ARTICLES

A CONTINUUM APPROACH TO SYSTEMIC RISK AND TOO-BIG-TO-FAIL*

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This Article highlights differences between principle and practical implementation of prudential financial regulation and resolution rules for failing financial institutions. In principle, prudential regulation gradually enhances enforcement along a risk-based continuum. Under this approach, systemically important financial institutions, which pose greater potential threats to economic stability, theoretically should be more strictly regulated than other financial entities. In reality, however, regulators often opt not to fully enforce prudential financial regulations against such large institutions, a practice sometimes referred to as regulatory forbearance. In ironic contrast, rules for resolving failing financial institutions have increasingly restricted regulators' options, often limiting them to a binary choice between allowing the entity to fail and providing a government "bailout." In reality, however, regulators have flexibly responded to failing institutions along a continuum ranging from little or no intervention to public rescue. Despite Dodd-Frank's attempt to limit this "reality," regulators are likely to continue the flexible exercise of their resolution authority.

In this Article, I argue that a continuum-based approach is important for both prudential regulation and the resolution of failing firms. With respect to regulation, this approach should ensure proper implementation of existing gradually enhanced prudential regulatory rules. With respect to resolution, this approach acknowledges and accepts the range of existing and potential government responses to failing financial institutions. Rather than pretend to rid the system of bailouts, policy makers should develop an equitable and transparent process and substantive criteria for allocating risk in the event of systemically important financial institution failures.

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INTRODUCTION

Congress responded to the Great Recession of 2007–2009 [1] by addressing a wide array of financial issues in its historic and sweeping Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010

1. After the media began using the term, the Associated Press granted its official blessing, adding "Great Recession" to its official stylebook. ASS. PRESS, THE ASSOCIATED PRESS STYLEBOOK AND BRIEFING ON MEDIA LAW 125 (2011). According to the National Bureau of Economic Research (NBER), the recession that began in December 2007 and ended in June 2009 was the longest of any U.S. recession since World War II. NAT'L BUREAU OF ECON. RESEARCH, DETERMINATION OF THE DECEMBER 2007 PEAK IN ECONOMIC ACTIVITY 1–2 (2008), *available at* http://www.nber.org/dec2008.pdf; NAT'L BUREAU OF ECON. RESEARCH, BUSINESS CYCLE DATING COMMITTEE (2010), *available at* http://www.nber.org/cycles/sept2010.html.

(Dodd-Frank).[2] Among other things, Dodd-Frank created a new Bureau of Consumer Financial Protection,[3] adopted anti-predatory lending rules,[4] and provided new regulatory authority with respect to over-the-counter (OTC) derivatives contracts and hedge fund advisors.[5] More important for purposes of this Article, Congress responded to the economic crisis with financial reforms focused on large banks, bank holding companies (BHCs), and nonbank financial institutions, all of which might present systemic economic risk. Dodd-Frank was enacted in a political climate fraught with voter frustration over lax regulatory oversight of the financial industry and anger at taxpayer-funded bailouts of companies considered "too-big-to-fail" (TBTF).[6] To appease angry voters, Dodd-Frank's preamble emphatically declared an end to TBTF policies and promised "to protect the American taxpayer by ending bailouts."[7] Though perhaps politically efficacious, this questionable statutory rhetoric alone hardly justifies Dodd-Frank's status as landmark legislation.[8]

Rather, Dodd-Frank's significance with respect to systemic risk regulation is its provision for new and enhanced monitoring, supervision, and enforcement tools designed to prevent or minimize potential system-wide economic harms, and its expansion of regulatory authority over large, interconnected nonbank financial institutions. Consistent with financial

2. Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified in scattered sections of the U.S.C.).

3. *Id.* § 1011.

4. *Id.* §§ 1400–1498.

5. *Id.* §§ 711–774 (regulation of derivatives); *id.* §§ 1570–1580 (regulation of hedge fund advisors).

6. *See, e.g.*, Jackie Calmes, *Democrats Seize on Oversight*, WASH. POST, Apr. 19, 2010, at A1 (referring to increased confidence among Democrats about prospects for financial regulatory reform given "voter anger at big banks and bailouts"); Jim Puzzanghera, *Debate Begins on Final Overhaul Reform: Sides Must Reconcile Differing Bills Passed in House, Senate*, CHI. TRIB., June 11, 2010, at C31 (quoting Rep. Paul Kanjorski as saying, "[f]eelings of anger, frustration and rage justifiably hang over this proceeding because of the recklessness of financial whiz kids, the greediness of Wall Street bankers and the shortsightedness of our economic regulators").

7. *See* Dodd-Frank Act, 124 Stat. 1376 (codified in scattered sections of the U.S.C.). As he signed the legislation, President Obama asserted: "*There will be no more tax-funded bailouts, period.*" President Obama Remarks on Signing the Dodd-Frank Wall Street Reform and Consumer Protection Act, *in* 2010 DAILY COMP. PRES. DOC. 617 (July 21, 2010) (emphasis added).

8. *See* Cheryl D. Block, *Measuring the True Cost of Government Bailout*, 88 WASH. U. L. REV. 149, 154–55 (2010) [hereinafter Block, *Measuring Bailout Cost*] (arguing that "no bailout" claims are not credible precommitment devices). *See also* Jonathan R. Macey & James P. Holdcroft, Jr., *Failure Is an Option: An Ersatz-Antitrust Approach to Financial Regulation*, 120 YALE L.J. 1368, 1389 (2011) ("[T]here is reason to believe that the Dodd-Frank Act actually will increase the probability that financial institutions in general, and insurance companies in particular, will be bailed out in the future."); Adam J. Levitin, *In Defense of Bailouts*, 99 GEO. L.J. 435, 439 (2011) ("Bailouts are an inevitable feature of modern economies, in which the interconnectedness of firms means that the entire economy bears the risk of an individual firm's failure. . . . Any prefixed resolution regime will be abandoned whenever it cannot provide acceptable distributional outcome. In such cases, bailouts are inevitable.").

reform legislation more generally, Dodd-Frank's approach includes two categories of response. First, prudential financial regulation reform—the *regulatory response*[9]—theoretically addresses the problem of systemic risk through a long-term, forward-looking lens, subjecting regulated entities to ex ante substantive requirements or restrictions designed to maintain financial stability and general confidence in the economy, and more specifically, to mitigate or prevent system-wide economic harms.[10] Second, the *resolution response* emphasizes ex post rules on the scope and limits of government authority to intervene in the event of imminent or actual systemic financial crisis.[11]

Commentary on Dodd-Frank to date has given it mixed reviews.[12] On the other hand, most commentators have found at least some praiseworthy details among the Act's thousands of pages.[13] In any event, if for no other

9. For purposes of this Article, I use the term "prudential regulation" as a combined reference to: (1) monitoring and supervision rules, which deal with government access to information, bank examination, and related regulatory enforcement; and (2) prudential rules, which impose substantive mandates, such as minimum capital and liquidity reserve requirements. My focus on systemic risk is not to minimize the importance of other prudential regulation functions, including protecting consumers from fraud, abuse, and discriminatory lending practices, and correcting for information asymmetries that result in imbalanced bargaining power.

10. One illustration of Dodd-Frank's ex ante regulatory response is its "Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies." Dodd-Frank Act § 113, 124 Stat. 1398 (codified at 12 U.S.C. § 5323). For more detailed discussion, see *infra* notes 140–79 and accompanying text. Additional Dodd-Frank regulatory responses provide enhanced regulatory authority for hedge funds, Dodd-Frank §§ 401–419, 124 Stat. 1570–80 (codified in scattered section in 15 U.S.C.) (Regulation of Advisers to Hedge Funds), and derivatives and other swap markets, *id.* §§ 721–774 (Regulation of Swap Markets). Although insurance companies will continue to be regulated primarily by the states, the definition of "U.S. nonbank financial company," *id*. § 102(a)(4)(B), is broad enough to permit the new Financial Stability Oversight Council (FSOC) to subject certain insurance companies to Federal Reserve Board prudential standards. *Id.* § 113(a).

