possible with a credit-linked note structure.[100] First, a financial institution sponsor could create a special-purpose entity ("SPE"). The SPE would then issue notes and escrow the investment proceeds from the note, investing the proceeds in liquid, safe assets like Treasury securities. The SPE would also enter into a swap with the financial institution that would be triggered by the financial institution's bankruptcy filing. Until the financial institution filed for bankruptcy, it would make periodic payments to the SPE, which would in turn pay the noteholders (who would also receive the investment earnings on the escrowed funds). Upon a bankruptcy filing, however, the flow of funds would reverse: the SPE would pay out the escrowed funds to the financial institution in the form of a pre-negotiated DIP facility.

While credit-linked notes are a common financing structure, they have never before been used for a DIP lending facility, and such a facility would not be cheap. Credit-linked notes would function as a type of insurance for a financial institution to ensure that it would have funding in the event that it failed. If the financial institution filed for bankruptcy, then the DIP facility would be funded automatically, like an insurance payment triggered by a loss. The periodic payments to the SPE are essentially insurance premiums for DIP lending insurance. If this process is workable, it would add substantial costs to running a financial institution simply by virtue of the volume of credit-linked notes that would have to be issued. Such cost might in fact be desirable, if the credit-linked note requirement is triggered only upon a certain size or complexity threshold. A regulatory requirement of a standby DIP facility through credit-linked notes would serve as a type of tax on systemically important financial institutions, which would create an incentive for those firms to reduce their size and complexity. But all this presupposes that there would even be a market for such credit-linked notes.

One can get some sense of market appetite for this sort of credit risk by looking at the market for catastrophe bonds. Catastrophe bonds are a type of security that provides a capital-market-funded type of insurance for firms concerned about exposure to natural disasters such as hurricanes and earthquakes.[101] The bonds work similarly to credit-linked notes: a transaction sponsor forms an SPE with no assets or noncontractual liabilities. The SPE then issues catastrophe bonds; the investors in the bonds have no recourse

100. For a description of credit-linked notes, see William W. Bratton & Adam J. Levitin, *A Transactional Genealogy of Scandal: From Michael Milken to Enron to Goldman Sachs*, 86 S. CAL. L. REV. 783, 852 (2013).

101. For a general description of catastrophe bonds, see Thomas Berghman, Note, *A Market Under(writing) the Weather: A Recommendation to Increase Insurer Capacity*, 2013 U. ILL. L. REV. 221, 250–51 (2013).

against the sponsor, only against the SPE. The funds used by investors to pay for the bonds are held in escrow by the SPE. If a specified catastrophe event does not occur, the funds remain in escrow, and the investors receive periodic interest payments from the transaction sponsor plus the investment earnings on the escrowed funds. The escrowed funds are ultimately returned when principal payments are due on the bonds. If a specified catastrophe does occur, however, the escrowed funds are released by the SPE to the transaction's sponsor. Because the bonds are nonrecourse against the sponsor, the effect of the release of the escrowed funds to the sponsor is that the catastrophe bond investors will incur a loss; the SPE has no other assets to repay the bondholders. Thus, the catastrophe bond investors assume the risk of the catastrophe up to the level of their investment.

Catastrophe bonds tend to be issued by reinsurance companies as a way using capital markets to reinsure the risks they have assumed.[102] The total global catastrophe bond market has never had more than $31 billion of bonds outstanding, and issuance has never exceeded $12.5 billion per year in a market where there is unlikely to be substantial correlations between catastrophes. For example, a hurricane in the Caribbean is not correlated with an earthquake in California.[103]

Another measure of market appetite for this type of risk is the market for contingent convertible or "co-co" bonds. Co-cos are a type of "bail-in-able" capital—debt that converts to equity upon the occurrence of a specified trigger event. The conversion de-levers the debtor, immediately increasing its solvency. It also helps the debtor's liquidity as the conversion reduces its debt service. Such co-co bonds are fairly popular among European banks, but the total amount outstanding has never exceeded $140 billion.[104] Critically, co-cos do not themselves provide liquidity to the debtor upon conversion. They simply change where they sit in the debtor's capital structure. Nonetheless, they provide a measure for the appetite among investors for assuming credit risk on large financial institutions.

The largest financial institutions in the United States would require a couple magnitudes more of credit-linked notes than the entire catastrophe

102. *See* James Ming Chen, *Correlation, Coverage, and Catastrophe: The Contours of Financial Preparedness for Disaster*, 26 FORDHAM ENVTL. L. REV. 56, 70 (2014).

103. *Catastrophe Bonds and ILS Issued and Outstanding by Year*, ARTEMIS, http://www.artemis.bm/deal_directory/cat_bonds_ils_issued_outstanding.html [http://perma.cc/2UMC-395U] (last visited Sept. 14, 2018).

104. Justin Yang, *Co-Co Bond Market Pulls Through Recent Setbacks*, WALL ST. J., (June 25, 2017), https://www.wsj.com/articles/coco-bond-market-pulls-through-recent-setbacks-1498477962 [http://perma.cc/VU7M-SWYS]. That total is likely inflated in part because it reflects the relatively high yields on co-cos in a low interest rate environment. When rates rise, investors seeking to achieve certain return hurdles will have more options for higher-yielding investments and thus less interest in co-cos.

bond market or co-co bond market to finance a bankruptcy. JPMorgan alone, for example, would need up to $560 billion of liquidity support.[105] Given the high correlation risk between credit-linked notes for large financial institution, it's doubtful that there would be sufficient demand from global credit markets for such credit-linked notes to be sellable at a nonprohibitive rate.

3. Too Big to Fail Is Too Big to DIP

Ultimately if a firm is too-big-to-finance in bankruptcy or "too big to DIP," it's also too big to fail. If the private market cannot provide the DIP financing, that is a strong indicator that the firm is systemically important.[106]

There is only one source in the world capable of credibly providing a DIP loan of tens or hundreds of billions of dollars with minimal notice. That is the US government. No other entity in the world has this sort of financial strength. Yet it is inconceivable to imagine the federal government acting as a DIP lender without attaching strings to the extension of credit, such as demanding particular treatments for favored creditor constituencies.[107] And that takes us right back to the bailout situation, which has simply been moved into the bankruptcy system.

B. Lack of International Coordination Will Frustrate Financial Institution Bankruptcy

A second problem a FIB would face is international coordination, most critically because of a lack of agreement about loss distribution.[108] Large financial firms often operate internationally and have cross-border assets that may be a critical component of a financial firm's value. Chapter 15 of the Bankruptcy Code provides a voluntary mechanism for international coordination between US and foreign insolvency proceedings.[109] The

105. *See supra* text accompanying note 84.

106. Indeed, this suggests that perhaps bankruptcy could be used as a systemic risk shibboleth: if a firm is capable of prearranging standing DIP financing on a level that regulators believe is sufficient (presumably its maximum liquidity needs over the past several years), then bankruptcy might be a reasonable regime for the firm. But if the firm is too big to DIP, then it is also too big to fail and should be dealt with outside a bankruptcy regime.

107. In theory, conditions for DIP lending could be legislated, but it is difficult to do ex ante, and any such legislation would likely have a hydraulic effect on contractual terms—to the extent that one term is forbidden, it will likely be recreated synthetically through other terms.

108. *See* Anna Gelpern, *Common Capital: A Thought Experiment in Cross-Border Resolution*, 49 TEX. INT'L L. J. 355, 372 (2014); Jay Lawrence Westbrook, *SIFIs and States,* 49 TEX. INT'L L. J. 327, 347–48 (2014).

109. 11 U.S.C. § 1501(a) (2012). Chapter 15 authorizes the filing of an "ancillary case" by a foreign representative—such as a foreign trustee or court—to seek U.S. recognition of a "foreign proceeding." *Id.* § 1504. If granted, the U.S. automatic stay immediately comes into effect, and the foreign representative is authorized to operate the U.S. debtor's business in the ordinary course. *Id.* §§ 1520(a), 362(a). Additionally, Chapter 15 enables U.S. bankruptcy trustees to be authorized "to

coordination at issue in a US FIB may well be with other foreign regulatory processes rather than with bankruptcy, and foreign financial regulators are hardly guaranteed to cooperate with a US bankruptcy court.

Foreign regulators are likely to face domestic political pressure to ringfence the assets of the debtor firm's foreign affiliates, meaning that they will not make these assets available to support US creditors' claims.[110] In such a case, substantial going concern value could be lost as foreign creditors dismantle the financial institution's foreign assets.