11. Perhaps the most significant of Dodd-Frank's ex post responses is its new "Orderly Liquidation Authority," *id.* §§ 201–216, designed "to provide the necessary authority to liquidate failing financial companies that pose a significant risk to the financial stability of the United States *in a manner that mitigates such risk and minimizes moral hazard*." *Id.* § 204(a) (emphasis added). For an overview of these and other aspects of the Act, see DAVID A. SKEEL, JR., THE NEW FINANCIAL DEAL: UNDERSTANDING THE DODD-FRANK ACT AND ITS (UNINTENDED) CONSEQUENCES (2010) [hereafter SKEEL, NEW FINANCIAL DEAL]. For further discussion on the meaning of "resolution" and the distinction between resolution and regulation, see *infra* notes 186–211 and accompanying text.

12. *See, e.g.*, Joel Seligman, *Tyrell Williams Lecture: Key Implications of the Dodd-Frank Act for Independent Regulatory Agencies*, 89 WASH. U. L. REV. 1, 11–12 (2011) (Dodd-Frank "establishes pivotal new powers for the Financial Stability Oversight Council, reduces gaps and omissions that had proven quite problematic, and enacts some substantive limits, . . . which should, in fact, reduce financial risk"). *Cf.* SKEEL, NEW FINANCIAL DEAL, *supra* note 11, at 8 ("Unless its most dangerous features are arrested, the legislation could permanently ensconce the worst tendencies of the regulatory interventions during the recent crisis as long-term regulatory policy.").

13. Bernard S. Sharfman, *Using the Law to Reduce Systemic Risk*, 36 J. CORP. L. 607, 615–16 (2011) (praising regulation of capital ratios, but arguing that this approach in Dodd-Frank is "incomplete because it is backward-looking"). *See also* Arthur E. Wilmarth, Jr., *The Dodd-Frank Act: A Flawed and Inadequate Response to the Too-Big-To-Fail Problem*, 89 OR. L. REV. 951,

reason than that insufficient time for assessment has passed, few would claim complete success for Dodd-Frank's financial reforms. Various aspects of the Dodd-Frank reforms undoubtedly will be scrutinized, praised, criticized, and empirically tested for years to come. While this Article focuses particular attention on systemic risk regulation and resolution authority, its purpose is not to comprehensively review Dodd-Frank's systemic-risk related measures, provide a thorough analysis and critique of any specific Dodd-Frank titles or provisions, or to debate any particular regulatory models.

Instead, this Article argues more generally that regulators and legislators have suffered from a collective practical tendency to approach the *problem* of regulating potential or imminent system-wide economic harm, and the *solutions* when such harms arise, in black and white terms.[14] This frequently binary reality of financial regulation and resolution of systemic risk is especially striking given its inconsistency with formal and informal regulatory and resolution principles. Prudential *regulation* principles reflected in statutory and regulatory language generally impose progressively more stringent supervision and regulatory enforcement actions against financial institutions as risk levels increase or the economic health of the regulated entity declines. In other words, prudential regulators acknowledge and purport to apply a risk-based continuum approach. In practice, however, these principles are often disregarded with respect to large, systemically important institutions. Moreover, Dodd-Frank's prudential regulation reforms adopt a binary classification, which now includes one set of "ordinary" rules, and a separate category of special rules applicable to systemically important institutions. The underlying logic is that certain characteristics can identify financial entities so large or interconnected that their failures would pose systemic threats to financial stability. Financial entities on the systemic risk side of this magic line, often referred to as systemically important financial institutions, or "SIFIs," theoretically should be subject to heightened prudential regulation.[15]

Government options with respect to *resolution* authority also tend to be presented starkly. Prior to Dodd-Frank, the Treasury Department complained that large, interconnected financial companies during a

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1009 (2011) [hereinafter Wilmarth, *Dodd-Frank*] (recognizing "valuable improvements" from new rules applicable to systemically important financial institutions (SIFIs), but noting that "those provisions are unlikely to prevent future failures of SIFIs with the attendant risk of governmental bailouts for systemically significant creditors."); John C. Coffee, Jr., *Systemic Risk After Dodd-Frank: Contingent Capital and the Need for Regulatory Strategies Beyond Oversight*, 111 COLUM. L. REV. 795, 802 (2011) [hereinafter Coffee] (arguing that "[a]lthough greater regulatory oversight [as provided in Dodd-Frank] is certainly desirable, . . . exclusive reliance upon it is unrealistic").

14. For purposes of this Article, I loosely consider congressional *regulatory* response as a reaction to "the problem," and the *resolution* response as an attempt at a "solution."

15. For further discussion of SIFIs, see *infra* notes 140–46, 176–79 and accompanying text.

financial crisis faced "only two untenable options: obtain emergency funding from the US government [bailout] . . . , or file for bankruptcy. . . ."[16] Responding to this concern, Dodd-Frank established new authority for regulators to make a formal "systemic risk determination"[17] with respect to a large financial company that poses "a significant risk to the financial stability of the United States,"[18] after which the Federal Deposit Insurance Corporation (FDIC) is appointed as receiver and *required* to proceed with an "orderly liquidation" of the entity.[19] Committee reports accompanying the legislation explain that the "orderly liquidation authority" (OLA) provision was designed "to give the U.S. government a viable alternative to the undesirable choice . . . between bankruptcy of a large, complex financial company that would disrupt markets and damage the economy, and [a] bailout . . . that would expose taxpayers to losses and undermine market discipline."[20]

Just as it established a binary classification of systemically important financial institutions subject to enhanced prudential supervision and other financial institutions that are not, Dodd-Frank for resolution purposes similarly imagines a point—identified by a "systemic risk determination"—beyond which the actual or imminent default of a particular large financial entity presents an economic stability threat so severe that the institution should be subject to a special OLA regime.[21] By adding orderly liquidations and purporting to eliminate the bailout option, Dodd-Frank apparently just substitutes one binary choice (bankruptcy vs. bailout) for another (bankruptcy vs. orderly dissolution). Binary approaches to the problem (systemic risk or not) and structural options for the solution (bankruptcy vs. bailout, or bankruptcy vs. orderly liquidation) fail to capture nuances on both sides. With respect to the problem, "systemic risk" is not a precise term, but a concept embodying several distinct dimensions more usefully analyzed along a continuum. With respect to the solution, "bankruptcy" and

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16. U.S. DEP'T OF THE TREAS., FINANCIAL REGULATORY REFORM: A NEW FOUNDATION: REBUILDING FINANCIAL SUPERVISION AND REGULATION 76 (2010) [hereinafter TREAS. REFORM REPORT]. The Treasury Report further concluded that, "[n]either of these options is acceptable for managing the resolution of the firm efficiently and effectively in a manner that limits the systemic risk with the least cost to the taxpayer." *Id*.

17. Dodd-Frank Act § 203, 124 Stat. 1450 (2010) (codified at 12 U.S.C. § 5383) (procedural mechanisms for systemic risk determination with respect to struggling financial company). For discussion of "systemic risk determinations," see *infra* notes 277–86 and accompanying text.

18. Dodd-frank Act § 204(a), 124 Stat. 1454 (codified at 12 U.S.C. § 5384). The definition of "financial company" includes bank holding companies, nonbank financial companies supervised by the Federal Reserve Board, and certain companies predominantly engaged in activities determined to be financial in nature or incidental thereto by the Federal Reserve Board. *Id.* § 201(a)(11).

19. *Id.* § 204. For further discussion of the new "orderly liquidation authority," see *infra* notes 275–301 and accompanying text.

20. S. REP. NO. 111-176, at 4 (2010).

21. Dodd-Frank Act § 203(a)(2), 124 Stat. 1450 (codified at 12 U.S.C. § 5383) (listing required contents of systemic risk determination recommendation).

"bailout" themselves are broad terms; bankruptcies may be resolved in many different ways, and the term bailout—to the extent that it can be defined—encompasses an even broader array of possibilities. Even broadly defined, the terms "bailout" and "bankruptcy" fail to capture the full range of risk allocation mechanisms that should be considered in developing coherent rules and norms for resolving actual or potentially imminent business insolvencies. Although the debate appears to be about public (bailout) vs. private (bankruptcy) resolution of business failures, I argue that business resolution devices cannot be readily classified as one or the other, but rather belong on a private-public continuum.