C. Financial Contract Safe Harbors Will Frustrate Financial Institution Bankruptcy

Large financial institutions have substantial books of various financial contracts: swaps, repos, forward and future contracts, and securities contracts (collectively sometimes referred to as "qualified financial contracts" or "QFCs"). All of these financial instruments are potentially valuable assets. Under current bankruptcy law, non-debtor QFC counterparties may accelerate, terminate, and liquidate their positions without violating the automatic stay that otherwise stops creditor collection efforts upon the filing of a bankruptcy.[111] This means that if at any point post-petition the counterparty is in the money, the counterparty can terminate the contract and seize any collateral that has been posted for the transaction.[112] Thus, as soon as a financial institution is in trouble, QFC counterparties can run. The rationale for this treatment of QFCs is to limit systemic risk by ensuring that a failed institution's counterparties are not locked into a bankruptcy, thus resulting in a domino effect of illiquidity and insolvency.[113]

A FIB system need not keep with current law, of course. Every version of FIB legislation has proposed a forty-eight-hour stay for QFCs, in keeping

---

act in a foreign country on behalf of a [U.S. bankruptcy] estate." *Id.* § 1505. This mechanism enables coordination between U.S. and foreign insolvency proceedings, but it is not self-executing, nor does it guaranty any particular result. It simply creates a mechanism for U.S. judicial recognition of foreign proceedings, but it does not bind U.S. courts to cooperation with foreign proceedings.

110. Westbrook, *supra* note 98, at 346–47.

111. 11 U.S.C. §§ 362(b)(6), (b)(7), (b)(17), (b)(27) (2012); *id.* §§ 555, 556, 559, 561.

112. LEVITIN, *supra* note 20, at 301.

113. H.R. REP. NO. 97-420, at 1 (1982), *as reprinted in* 1982 U.S.C.C.A.N. 583, 583 (noting that "certain protections are necessary to prevent the insolvency of one commodity or security firm from spreading to other firms and possibly threatening the collapse of the affected market"). The report goes on to note that "[t]he prompt liquidation of an insolvent's position is generally desirable to minimize the potentially massive losses and chain reaction of insolvencies that could occur if the market were to move sharply in the wrong direction." *Id.* at 4, 1982 U.S.C.C.A.N. at 585. Whether the safe harbors continue to limit systemic risk post-Dodd-Frank Act is another matter. In other work, I have observed that the Dodd-Frank Act's requirement that most derivatives clear through clearinghouses eliminates the financial contagion concern for cleared derivatives, rendering the safe harbors duplicative. Levitin, *Prioritization and Mutualization*, *supra* note 79, at 132, 146, 154.

with the International Swaps and Derivatives Association's forty-eight-hour Universal Resolution Stay Protocol, which is incorporated into the contractual terms of most swaps contracts, although it is not in all QFC contracts.[114] The goal of the forty-eight-hour stay is to facilitate a transfer of the failed institutions' derivatives book to a solvent institution through a quickie "weekend" bankruptcy that will not disrupt global financial markets.[115]

But what if a buyer cannot be found on such short notice? If all large financial institutions are distressed, there might not be any buyers capable of assimilating a large QFC book. In such a case, a temporary stay, no matter what the length, merely delays the start of a run. Unless the stay lasts beyond the time of the sale in a GB/BB transaction, it will not be adequate to protect the debtor's QFC book. The longer the stay, however, the less work the QFC exceptions do to prevent systemic risk.[116]

The bigger problem with QFCs, however, is that the value of a debtor's individual QFC positions, much less the value of its total QFC book or segments thereof, is often not immediately knowable. This is especially true when some of the QFCs are hedges of various loans and others are simply free-standing gambles. JPMorgan Chase Bank, N.A. had, as of March 31, 2018, over $56 trillion in derivative exposures in what are surely thousands

114. Financial Institutions Bankruptcy Act of 2014, H.R. 5421, 113th Cong. § 3 (2014) (creating proposed section 1187(a)(3) to title 11 of the United States Code); Financial Institutions Bankruptcy Act of 2016, H.R. 2947, 114th Cong. § 3 (same); The Financial CHOICE Act of 2016, H.R. 5983, 114th Cong. § 232 (same); Financial Institutions Bankruptcy Act of 2017, H.R. 1667, 115th Cong. § 3 (same); Financial CHOICE Act of 2017, H.R. 10, 115th Cong. § 122 (same); INT'L SWAPS & DERIVATIVES ASS'N, INC., ISDA 2015 UNIVERSAL RESOLUTION STAY PROTOCOL 41 (2015), https://online.ercep.com/media/attachments/httpassetsisdaorgmediaa-en-94349.pdf [http://perma.cc/2DNM-ZGZ8]. In contrast, OLA has a stay until 5pm on the business day following the appointment of the FDIC as a receiver. 12 U.S.C. § 5390(b)(10)(B). The resulting stay could be as little as a 17-hours if the FDIC were appointed on at the end of a Monday-Thursday during a regular week or as much as a 113-hours if the FDIC were appointed as receiver the day before a 3-day weekend. The OLA stay and the contractual ISDA 48-hour stay overlap, such that the longer period would always apply.

115. H.R. REP. NO. 114-477, at 14–15 (2016).

116. The solution utilized in some FIB bills, as well as in OLA, is to have a "bridge institution" assume the qualified financial contracts, including derivatives. The bridge institutions, however, is not a permanent solution. It is a holding pen for assets until the assets or the equity of the bridge institution can be sold to a purchaser. All the creation of the bridge institution does is impose an intermediate step in moving the failed firm's valuable assets to new ownership. Yet just as with a debtor-in-possession, a bridge institution itself requires financing, and to the extent that a buyer or other source of financing cannot be found before the stay on the qualified financial contracts expires, there will be a run on the bridge institution.

of contracts.[117] Citibank, N.A. had over $55 trillion in derivative exposures at the same time.[118]

It would take substantial time to responsibly sort through those positions, particularly at a time when the firm is in disarray and key personnel in the debtor's organization may be looking for or have already taken other employment opportunities. This means that there will be substantial valuation uncertainty about the QFC book of the financial institution, even if its problems do not stem from that book of business.[119] That valuation uncertainty means that a potential buyer in a GB/BB structure will either not purchase the QFC book or will insist on a steep discount because of the valuation uncertainty. Either situation is likely to magnify the losses in bankruptcy and thus increase the likelihood of a domino effect as impaired creditors themselves fail.

D. *FIB Lacks of a Mechanism for Addressing Valuation Uncertainty Like the Orderly Liquidation Fund*

The valuation uncertainty problem is particularly acute for QFCs, but it is hardly limited to them. The failed financial institution might have a large book of residential or commercial mortgages of uncertain value, and the need for speed created by the automatic stay exceptions for QFCs also creates a valuation uncertainty problem for non-QFC assets.

In FDIC receiverships, including under OLA, the valuation uncertainty problem for QFCs and other types of assets can be addressed through an FDIC shared loss agreement. A common form of FDIC bank resolution is through a Purchase and Assumption agreement in which a solvent bank agrees to take over certain assets of a failed bank. Sometimes the FDIC guaranties the performance of some of the purchased assets under such agreements.[120] The result is that the purchased assets are on the books of the purchaser, but the valuation risk, at least the extent that it is due to the credit performance on the purchased assets lies (at least in part) with the FDIC.

117. *Statistics on Depository Institutions*, FDIC, https://www5.fdic.gov/sdi/main.asp?formname=compare [http://perma.cc/4NXA-KT9H (staff-uploaded archive)] (last visited Sept. 14, 2018).

118. *Id.*

119. The all-or-nothing assumption requirements that require the transfer as a block of all or no QFCs with any given counterparty only add to the valuation uncertainty problem. While these provisions are designed to prevent cherry-picking and create pressure for the transfer of all QFCs, they also mean that the transferee has no idea what it is taking. Notably, such all-or-nothing assumption is also required in OLA. 12 U.S.C. § 5390(c)(9)(A).

120. *See, e.g.*, https://www.fdic.gov/bank/individual/failed/lossshare/index.html; Thomas Vartanian and Gordon L. Miller, *A Review of the FDIC's Latest Tools for Resolving Problem Banks* 8, *at http://apps.americanbar.org/buslaw/newsletter/0079/materials/pp3.pdf*

Nothing prevents the FDIC from expanding loss sharing agreements to cover risks beyond credit performance, however.

The FDIC uses such shared loss agreements in part because of the need for speed in the FDIC resolution process. The FDIC likes, when possible, to maintain the operations of a failed bank without interruption. That means finding a buyer between the time when the FDIC takes over a bank (often at the close of business on Friday) and when the bank is next scheduled to open for business. Such a speedy turnaround precludes meaningful diligence of the assets—and hence a precise valuation—by the purchaser. The use of shared loss agreements enables the transaction to close quickly by shifting valuation risk onto the FDIC.

The limited stay for QFCs generates a similar need for speed in FIB proposals. There is no provision for FDIC shared loss agreements in FIB proposals, however, because this sort of use of government funds (even if they are only of a mutual insurance fund administered by the government) is anathema to the whole "private" FIB concept. In contrast, OLA expressly provides for an Orderly Liquidation Fund that could be used to address the valuation uncertainty in quick-turnaround GB/BB transactions that preclude careful buyer diligence of assets.[121]

Thus, not only does FIB lack a credible mechanism for financing a bankruptcy, even a very fast one, but it also lacks a mechanism to overcome the valuation uncertainty problem that the GB/BB transaction structure is meant to overcome. A GB/BB problem is supposed to address valuation uncertainty by separating good assets from a debt overhang. But if the assets to be transferred to the Good Bank are of uncertain value, it is unlikely that there will be a purchaser readily available within forty-eight hours absent a regulatory shotgun to the back.