My objective with this Article is first to highlight differences between principle and practical implementation of prudential regulation and resolution rules. A close look at these differences exposes an odd twist. In principle, even though general prudential *regulatory* rules reflect a gradual risk-based continuum approach, their implementation with respect to large systemically important institutions has often been through regulatory forbearance.[22] Particularly when confronted with lobbying pressure from very large banks, regulators have opted for inaction. In ironic contrast, statutory and regulatory *resolution* rules over time have increasingly restricted regulators' options, often apparently leaving regulators to make a binary choice between letting the entity fail and providing a major government rescue or "bailout." In reality, however, regulators have adopted a range of government strategic responses to imminent or actual large private business failures. In the end, resolution authority is binary in principle, but actually implemented along a private-public continuum. Despite Dodd-Frank's attempt to limit this "reality," I conclude that regulators are likely to continue to exercise their resolution authority in a more flexible manner along this continuum than might otherwise appear from formal and statutory rules.

I contend that a continuum-based approach is important for both regulation and resolution. On the regulation side, this approach suggests better implementation of the risk-based principles *already in place* and assurance that new enhanced prudential regulatory rules will be properly implemented. On the resolution side, it means understanding that resolution authority reflects government policy with respect to allocating large financial entity failure risks. Rather than to focus on and pretend to rid the system of bailouts, regulators should acknowledge the range of existing and potential government responses to risk allocation, and work toward developing an equitable and transparent process and substantive criteria for making allocative choices in the case of systemically important financial institution failures.

22. *See infra* notes 44–71 and accompanying text.

Part I of this Article focuses first on the contrast between principle and reality in the systemic-risk related prudential regulation of banking institutions, followed by a similar analysis with respect to nonbank financial institutions. I conclude—at least with respect to large financial institutions—that prudential regulation reality is much closer to a binary model than prudential financial regulatory principles would suggest. Part I also includes an analysis of related Dodd-Frank reforms, arguing that they have done little to alter this principle-reality divide. Part II begins by distinguishing prudential regulation from resolution, focusing on resolution as a risk allocation mechanism. After briefly discussing bank and nonbank financial institution resolution rules, Part II follows with an analysis of Dodd-Frank's impact on systemic-risk related resolution authority. Here, too, I find a divide between reality and practical implementation of systemic-risk related resolution rules. Part III develops a private-public continuum for risk allocation, and concludes with a discussion of implications.

I. REGULATORY RESPONSE TO SYSTEMIC RISK: PRINCIPLE VERSUS REALITY

A. PRUDENTIAL BANK REGULATORY LANDSCAPE

1. Primary Bank Regulators[23]

History, politics, and turf battles over regulatory authority since the Civil War have contributed to the existing U.S. banking and financial regulation system, a complex patchwork quilt incorporating multiple federal and state regulators with sometimes overlapping jurisdiction.[24] Within this complex landscape, three federal agencies now dominate bank regulation and resolution authority. First, the Office of the Comptroller of the

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23. This section provides only brief background information. Detailed discussion of the U.S. financial regulatory system overall, or the three primary federal bank regulators in particular, is beyond the scope of this Article.

24. *See, e.g.*, U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-09-216, FINANCIAL REGULATION: A FRAMEWORK FOR CRAFTING AND ASSESSING PROPOSALS TO MODERNIZE THE OUTDATED U.S. FINANCIAL REGULATORY SYSTEM 48, (2009) [hereinafter GAO, FINANCIAL REGULATION] (describing U.S. regulatory system as a "fragmented and complex system of federal and state regulators"). *See also* Rose Marie Kushmeider, *The U.S. Financial Regulatory System: Restructuring Federal Bank Regulation*, 17 FDIC BANKING REV. 1 (2005) (referring to a U.S. "highly decentralized system that has muddled along more or less in its present form since the New Deal reforms of the 1930s . . . . [A] confusing system that no one building a system anew would want to duplicate"). For a chart and description of the various bank regulators and their responsibilities, see MARK JICKLING & EDWARD V. MURPHY, CONG. RES. SERV., R40249, WHO REGULATES WHOM? AN OVERVIEW OF U.S. FINANCIAL SUPERVISION 6–7 (2009). This report provides a useful overview, with the caveat that Dodd-Frank has since abolished the Office of Thrift Supervision (OTS), transferring some of its oversight responsibilities to the OCC and others to the Federal Reserve and the FDIC. Dodd-Frank Act §§ 312–313, 124 Stat. 1521–23 (codified at 12 U.S.C. §§ 5412–5413).

Currency (OCC), established in 1863[25] remains the primary agency responsible for regulating nationally chartered banks.[26] Second, the Federal Reserve, established in 1913,[27] regulates state-chartered Federal Reserve member banks and BHCs.[28] Finally, legislation creating the federal deposit insurance system in 1933,[29] added the FDIC as a third major bank regulator with primary regulatory authority over non-Federal Reserve member state banks.[30] Of course, each of the three major bank regulators is concerned with the economic health of the particular banking institutions within their supervisory jurisdiction.[31] Given its unique responsibility for administering the federal deposit insurance fund, however, the FDIC's exercise of its regulatory powers must focus particular attention on protecting and minimizing costs to the deposit insurance fund.[32] As federal deposit insurer, the FDIC has additional special supervision and enforcement powers enabling it to fulfill its mandate to protect depositors and the deposit insurance fund.[33]

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25. National Currency Act of 1863, ch. 58, 12 Stat. 665 (1863), *repealed by and replaced with* National Bank Act of 1864, ch. 106, 13 Stat. 99 (establishing the OCC as a bureau within the Treasury Department). OCC also recently inherited regulatory responsibility for savings and thrift institutions from the OTS, when the latter was eliminated by the Dodd-Frank Act, §§ 312–313, 124 Stat. 1521–1523 (codified at 12 U.S.C. §§ 5412–5413).

26. The OCC is responsible for approving charters and acting as primary regulator for nationally-chartered banks. 12 U.S.C. § 27.

27. Federal Reserve Act of 1913, Pub. L. No. 63-43, 38 Stat. 251 (codified as amended in 12 U.S.C. § 343 (2006)). The 1913 Act created a Federal Reserve System incorporating: (1) a central Board of Governors in Washington, D.C.; (2) twelve regional Federal Reserve Banks; and (3) member banks. *See* BD. OF GOVERNORS OF THE FED. RESERVE SYS., THE FEDERAL RESERVE SYSTEM: PURPOSES AND FUNCTIONS 12 (9th ed. 2010) [hereinafter PURPOSES AND FUNCTIONS]. Perhaps most important, the Act establishes the Federal Reserve Bank as the U.S. central bank responsible for formulating and implementing monetary policy. For an overview of the Federal Reserve's functions, see *id.* at 1 (identifying major responsibilities as: (1) monetary policy; (2) bank supervision and regulation; (3) "last resort" lending and systemic-risk containment; and (4) serving as the federal government's fiscal agent). *See also* PAULINE SMALE, CONG. RESEARCH SERV., RS20826, STRUCTURE AND FUNCTIONS OF THE FEDERAL RESERVE SYSTEM 1 (2005).

28. Bank Holding Company Act of 1956, Pub. L. No. 84-511, 70 Stat. 133 (codified at 12 U.S.C. §§ 1841–1849) (making Federal Reserve the primary regulator for bank holding companies); PURPOSES AND FUNCTIONS, *supra* note 27, at 59 (describing financial entities subject to Federal Reserve supervision and regulation). The general definition of a "bank holding company" is "any company which has control over any bank or over any company that is or becomes a bank holding company . . . ." 12 U.S.C. § 1841(a)(1).

29. Banking Act of 1933, ch. 89, 48 Stat. 162.

30. 12 U.S.C. § 1813(q)(3).

31. For discussion of rules to promote uniformity and consistency among bank regulators, see *infra* notes 39–43and accompanying text.

32. Prior to 2006, the FDIC had been administering two separate insurance funds: (1) the Bank Insurance Fund (BIF) for commercial bank deposits; and (2) the Savings Account Insurance Fund (SAIF) for thrifts. The two funds were merged to create the current Deposit Insurance Fund (DIF). Federal Deposit Insurance Reform Act of 2005, Pub. L. No. 109-171, § 2102, 120 Stat. 9 (2006) (codified at 12 U.S.C. § 1821). For further discussion of the FDIC's unique regulatory focus, see *infra* notes 229–32 and accompanying text.