III. SYSTEMIC FINANCIAL RISK AS A POLITICAL QUESTION

A. *The Political Nature of Systemic Risk*

The failure of a large financial institution is not merely a private matter between the debtor and its creditors. It is a matter of public concern because of the possibility of a systemic financial risk externality—that the failure of a financial institution would impose costs throughout the financial system, potentially resulting in a domino effect of financial institution failures and ultimately a contraction of economic activity in the real economy because of a lack of liquidity from financial markets. As I have argued elsewhere, there

121. 12 U.S.C. § 5390(n).

is no meaningful economic definition of "systemic risk."[122] It is not a measurable concept. Instead, the term is only sensible as a label for the *political* importance of a firm's financial failure in terms of political unwillingness to allow the social consequences from the institution's failure to materialize without intervention. Systemic risk is a political question, but the bankruptcy court system is not built to handle matters of public policy—political questions.

American courts have a long-standing political question doctrine—the courts will not insert themselves into political questions properly committed to another branch of government.[123] There are two related reasons underlying this prudential doctrine. First, if the courts insert themselves into political issues, they might simply be disregarded, thereby eroding the standing of the courts, and second, it protects the legitimacy of the courts for when they rule on nonpolitical questions.

We should see systemic financial problems as political questions. The failure of large financial institutions creates a high likelihood of spillover effects into the broader economy and a response that involves the public fisc. Thus, systemic financial crises are ultimately distributional matters writ large and affect the general public, not just disputes between private parties. Such policy questions are not appropriate for the courts, much less for non–Article III courts. The courts are designed for conducting an adversarial process to resolve cases and controversies among litigants, not for determining broader questions of economic distribution in society that may affect third parties. Those parties have no voice in the court whether because of lack of legal standing, lack of knowledge of the case, or lack of wherewithal to participate in the case. Such broader distributional policy questions are therefore best left to the political branches of government.

It is true that courts regularly adjudicate matters involving the public fisc—all tax cases for example[124]—but these are adjudicated within a statutory framework that deals with the liability of individual entities to the government (or vice-versa). It is never in the context of general distributional questions, such as which groups of creditors should be paid and which should not be. That sort of distributional decision is reserved for the legislature (which may delegate it to an administrative agency, as with OLA). The combination of the use of the public fisc outside normal government

122. *See* Levitin, *supra* note 4, at 439–40.

123. Nixon v. United States, 506 U.S. 224, 228–29 (1993); Baker v. Carr, 369 U.S. 186, 210–11 (1962).

124. *See, e.g.*, Fredericks v. Comm'r, 126 F.3d 433, 435, 449 (3d Cir. 1997) (adjudicating dispute between appellant and IRS about whether appellant's tax deficiency assessment resulting from disallowance of tax-shelter deduction was valid and analyzing the impact of the doctrine of estopel on the public fisc).

spending processes with distributional decisions about who should benefit directly or indirectly from the use of those public funds is a fundamentally different matter than courts are used to addressing.

B. The New Bankruptcy: Bankruptcy as a Public Policy Forum

Since 2008, however, bankruptcy has changed. It has ceased to simply be a forum for readjusting financial obligations of private firms and individuals and has also become a forum for resolving thorny political problems. The Chrysler and General Motors bankruptcies were the first and most explicit instance of this. The auto manufacturers' bankruptcies provided a vehicle for the federal government to intervene to support the industrial economy throughout the Rust Belt. Likewise, post-2008 bankruptcy has been used as a way to provide a lifeline to the struggling domestic coal industry by enabling coal producers to shed their environmental liabilities and continue production.[125] To be sure, bankruptcy law always played a role in addressing public policy questions, such as how to allocate the risk of mass toxic torts or how to deal with the volatile finances of the airline industry. But post-2008 bankruptcy has been used more explicitly and deliberately by the executive branch as a forum for implementing policy.

Also starting in 2008, the use of Chapter 9 municipal bankruptcy began to change. Prior to 2008, there were only two hundred non-erroneous Chapter 9 filings, only thirty-four of which were by general-purpose municipalities.[126] Most were by special-purpose hospitals,[127] water or sanitary districts,[128] or other specialized local governments with discrete financial problems. The only general-purpose government of any size to file prior to 2008 was Orange County, California, which governs the unincorporated areas of the County; most other general-purpose municipalities had fewer than one thousand residents.[129]

125. *See* Joshua Macey, *Bankruptcy as Bailout: Coal, Chapter 11, and the Erosion of Federal Law*, 71 STAN. L. REV. (forthcoming 2019).