33. *See generally* PURPOSES AND FUNCTIONS, *supra* note 27, at 60–61 (providing an overview of federal banking agencies' supervisory and regulatory responsibilities and noting that the FDIC

2. Prudential Bank Regulation

a. General Risk Continuum Regulation Principle

Ideally, prudential bank regulation would eliminate bank problems before they posed systemic threats to regional or national financial stability. Toward this end, federal bank regulators are empowered with flexible enforcement tools to tailor specific standards and enforcement requirements for individual banks based upon performance risk evaluations or other concerns [34] For example, federal banking agencies are authorized to establish capital adequacy requirements applicable to specific banking institutions that are higher than standards otherwise provided in regulations as the "agency, in its discretion, deems to be necessary or appropriate in light of the particular circumstances of the banking institution." [35] Enforcement options available to bank regulators range from seeking informal written commitments from bank managers to correct deficiencies, [36] to formal compliance agreements, [37] to cease and desist orders, and mandatory prompt corrective action (PCA) measures.[38]

To promote greater uniformity and consistency in financial regulators' application of these flexible tools, and to "insure progressive and vigilant supervision,"[39] Congress in 1978 created the interagency Federal Financial Institutions Examination Council (FFIEC), which was directed to "establish uniform principles and standards and report forms" to be used by all financial regulatory agencies for conducting financial institution

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has "special examination authority to determine the condition of an insured bank or savings association for insurance purposes"). *See, e.g.*, 12 U.S.C. § 1828(c) (requiring FDIC approval with respect to certain mergers and acquisitions of insured depository institutions).

34. *See, e.g.*, OFFICE OF COMPTROLLER OF THE CURRENCY, BANK SUPERVISION PROCESS: COMPTROLLER'S HANDBOOK 22 (2007) [hereinafter OCC HANDBOOK] ("[F]ollowing risk evaluations, examiners tailor supervisory activities to the risks identified."). *See also* U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-09-499T, FINANCIAL REGULATION: REVIEW OF REGULATORS' OVERSIGHT OF RISK MANAGEMENT SYSTEMS AT A LIMITED NUMBER OF LARGE, COMPLEX FINANCIAL INSTITUTIONS 10 (2009) [hereinafter GAO, RISK MANAGEMENT REVIEW] (combination of ongoing on and off-site supervision "allows for timely adjustments to the supervisory strategy of the examiners as conditions change within the institution.").

35. 12 U.S.C. § 3907(a)(2).

36. GAO, RISK MANAGEMENT REVIEW, *supra* note 34, at 14. For a good description of various capital requirement enforcement tools available to bank regulators, see Julie Anderson Hill, *Bank Capital Regulation by Enforcement: An Empirical Study*, 87 IND. L. J. 645, 658–64 (2012) [hereinafter Hill].

37. 12 C.F.R. § 308.303.

38. U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-11-612, BANK REGULATION: MODIFIED PROMPT CORRECTIVE ACTION FRAMEWORK WOULD IMPROVE EFFECTIVENESS 8–9 (2011) [hereinafter GAO, PROMPT CORRECTIVE ACTION]. For further discussion of PCA, see *infra* notes 97–116 and accompanying text.

39. Financial Institutions Regulatory and Interest Rate Control Act of 1978, Pub. L. No. 95-630, § 1002, 92 Stat. 3641, 3694 (codified at 12 U.S.C. § 3301).

examinations.[40] Pursuant to this directive, the FFIEC established a uniform rating system, with six component measures used to classify financial institutions into categories,[41] ranging from "Composite 1," indicating strong performance in every respect, to "Composite 5," indicating "critically deficient operating performance.[42] Bank examiners use these classifications as guidance in determining when to exercise progressively more aggressive supervision and enforcement tools.[43]

b. Regulatory Practices Inconsistent With Continuum Principle

i) Agency Forbearance: Regulation by Inaction

Prudential bank regulation rules explicitly adopt a progressive approach applying increasingly strict supervision and enforcement standards as bank health deteriorates along a risk-based continuum. In practice, however, various structural, political, and budgetary features of the regulatory system create incentives for regulators to opt for forbearance or to otherwise assist troubled banks in lieu of initiating early intervention measures. In fact, banking regulators often choose *not* to exercise their early intervention authority, a practice referred to as "regulatory forbearance."[44] As a practical matter, such forbearance allows regulators to use prudential regulatory discretion as a resolution tool.[45]

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40. *Id.* § 1006(f) (codified at 12 U.S.C. § 3305). The FFIEC's members include representatives from each of the federal supervisory agencies and a representative state regulator. *Id.* § 1004(a) (codified at 12 U.S.C. § 3303(a)).

41. The six-component rating system, commonly referred to as CAMELS, considers: (1) Capital adequacy; (2) Asset quality; (3) Management; (4) Earnings; (5) Liquidity; and (6) Sensitivity to market risk. Uniform Financial Institutions Rating System, 61 Fed. Reg. 67,021, 67,026–29 (Dec. 19, 1996) (modifying rating system initially adopted in 1979).

42. Uniform Rating System for Information Technology, 64 Fed. Reg. 3109, 3111–12 (Jan. 20, 1999). These efforts at uniformity have not been entirely successful. *See, e.g.*, Hill, *supra* note 36, at 658–68, 707–08 (describing agency differences in capital adequacy regulations and concluding that "different bank regulators may not have similar standards for . . . imposing higher individual bank minimum capital requirements").

43. *See, e.g.*, OCC HANDBOOK, *supra* note 34, at 68–70, (composite 1: no cause for supervisory concerns; composite 2: informal and limited supervisory action; composite 3: formal or informal supervisory action may be necessary; composite 4: close supervision, and, in most cases, formal enforcement action; composite 5: ongoing supervisory attention).

44. *See, e.g.*, PHILIP F. BARTHOLOMEW, CONG. BUDGET OFFICE, THE COST OF FORBEARANCE DURING THE THRIFT CRISIS 2 (1991) [hereinafter CBO, COST OF FORBEARANCE] (defining forbearance as "the discretionary practice of not enforcing an existing rule"); Richard Scott Carnell, *A Partial Antidote to Perverse Incentives: The FDIC Improvement Act of 1991*, 12 ANN. REV. BANKING L. 317, 322 (1993) [hereinafter Carnell, *Perverse Incentives*] (defining forbearance as "failing to take timely and appropriate action to reduce the risk an unhealthy institution poses to the deposit insurance fund").

45. *See infra* notes 203–11 and accompanying text (fuzzy boundary between regulation and resolution), and notes 391–95 (prudential regulatory discretion as an ex post response tool to assist failing firms).

Forbearance options include informal case-by-case decisions,[46] written forbearance agreements between the regulatory agency and a particular financial institution,[47] and informal regulatory practices or formal programs applicable to a particular class of financial institutions.[48] Regulatory forbearance perhaps reached its zenith during banking crises in the 1980s, when large numbers of insolvent and marginally solvent banks were permitted to remain open through regulatory agency forbearance programs.[49] In addition to such regulatory forbearance policies, Congress during the 1980s also established statutory forbearance programs to assist struggling banks.[50]

In fairness, though the "forbearance" label is often used pejoratively,[51] regulators sometimes opt not to exercise early intervention authority in the case of troubled banks, reasoning in good faith that inaction is the wiser policy course. Regulators may choose forbearance, for example, on the theory that a struggling bank's problems are merely temporary, or that the bank's circumstances can be corrected with less intrusive and potentially disruptive measures.[52] In 1986, for example, the OCC, the Federal Reserve,

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46. *See, e.g.*, FDIC, HISTORY OF THE EIGHTIES – LESSONS FOR THE FUTURE: AN EXAMINATION OF THE BANKING CRISIS OF THE 1980S AND EARLY 1990S 46 (1997) [hereinafter FDIC, HISTORY OF THE EIGHTIES] (describing discretion-based, case-by-case forbearance).