126. Author's analysis of PACER data; *see generally* Omer Kimhi, *Chapter 9 of the Bankruptcy Code: A Solution in Search of a Problem*, 27 YALE J. ON REG. 351 (2010) (expressing doubts about bankruptcy's utility in the municipal context).

127. *See, e.g.*, *In re* Green Cty. Hosp., 59 B.R. 388, 391 (Bankr. S.D. Miss. 1986).

128. *See, e.g.*, *In re* Sullivan Cty. Reg'l Refuse Disposal Dist., 165 B.R. 60 (Bankr. D. N.H. 1994).

129. For example, Moffett, Oklahoma, population 128 in the 2000 census, filed for bankruptcy after it lost its revenue from operating an illegal speed-trap on the Interstate highway. Tony Thornton & Sheila Stogsdill, *Moffett Seeks Bankruptcy Protection: Town Bears Toll of Designation as a Speed Trap and Debts Incurred by the Late Mayor*, NEWSOK (Feb. 2, 2007, 12:00 AM), https://newsok.com/article/3007448/moffett-seeks-bankruptcy-protectionbrspan-classhl2town-bears-toll-of-designation-as-a-speed-trap-and-debts-incurred-by-the-late-mayorspan? [http://perma.cc/TC64-PTZZ]. Likewise, the city of Washington Park, Illinois, population 5,345 in the 2000 census, filed for Chapter 9 unsuccessfully twice, once after a town

Since 2008, however, Chapter 9 has been used by large, general purpose municipalities: Detroit, Michigan; San Bernardino, Stockton, and Vallejo, California; and Jefferson County, Alabama have all gone through Chapter 9. Navigating these cities' insolvencies was not just a matter of financial decisionmaking but also political decisions. All bankruptcies involve distributional choices between creditor constituencies: Will money go to bondholders, vendors, or tort creditors for their prepetition claims? But with municipal bankruptcies there are also taxpayers who are not creditors, yet whose interests are very much implicated by any sort of payment plan: What level of municipal services will be offered going forward? What will municipal tax rates be? Will prized municipal assets that add substantially to quality of life, such as the artwork in the Detroit Institute of Arts, be sold to pay creditors or retained? Chapter 9 cases require navigating the politics of failed cities.

Bankruptcy scholarship has only just started grappling with the increased use of bankruptcy to manage political problems. Melissa Jacoby and Edward Janger have both recently written about how bankruptcy can manage the politics of decisions in Chapter 9.[130] In earlier work regarding proposals to allow states to file for bankruptcy, I have suggested that bankruptcy is generally an inherently political process because of its distributional nature, but when bankruptcy affects more than creditors, its politics become unmanageable.[131] Likewise, in other work with Aurelia Chaudhury and David Schleicher, I deal with this problem in the context of simultaneous financial crises for overlapping municipal governments.[132]

All of this work recognizes the fundamental difficulty of managing politics in the bankruptcy process. While bankruptcy judges have figured out creative ways to do this in Chapter 9, it is far from an ideal process because

employee embezzled the town's funds and another time after a successful challenge to the town's topless dancer license fee. J.C. Pistor, *Washington Park Files for Bankruptcy Protection,* ST. LOUIS POST-DISPATCH (July 31, 2009), https://www.stltoday.com/news/washington-park-files-for-bankruptcy-protection/article_b2a68ed0-91a3-53c7-87bc-d157c6aa181a.html [https://perma.cc/4RF5-VHK5] (describing Washington Park, IL's repeated bankruptcy filings following successful challenges to topless dancer license fee). While these examples are colorful, they are also typical of the size of general-purpose municipalities that have historically filed for Chapter 9 bankruptcy.

130. *See* Melissa B. Jacoby, *Federalism Form and Function in the Detroit Bankruptcy*, 33 YALE J. ON REG. 55, 70–71 (2016); Melissa B. Jacoby, *Presiding over Municipal Bankruptcies: Then, Now and Puerto Rico*, 91 AM. BANKR. L.J. 375, 385–88 (2017); Edward J. Janger, *Towards a Jurisprudence of Public Law Bankruptcy Judging*, 12 BROOK. J. CORP. FIN. & COM. L. 39, 46–48 (2017).

131. Adam J. Levitin, *Bankrupt Politics and the Politics of Bankruptcy*, 97 CORNELL L. REV. 1399, 1451–55 (2012) (arguing that bankruptcy problems need to be addressed in political rather than financial terms).

132. Aurelia Chaudhury, Adam J. Levitin & David Schleicher, *Junk Cities: Resolving Insolvency Crises in Overlapping Municipalities*, 107 CAL. L. REV. (forthcoming 2019).

it gives an unelected judge tremendous discretion and is ultimately not at all a democratic process. This observation does not commend the expansion of bankruptcy to political cases like those of too-big-to-fail financial institutions.

Ironically, some of those who support the idea of FIB, such as Professors David A. Skeel, Jr. and Mark J. Roe, were sharp critics of the Chrysler and General Motors bankruptcies.[133] The Chrysler and General Motors bankruptcies both used a GB/BB format with the firms' good assets and certain politically favored liabilities—such as obligations to the firms' unionized workforces—assumed by the Good Chrysler and Good GM, and the bad assets and disfavored liabilities left behind in Bad Chrysler and Bad GM for liquidation.[134] The Chrysler and GM bankruptcies were harshly criticized as having violated bankruptcy rules of priority and for being sub rosa reorganization plans.[135]

While these criticisms are arguably incorrect,[136] they underscore a more fundamental point: the bankruptcy system is not designed for dealing with systemic financial crises. When the bankruptcy system is used to handle systemically important firms, it is very likely to be warped by the weight of political concerns and cease to be the neutral, fair process that FIB advocates imagine it to be.[137] This will be all the more true if DIP financing comes from the only realistic source, the U.S. government.

133. *See* Mark J. Roe & David Skeel, *Assessing the Chrysler Bankruptcy*, 108 MICH. L. REV. 727, 729–31 (2010) (criticizing the Chrysler bankruptcy for failing to adhere to bankruptcy priorities). While Professor Skeel has strongly endorsed financial institutions bankruptcy, *see, e.g.*, Skeel, Jr., *supra* note 3, at 329, Professor Roe rightly recognizes the problems with financial institutions bankruptcy, but argues it should exist as an option alongside a regulatory resolution scheme. *See* Mark J. Roe, *Why Regulators Are Needed to Handle Failed Banks*, N.Y. TIMES (June 6, 2017), https://www.nytimes.com/2017/06/06/business/dealbook/why-regulators-are-needed-to-handle-failed-banks.html [https://perma.cc/S5MY-5A55].

134. *See* Jeffrey McCracken, John D. Stoll & Neil King Jr., *U.S. Threatens Bankruptcy for GM, Chrysler*, WALL ST. J. (Mar. 31, 2009, 12:01 AM), https://www.wsj.com/articles/SB123845591244871499 [https://perma.cc/6QL5-8UDE] (describing use of bankruptcy for implementing good bank/bad bank plan).

135. *See* Roe & Skeel, *supra* note 120, at 741; *see also* Barry E. Adler, *A Reassessment of Bankruptcy Reorganization after* Chrysler *and* General Motors, 18 AM. BANKR. INST. L. REV. 305, 308 (2010); Ralph Brubaker & Charles Jordan Tabb, *Bankruptcy Reorganizations and the Troubling Legacy of* Chrysler *and* GM, 2010 U. ILL. L. REV. 1375, 1377–79 (2010).

136. The absolute priority rule applies only in a cramdown confirmation, and then only to nonconsenting classes of unsecured claimants and equity interests. 11 U.S.C. § 1129(b)(2)(B)–(C) (2012). By its own terms, it does not apply to asset sales or to consensual plans. The objecting creditors in Chrysler were part of a consenting class of secured creditors. *In re* Chrysler LLC, 405 B.R. 84, 104 (Bankr. S.D.N.Y. 2009), *aff'd*, 576 F.3d 108 (2d Cir. 2009), *appellate decision vacated as moot sub nom.* Ind. State Pension Tr. v. Chrysler LLC, 558 U.S. 1087 (2009). For a convincing argument that there was nothing particularly unusual or illegal about the transaction structures used in the GM and Chrysler bankruptcies, see generally Stephen J. Lubben, *No Big Deal: The GM and Chrysler Cases in Context*, 83 AM. BANKR. L.J. 531 (2009).

137. *See, e.g.*, Brubaker & Tabb, *supra* note 122, at 1405.

Contemporary bankruptcy practice often follows the "golden rule"—he who has the gold makes the rules.[138] This means that it is often the DIP lender calling the shots on things such as whether there will be an asset sale, what assets will be sold, and what the bidding procedures will be.[139] Sometimes these issues have to be decided at the very beginning of a case before creditors have managed to organize themselves.