47. Regulators during the 1980s savings & loan and thrift crisis, for example, frequently used formal forbearance agreements to encourage healthy banks to acquire insolvent banks without concern that the merged insolvent bank would cause the acquirer to violate minimum capital requirements. To expedite the processing of an enormous number of forbearance requests, the Federal Home Loan Bank Board in 1986 issued a public memorandum with guidance to applicants, indicating circumstances under which such forbearance would, would not, or might be granted. Memorandum from Francis M. Passarelli, Dir. of the Office of Examinations and Supervision, Fed. Home Loan Bank Bd., to Principal Supervisory Agents (March 7, 1986), *available at* 1986 FHLBB Lexis 288.

48. *See* FDIC, HISTORY OF THE EIGHTIES, *supra* note 46, at 46–50 (describing broad-based "class-of-bank" regulatory agency forbearance for savings & loans).

49. *Id.* at 46–47. *See also, supra* note 47 (describing extensive use of forbearance agreements as incentives for healthy bank acquisitions of insolvent banks).

50. *See, e.g.*, The Competitive Equality Banking Act of 1987, Pub. L. No. 100-86, § 404, 101 Stat. 552, 609 [hereinafter CEBA] (establishing forbearance policies for "troubled but well-managed and viable" thrift institutions)].

51. *See* FDIC, HISTORY OF THE EIGHTIES, *supra* note 46, at 46 ("[F]orbearance has taken on such pejorative connotations that various uses of the term need to be distinguished.") For purposes of this Article, the discussion of "forbearance" does not emphasize inaction resulting from regulators' unawareness of risk. In the recent crisis, for example, some innovative risk-spreading mechanisms initially were very profitable. Regulators with insufficient information to assess these risks had little reason to intervene with respect to high-risk, but profitable, entities in a growing economy. For a brief description of this political economy-focused explanation for regulatory inaction, *see* Jeffrey N. Gordon & Christopher Muller, *Confronting Financial Crisis: Dodd-Frank's Dangers and the Case for a Systemic Emergency Insurance Fund*, 28 YALE J. ON REG. 151, 177–78 (2011).

52. *See, e.g.*, Robert A. Eisenbeis & Paul M. Horvitz, *The Role of Forbearance and its Costs in Handling Troubled and Failed Depository Institutions, in* REFORMING FINANCIAL INSTITUTIONS AND MARKETS IN THE UNITED STATES: TOWARDS REBUILDING A SAFE AND MORE EFFICIENT SYSTEM 49, 52 (George G. Kaufman, ed. 1994).

and the FDIC jointly issued a policy statement outlining a capital forbearance policy to "support basically sound, well-managed banks in weathering what is expected to be a difficult but transitional period."[53]

On the other hand, bank regulators face numerous more "perverse"[54] forces and incentives impeding full use of their supervision and enforcement powers.[55] First, by its nature, regulatory action is public and manifest, whereas regulatory inaction is inconspicuous. As one commentator notes, "when regulators get tough, the people who stand to lose get incensed, while the people who stand to benefit hardly notice."[56] Thus, inaction is the natural response of regulators wishing to avoid sparking public anger and criticism. A related second factor is regulators' fear that enforcement intervention with respect to a struggling bank may be construed as evidence of their regulatory incompetence in implementing the bank monitoring and enforcement rules designed to avoid problems in the first place.[57] Regulators concerned about their reputation and career advancement also prefer not to be seen as having problems develop on their watch.[58] Third, inaction creates no immediate government expense, thus permitting regulators to put off economic pain and delay reporting budgetary costs.[59] Finally, regulators face pressures from powerful special

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53. OFFICE OF THE COMPTROLLER, BANKING CIRCULAR BC-212, at 1–2 (1986), *available at* 1986 OCC CB Lexis 11 (referring to March 11, 1986 joint statement announcing forbearance policy for qualified agricultural and oil and gas banks). The OCC further noted its belief that "most have sound prospects for the future . . . [and that] these banks retain substantial strength." *Id.* 4. The program was later extended to any bank if it "demonstrated that its difficulties [were] primarily attributed to economic problems beyond the control of management." OFFICE OF THE COMPTROLLER, BANKING CIRCULAR BC-212 SUPP. #2, at 7 (1987), *available at* 1987 OCC CB Lexis 6.

54. *See, e.g.*, Carnell, *Perverse Incentives*, *supra* note 44, at 319.

55. GARY H. STERN & RON J. FELDMAN, TOO BIG TO FAIL: THE HAZARDS OF BANK BAILOUTS 52–56 (2004) [hereinafter STERN & FELDMAN] (discussing fear of running afoul of powerful interest groups, desire to appear competent, and career reputation as incentives for regulators to forbear). *See also* Wilmarth, *Dodd-Frank, supra* note 13, at 1011–12 (describing the "political economy of regulation," in which "regulators face significant political and practical challenges that undermine their efforts to discipline" large complex financial institutions).

56. Richard Scott Carnell, *The Culture of Ad Hoc Discretion, in* ASSESSING BANK REFORM: FDICIA ONE YEAR LATER 113, 115 (George G. Kaufman & Robert E. Litan, eds. 1993) [hereinafter Carnell, *Culture of Discretion*].

57. *See generally* Arnoud W. A. Boot & Anjan Thakor, *Self-Interested Bank Regulation*, 83 AM. ECON. REV. 206 (1993).

58. *See, e.g,. Restructuring of the Banking Industry: Hearings Before the Subcomm. on Financial Institutions Supervision and Insurance of the H. Comm. on Banking, Finance and Urban Affairs* 994, 102d Cong. 994 (1991) (prepared statement of Prof. Edward J. Kane, Ohio State Univ.) ("It pays regulators to use their discretion to cover up emerging problems and put off painful adjustments to someone else's watch."). *See also* Carnell, *Culture of Discretion, supra* note 56, at 115 ("By confronting problems, regulators risk blame for causing them."); STERN & FELDMAN, *supra* note 55 (noting desire to appear competent and career reputation as incentives for regulators to forbear).

59. Carnell, *Perverse Incentives*, *supra* note 44, at 322 (emphasizing desire to delay apparent budget cost as incentive to forbear). Costs from failed banking institutions include insured depositors' claims against the federal deposit insurance fund. Since the insurance fund is

interests. Political science and economic public choice theories suggest that organized large special bank interests may successfully co-opt government decision-makers in order to extract private benefits at the expense of the diffuse, less organized public.[60] Professor Jonathan Macey argues that "nowhere does the model appear to be more robust than as applied to banking,"[61] adding that "agency capture" by special interests is more likely in circumstances that generally prevail in bank regulation, "where each constituency has its own regulatory agency, which is not responsible to other interests."[62]

Not surprisingly, incentives interfering with early regulatory intervention decisions are particularly acute with respect to threatened large, interconnected banks failures.[63] Early intervention for large banks is likely to face much more powerful special interest opposition than similar intervention with respect to smaller banks. Moreover, regulatory enforcement actions against large banks receive much greater publicity, involve many more interested parties, and, thus, theoretically pose greater risk of contagious harm to the banking sector.[64] Given the high stakes involved in making the wrong decision, regulators may err in favor of allowing the failing bank's operations to continue rather than opt for early enforcement.

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maintained by assessments against the insured banks themselves, these costs typically are not borne by general taxpayers. In the event that the insurance fund is inadequate to cover claims, however, Congress has indicated that insured depositor claims will be backed by the "full faith and credit" of the U.S. government. 12 U.S.C. § 1828(a)(1)(B) (2006). In other words, costs may ultimately be imposed upon general taxpayers. *See also infra* notes 92–96 and accompanying text.

60. Making a related point, Professor Anna Gelpern adds that "[r]egulated entities develop a vested interest in forbearance, and lobby hard to keep it going: it becomes part of the business model." Anna Gelpern, *Financial Crisis Containment*, 41 CONN. L. REV. 1051, 1075 (2009) [hereinafter Gelpern].

61. Jonathan R. Macey, *The Political Science of Regulating Bank Risk,* 49 OHIO ST. L. J. 1277, 1278 (1989) [hereinafter Macey]. *See also* Joseph A. Grundfest, *Lobbying in Limbo: The Political Ecology of the Savings and Loan Crisis*, 2 STAN. L. & POL'Y REV. 25, 28–29 (1990) (describing U.S. League of Savings Institutions' powerful 1980s influence, arguing that "it would be hard to find a better example of the 'capture' hypothesis than the relationship that existed between the League and the FHLBB, the agency responsible for regulating the S&L industry") (footnote omitted).

62. Macey, *supra* note 61, at 1285. Macey cites the Federal Reserve as an exception because it is responsible not only for regulating bank holding companies and state banks, but also for monetary policy. *Id.*

63. Similarly acute pressure to forbear may arise when multiple smaller banks face severe threats at the same time. Most failing banks during the 1980s S&L crisis, for example, were relatively small. At that time, forbearance pressures stemmed not from the *size* of the struggling banks, but from the tremendous *number* of simultaneously threatened banks.

64. Some argue that such fears of contagion can be exaggerated. According to one report, for example, "[a]fter-the-fact analysis of financial records indicates that the failure of Continental Illinois [which received federal assistance in 1984] would not have wiped out the entire financial capital of any respondent banks (that is, banks that used Continental Illinois to manage their short-term funding and other operations) and therefore would not have led many of them to fail." STERN & FELDMAN, *supra* note 55, at 48.

The 2007–2009 economic crisis provides some evidence of class-based regulatory forbearance with respect to large banks. Based on an empirical study of formal capital enforcement actions between 1993 and 2010, Professor Julie Anderson Hill found "a near-complete absence of formal capital enforcement actions issued to the largest banks" despite an otherwise sharp increase in the overall number of such actions.[65] One possible explanation for the lack of enforcement action against large banks may be simply that such banks were healthier. Given economic circumstances at the time, however, this explanation does not hold up. FDIC Chair, Sheila Bair, noted in May 2009 that "[o]ver the last 18 months, large banks, as a group, have posed much greater risks to the banking system than small banks have."[66] Regulators began hundreds of enforcement proceedings against smaller banks, but no action was taken against Bank of America and Citigroup, two of the nineteen largest banks, even though they were on the brink of failure.[67] Neither was any formal capital enforcement action taken against Washington Mutual, the sixth-largest bank measured by domestic deposits, before it ultimately failed.[68]

In any particular instance, it can be difficult to assess whether forbearance is a wise regulatory action or a perverse response to outside pressures and incentives. As Professor Anna Gelpern aptly notes:

> [F]orbearance can work both as a crisis response measure and as a means of denial. In the first instance, it creates a breathing space for other response measures. In the second, it serves as cover for channeling scarce resources to the regulated entities and their creditors. The difference between the two uses of forbearance is often hard to tell and politically determined.[69]

Whether regulators typically exercise forbearance with respect to troubled banks because of perverse incentives, or based upon good faith

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65. Hill *supra* note 36, at 648. Professor Hill notes that her findings are consistent with an earlier study finding no PCA actions issued to major banks between 1993 and 2001. *Id.* at 666 n.154 (citing Phillip A. Wellons, *Enforcement of Risk-Based Capital Rules*, *in* CAPITAL ADEQUACY BEYOND BASEL: BANKING, SECURITIES, AND INSURANCE 284 (Hal S. Scott ed. 2005)).

66. Binyamin Appelbaum, *Big Banks to Pay Larger Share of FDIC Levy Fees to Replenish Fund Altered After Protest by Small Institutions*, WASH. POST, May 23, 2009, at A13 (quoting FDIC Chair, Sheila C. Bair).

67. *See, e.g.*, Arthur E. Wilmarth, Jr., *Reforming Financial Regulation to Address the Too-Big-to-Fail Problem*, 35 BROOK. J. INT'L L. 707, 744 (2010) [hereinafter, Wilmarth, *Reforming Financial Regulation*] (noting "non-enforcement" confidential memoranda of understanding between regulators and Bank of America and Citigroup, but hundreds of actions against smaller banks); Arthur E. Wilmarth, Jr., *Narrow Banking: An Overdue Reform That Could Solve the Too-Big-to-Fail Problem and Align U.S. and U.K. Financial Regulation of Financial Conglomerates*, 31 BANK & FINAN. SERVICES POL. REP. 1, 3 (2012) [hereinafter Wilmarth, *Narrow Banks*] (noting "white glove treatment," and no PCA actions, for the largest banks, but many PCA actions and failures among smaller banks).

68. *See* discussion in Hill, *supra* note 36, at 690–92.

69. Gelpern, *supra* note 60, at 1075.

reasoning that inaction is the more appropriate course of action, data on the effectiveness of forbearance policies in limiting ultimate losses to the deposit insurance fund is not uniformly promising.[70] Absent early intervention, circumstances at troubled banks often deteriorate, and many of them ultimately fail. When regulators opt for forbearance rather than early intervention, they may later face far more serious system-wide harm in the event that the institutions ultimately collapse.[71] By opting for inaction in such cases, regulators ultimately lose the flexibility to tailor more specific supervision and enforcement actions based upon a continuum of risk. Instead, bank regulators later confronted with potentially imminent system-wide threats face a more difficult binary choice: bank receivership and ultimate liquidation vs. emergency rescue or bailout.

ii) "Discount Window" Lending Parallels to Agency Forbearance

The same forces and incentives that induce regulatory forbearance may also prompt regulators to take affirmative steps to assist the continued operation of failing banks.[72] One such option is the extension of government loans through the "discount window," a Federal Reserve Bank facility authorized to make loans to eligible institutions.[73] The traditional policy explanation for bank access to rapid, short-term Federal Reserve loans was to bolster depositor confidence that their account funds would be available for withdrawal even if cash reserves were short, thus avoiding panic and preventing bank runs.[74] In other words, the discount window's general function is to address temporary *liquidity* crises, not *insolvency* crises. In addition to extending short-term—typically overnight—loans, the

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70. *See, e.g.*, Emile J. Brinkman, Paul M. Horvitz &Ying-Lin Huang, *Forbearance: An Empirical Analysis*, 10 J. FIN. SERVICES RES. 27, 27 (1996).

71. See *infra* notes 92–96 and accompanying text for discussion of deposit insurance claims, and potential costs imposed upon general revenues.

72. This discussion, which focuses on the regulatory response, does not address provisions allowing regulators to provide "open-bank assistance" as part of their resolution authority. These are discussed at *infra* notes 232–39 and accompanying text.

73. *See* 12 U.S.C. § 347b (2006) (advances to member banks); *id*. § 347c (advances to individuals, partnerships, corporations). *See also* PURPOSES AND FUNCTIONS, *supra* note 27, at 46–49 (describing three primary types of discount window lending: primary credit, secondary credit, and seasonal credit). The discount window also complements monetary policy tools used to regulate the supply and demand for funds. For a general discussion of Federal Reserve monetary policy tools, see MARC LABONTE, CONG. RESEARCH SERV., RL30354, MONETARY POLICY AND THE FEDERAL RESERVE: CURRENT POLICY AND CONDITIONS (2010) [hereinafter LABONTE, MONETARY POLICY]. For a general history of the Federal Reserve's lending function, see HOWARD H. HACKLEY, BD. OF GOVERNORS OF THE FED. RESERVE SYS., LENDING FUNCTIONS OF THE FEDERAL RESERVE BANKS: A HISTORY (1973).

74. *See, e.g.*, George G. Kaufman, *Lender of Last Resort: A Contemporary Perspective* 2–5, Fed. Reserve Bank of Dallas Research Paper, *available at* FedHistory@dal.frb.org (the central bank "should lend freely to *curb short-run liquidity problems that are independent of underlying equilibrium solvency problems*.") (emphasis added)).

Federal Reserve has also historically served as lender of last resort for banks experiencing longer-term, but still temporary, economic difficulties.[75] Finally, though it had not invoked this emergency authority until the most recent economic crisis,[76] the Federal Reserve has been authorized since 1932 to make loans to non-member individuals, partnerships, and corporations under "unusual and exigent circumstances."[77]

Modern central banks—the Federal Reserve included—generally approach their "lender of last resort" functions according to principles developed in a famous late-nineteenth-century banking treatise by Walter Bagehot.[78] Bagehot argued that central banks should only make *fully collateralized penalty-rate government loans*, which would then be used as a last resort only by generally sound businesses unable to obtain quick access to regular rate loans in the private market. Insistence on a solvent debtor offered reasonable assurance that the loan would be repaid, and confidence that the government would not be wasting resources on a private entity likely to collapse in any event. In addition, the logic was that penalty rates would reduce incentives for borrowers to engage in high-risk behavior—often referred to as moral hazard—that might otherwise accompany a below-market rate loan.