In such a situation, the only party capable of staring down an over-reaching DIP lender is the bankruptcy judge, but bankruptcy judges are not well suited for this role. Bankruptcy judges are not Article III judges with life tenure. When a non–Article III judge who likely has no expertise regarding the particular debtor firm or financial markets generally is presented with a situation in which he is told that he must immediately approve a transaction or else the global economy will collapse, the judge is put in an untenable position. The judge is likely to approve the transaction, whether or not it complies with the law. The judge might make some noise, but will ultimately be rolled.[140]

The rule-of-law virtues of the bankruptcy system will inevitably become warped if the system is dragooned to handle systemic risks that trump any law. Put differently, it is bad for bankruptcy courts to deal with systemic risk, and it is bad for systemic risk to have bankruptcy courts managing the resolution process. Political questions like resolution of systemic financial distress should be resolved in the political forum, not the courts.

CONCLUSION

What would happen if we go down the FIB rabbit hole? One of three things: First, the bankruptcy process will be abused, as alleged to have occurred in GM and Chrysler, to achieve the financial stability end sought by whatever administration is in office. In other words, a bailout will occur through bankruptcy; Second, there will be a questionably illegal, ad hoc bailout, with lots of finger-wagging, clucking, and tsk-tsking after the fact, as occurred with the use of the Exchange Stabilization Fund to aid Mexico in 1995,[141] or the Federal Reserve's Maiden Lane structures in 2008,[142] or

138. *See, e.g.*, Adler, *supra* note 122, at 308, 313–14. This alone should call into question the desirability of bankruptcy as a mechanism for dealing with any problem.

139. *See id.*

140. *See, e.g.*, Baird, *supra* note 35, at 290.

141. *See* Russell Dean Covey, *Adventures in the Zone of Twilight: Separation of Powers and National Economic Security in the Mexican Bailout*, 105 YALE L.J. 1311, 1313–14 (1996) (arguing that the Clinton administration's use of the Exchange Stabilization Fund in 1995 to bail out Mexico was illegal).

142. *See, e.g.*, Alexandra Mehra, *Legal Authority in Unusual and Exigent Circumstances: The Federal Reserve and the Financial Crisis,* 13 U. PA. J. BUS. L. 221, 238–41 (2011); Eric A. Posner,

the use of the Exchange Stabilization Fund in 2008 to bailout money market mutual funds;[143] Or third, Congress will rapidly pass bailout-authorization legislation, much as it did with the Emergency Economic Stabilization Act in 2008.[144]

None of these are desirable outcomes. Nobody likes bailouts. But realistically they are inevitable when things get bad enough because no one wants to deal with the political consequences of a true economic meltdown.[145] The realistic goal is not avoiding bailouts altogether but finding a predictable legal framework for the bailouts that distributes as much of the cost as possible to the beneficiaries of the bailout at a time when it will not cause systemic disruption. Insisting on bankruptcy as a bailout alternative is ideologically-driven self-deception. The pursuit of the Fool's Gold of FIB will ultimately result in bailouts whether in the guise of bankruptcy or otherwise.

We do not want to be comfortable with bailouts, and we should not be. The best way to avoid bailouts is through better ex ante regulation. If risk is adequately managed on the front-end, there will be no need to deal with the consequences on the back-end. Yet markets change and innovate, and there is constant political pressure for deregulation. Even without these pressures, no system of regulation is foolproof, so bailouts may be unavoidable in some circumstances.

It does no favor to the rule of law to saddle legal procedures like bankruptcy with political questions like bailouts. No end is served by pretending that bailouts are creatures of law; a wolf in sheep's clothing is still a wolf. Yet that is precisely what the pipedream of FIB would do. We need to accept that as distasteful as bailouts may be, the resolution dilemma will always be resolved with a bailout. We should plug our ears to the bankruptcy Lorelei's louche song and instead concentrate on bolstering the prudential regulatory regime that seeks to prevent crises in the first place so that the resolution dilemma, and its inevitable outcome, will not arise.

What Legal Authority Does the Fed Need During a Financial Crisis? 101 MINN. L. REV. 1529, 1548–49 (2017).

143. *See, e.g.*, PHILLIP A. WALLACH, TO THE EDGE: LEGALITY, LEGITIMACY, AND RESPONSES TO THE 2008 FINANCIAL CRISIS 75-77 (2015).

144. Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, §§ 101–102, 122 Stat. 3765, 3767–70 (2008).

145. Levitin, *supra* note 6, at 439–40.