Consistent with these principles, the Federal Reserve's discount window historically has provided primarily short-term, overnight loans to solvent banks.[79] Before the 1970s, the discount window had not been a

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75. PURPOSES AND FUNCTIONS, *supra* note 27, at 45.

76. *See, e.g.*, *An Examination of the Extraordinary Efforts by the Federal Reserve Bank to Provide Liquidity in the Current Financial Crisis: Hearing Before the H. Comm. on Financial Servs.*, 111th Cong. 8 (2009) (statement of Ben S. Bernanke, Chairman, Bd. of Governors of the Fed. Reserve Sys. on the Federal Reserve's unprecedented use of emergency powers).

77. Emergency Relief and Construction Act of 1932, Pub. L. No. 72-302, § 210, 47 Stat. 709, 7115 (1932) (adding § 13(3) to the Federal Reserve Act of 1913) (codified, as amended, at 12 U.S.C. § 343 (2006)) ("In *unusual and exigent circumstances*, the Federal Reserve [Board] . . . may authorize any Federal reserve bank . . . to *discount for any individual, partnership, or corporation*, notes, drafts, and bills of exchange . . . [p]rovided, [t]hat . . . the Federal reserve bank [obtains] evidence that such *individual, partnership, or corporation* is unable to secure adequate credit accommodations from other banking institutions.") (emphasis added) (prior to amendment by Dodd-Frank). Dodd-Frank replaced the statutory language limiting use of this emergency power to assist an "individual, partnership, or corporation" with substitute language now limiting its use to a "participant in any program or facility with broad-based eligibility." Dodd-Frank Act § 1101(a)(2)–(5), 124 Stat. 2113 (codified at 12 U.S.C. § 343(A)). This change is an attempt to hold the Federal Reserve more closely to its monetary policy functions; the Federal Reserve can no longer use its emergency power "for the purpose of assisting a single and specific company avoid bankruptcy." *Id.* § 1101(a)(6)(iii).

78. WALTER BAGEHOT, LOMBARD STREET: A DESCRIPTION OF THE MONEY MARKET 26–36 (1897). *See also* MILTON FRIEDMAN & ANNA JACOBSON SCHWARTZ, A MONETARY HISTORY OF THE UNITED STATES 1867–1960 395 (1963) [hereinafter FRIEDMAN & SCHWARTZ] (referring to Bagehot's *Lombard Street* as "the *locus classicus* of central bank policy").

79. Michael D. Bordo, Nat'l Bureau of Econ. Research, *The Lender of Last Resort: Some Historical Insights*, Working Paper No. 3011, at 23 (June 1989).

source of ongoing funds for troubled banks.[80] Researchers have uncovered evidence of several prolonged periods since the 1970s and 1980s, however, during which the Federal Reserve "contravened the ancient injunction to lend only to *illiquid* banks, not to *insolvent* ones."[81] Based on Federal Reserve discount window lending data from 1985 through 1991, a House Banking Committee staff analysis reported:

> 1. 90% of all institutions which received "extended" credit subsequently failed.
>
> 2. The Federal Reserve routinely extends credit to institutions with a CAMEL 5 [the lowest] rating.
>
> 3. A CAMEL 5 rated institution which borrowed from the discount window remained open for an average period of 10 - 12 months.
>
> 4. Borrowing from the discount window increases dramatically as an institution's financial condition deteriorates.[82]

The Federal Reserve also used its discount window for the first time in more than seventy years to lend to both banks and nonbanks during the 2007–2009 crisis.[83] Many of these loans were arguably designed not as deliberate measures to maintain failing banks, but instead to inject general liquidity into financial markets as an exercise of the Federal Reserve's

80. FRIEDMAN & SCHWARTZ, *supra* note 78, at 269 (noting Federal Reserve's tradition against continuous borrowing). *See also* Anna J. Schwartz, *The Misuse of the Fed's Discount Window*, 74 FED. RES. BANK OF ST. LOUIS REV., 58, 60 (1992) [hereinafter Schwartz, *Discount Window*] (citing Federal Reserve general principle reflected in Regulation A: "Federal Reserve credit is not a substitute for capital and ordinarily is not available for extended periods.").

81. *See, e.g.*, Schwartz, *Discount Window*, *supra* note 80, at 58. For a description of the most notable instances of discount window lending during this period, see FDIC, AN EXAMINATION OF THE BANKING CRISES OF THE 1980S AND 1990S 243–44 (1997), *available at* http://www.fdic.gov /bank/historical/history/vol1.html (from ch. 7 on Continental Illinois) (reporting $3.6 loan from the discount window to Continental Illinois in 1984). *See also* JOAN EDELMAN SPERO, THE FAILURE OF THE FRANKLIN NATIONAL BANK: CHALLENGE TO THE INTERNATIONAL BANKING SYSTEM 47, 124–25 (1980) (describing emergency use of Federal Reserve discount window in 1973 to rescue Franklin National Bank).

82. STAFF OF H. COMM. ON BANKING, FINANCE AND URBAN AFFAIRS, AN ANALYSIS OF FEDERAL RESERVE DISCOUNT WINDOW LOANS TO FAILED INSTITUTIONS 2 (Jun. 11, 1991). *See also* Schwartz, *Discount Window*, *supra* note 80, at 59 (concluding based on Federal Reserve data from the same period that "[a]t the time of [their ultimate] failure, 60 percent of [the banks receiving Federal Reserve loans] had outstanding discount window loans")

83. *See* MARC LABONTE, CONG. RESEARCH SERV., FINANCIAL TURMOIL: FEDERAL RESERVE POLICY RESPONSES, RL 34427 1 (2010) [hereinafter LABONTE FINANCIAL TURMOIL] (programs "marked the first time in more than 70 years that the Fed had lent to non-members"); *id.* at 5–15 (describing unprecedented new lending programs and borrowers); *id.* at 32 ($1.4 billion increase in Federal Reserve balance sheet from 2007–2009 crisis-related programs). *See also* Block, *Measuring Bailout Cost*, *supra* note 8, at 152. *See also* Wilmarth, *Narrow Banks*, *supra* note 67, at 5–6 (reporting that "total amount of Fed emergency credit reached a single-day peak of $1.2 trillion in December 2008. The Fed extended the vast majority of this emergency credit to large U.S. and European banks and provided very little help to smaller institutions.").

monetary policy.[84] Although many of these loans had much longer dates to maturity than traditional overnight discount window loans,[85] they were not meant to be long-term or continuing,[86] and the Federal Reserve claims that nearly all have been repaid.[87] All the same, until details were released by court order after a Freedom of Information Act (FOIA) lawsuit brought by Bloomberg News,[88] public information about the Federal Reserve's 2007–2009 emergency discount window lending was limited to aggregate numbers; specific loan amounts and the identity of borrowers and counterparties were kept secret. Released details now show that, contrary to general discount window lending practices, numerous loans were made to seriously troubled banks. By one report, for example, "Washington Mutual, which was on the verge of collapse in September 2008, borrowed $2 billion for several consecutive days before being taken over by J.P. Morgan Chase. IndyMac, another mortgage lender, borrowed $500 million just before regulators seized it in July 2008."[89]

The impact of prolonged discount window support to insolvent or otherwise troubled banks can be much the same as regulatory forbearance.[90] In other words, government assistance to facilitate a failing institution's continued operations risks simply postponing the institution's failure, thus potentially increasing significant losses to deposit insurance funds, and potentially even creating losses to general federal revenues upon the institution's ultimate failure.[91]

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84. *See* LABONTE, MONETARY POLICY, *supra* note 73, at 6–7. *But see* Jeffrey Manns, *Building Better Bailouts: The Case for a Long-Term Investment Approach*, 63 FLA. L. REV. 1349, 1380–81 (2011) ("[E]xpansion of the Federal Reserve's lending window into a de facto bailout fund during the early stages of the crisis placed the Federal Reserve in the contradictory position of propping up the financial institutions that it was supposed to regulate.").

85. *See* Block, *Measuring Bailout Cost*, *supra* note 8, at n.117.

86. Federal Reserve Chair Ben Bernanke also stressed that most of the Bank's direct loans were over-collateralized and made with recourse to the borrower's other assets in the event of nonpayment. Ben S. Bernanke, Chairman, Federal Reserve Board, The Crisis and the Policy Response, Speech at the Stamp Lecture London School of Economics (Jan. 13, 2009), *available at* http://www.federalreserve.gov/newsevents/speech/bernanke20090113a.htm.

87. Letter from Ben S. Bernanke, Chairman, Federal Reserve Board to the Honorable Tim Johnson, Chairman, S. Comm. on Banking, Housing, and Urban Affairs (Dec. 6, 2011).

88. Bloomberg L.P. v. Bd. of Governors of the Fed. Reserve Sys., 649 F. Supp. 2d 262, 282 (S.D.N.Y. 2009), *aff'd*, 601 F. 3d 143 (2d Cir. 2010), *cert. denied*, Clearing House Ass'n, L.L.C. v. Bloomberg, L.P. 131 S. Ct. 1674 (2011).

89. Neil Irwin, *Files Shed Light on Fed Lending Activity*, WASH. POST, Apr. 1, 2011, at A12.

90. *See supra* notes 72–89 and accompanying text and *infra* notes 125–26 and accompanying text.

91. Schwartz, *Discount Window*, *supra* note 80, at 66 ("Since 1985, prolonged discount window assistance has generally terminated not with restructuring but with closure of the insolvent banks. When banks are known to be insolvent, postponement of recognition of losses that have occurred might well have increased current losses.").

c. Efforts to Limit Regulatory Forbearance: Prompt Corrective Action (PCA)

Particularly during the 1980s and 1990s, a "culture of ad hoc discretion"[92] to forbear allowed bank conditions to worsen, resulting in extraordinary losses to the federal deposit insurance fund and to general revenues when many of the insolvent banks ultimately failed.[93] When the federal deposit insurance fund proved insufficient to cover insured depositor claims, Congress not only appropriated additional funds to cover all insured deposits,[94] but also funded bank rescues, thus protecting uninsured depositors and creditors.[95] The Congressional Budget Office (CBO) subsequently estimated that this regulatory policy of "forbearance may have doubled the cost of the thrift bailout."[96]

As it does so often in the aftermath of financial crisis,[97] Congress reacted to the 1980s savings & loan and thrift disaster with reforms supplementing traditional prudential regulatory bank rules with new "prompt corrective action" (PCA) requirements designed to limit agency discretion to forbear, and to mandate certain early intervention measures. With the PCA regime, Congress hoped to ensure more rapid and aggressive intervention by regulators with respect to troubled banks *before* they became insolvent, and to protect the federal deposit insurance fund and general revenues against costs resulting from regulatory forbearance.[98]

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92. Carnell, *Culture of Discretion*, *supra* note 56, at 113.

93. OFFICES OF INSPECTOR GENERAL, FDIC, DEP'T OF THE TREAS., & BD. OF GOVERNORS OF THE FED. RESERVE SYSTEM, EVAL-11-006, OIC-CA-11-008, FRB OIG 2011-05, EVALUATION OF PROMPT REGULATORY ACTION IMPLEMENTATION 10 (2011) [hereinafter INSPECTOR GENERAL REPORT]. *See also* GAO, PROMPT CORRECTIVE ACTION, *supra* note 38, at 1 (referring to critique of federal regulators for "failing to take timely and forceful action to address the causes of bank failures and prevent losses to taxpayers and the deposit insurance fund" as motivating Congress to enact 1991 legislation); H.R. REP. NO. 101-54, pt. 1, at 94 (1989) (identifying "regulatory and statutory accounting gimmicks" as facilitating program of forbearance and contributing to S&L crisis); CBO, COST OF FORBEARANCE *supra* note 44, at 3 ("Forbearance . . . set the stage for rampant investment speculation and fraudulent practices, all of which added to the ultimate cost of resolving the thrift crisis.").

94. Although deposit insurance claims are not formally guaranteed by the government, a statutory "sense of Congress" declares that "deposits up to the statutorily prescribed amount in federally insured depository institutions are backed by the full faith and credit of the United States." CEBA, *supra* note 50, at 657. *See also* 12 U.S.C. § 1828(a)(1)(B).

95. Financial Institutions Reform, Recovery, and Enforcement Act of 1989, Pub. L. No. 101-73, § 219(d), 103 Stat. 183, 263 (codified at 12 U.S.C. § 1825(d)).

96. CBO, COST OF FORBEARANCE, *supra* note 44, at 1 (estimating doubled resolution costs from $66 to $127 billion).

97. For similar observations about reactive legislation in response to economic crisis, see Charles K. Whitehead, *Reframing Financial Regulation*, 90 B.U. L. REV. 1, 2 (2010); Erik K. Gerding, *The Next Epidemic: Bubbles and the Growth and Decay of Securities Regulation*, 38 CONN. L. REV. 393, 418 (2006).

98. *See, e.g.*, Federal Deposit Insurance Corporation Improvement Act of 1991, sec. 131, § 38(a), 105 Stat. 2236, 2253 (codified at 12 U.S.C. § 1831*o*) [hereinafter FDICIA]. In addition to these new prudential regulation-focused PCA rules, the FDICIA also added new "least-cost resolution" (LCR) rules, addressing similar issues from the resolution perspective. *Id.* (declaring

Consistent with principles of progressively more stringent supervision and enforcement based on an increasing risk continuum, the PCA framework places banks into five categories, ranging from strongest to weakest,[99] and increases discretionary and mandatory agency actions to be taken by regulators as banks fall into progressively weaker categories.

Two key features distinguish PCA requirements from the discretionary progressive risk-based tools previously available to regulators. First, in order to limit regulators' discretion to forbear, the PCA framework *automatically* triggers specified bank activity restrictions. Beginning sixty days after being classified as "critically undercapitalized," for example, an insured depository institution is prohibited from making any payment of principal or interest on the institution's subordinated debt.[100] The PCA framework also triggers *mandatory* regulatory enforcement measures. Bank regulators, for example, are required to "appoint a receiver (or, with the concurrence of the [FDIC], a conservator)" within ninety days of a "critically undercapitalized" bank classification.[101]

Second, in contrast to the multi-factor risk assessment used for regular bank examination and regulation,[102] the PCA classification framework focuses almost exclusively upon risk measures related to adequacy of the regulated institution's capital.[103] The problem with this emphasis on capital adequacy is that capital tends to lag behind other early warning indicators of potential bank problems.[104] Given evidence that other leading indicators of

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legislative purpose "to resolve the problems of insured depository institutions at the least possible long-term loss to the deposit insurance fund"). For discussion of LCR rules, see *infra* notes 249–63 and accompanying text.

99. For PCA purposes, banks are classified as: (1) well capitalized; (2) adequately capitalized; (3) undercapitalized; (4) significantly undercapitalized; or (5) critically undercapitalized. FDICIA § 131(a), 105 Stat. 2253 (codified at 12 U.S.C. § 1831*o*(b)(1)(A)–(E)) (adding new § 38(b)(1)(A)–(E) to the Federal Deposit Insurance Act, incorporating bank capital-based classifications). These capital-based classifications are distinct from the broader uniform rating standards used by regulators in connection with general bank supervision and enforcement. *See supra* notes 34–43 and accompanying text.

100. FDICIA § 131(a), 105 Stat. 2253 (codified at 12 U.S.C. § 1831*o*(h)(2)(A)) (adding new § 38(h)(2)(A) to the Federal Deposit Insurance Act).

101. *Id.* § 38(h)(3)(i).

102. *See supra* text accompanying note 41 (describing six-component CAMELS rating system).

103. FDICIA § 131(a), 105 Stat. 2253 (codified at 12 U.S.C. § 1831*o*(c)) (adding new § 38(c) to the Federal Deposit Insurance Act, identifying relevant capital standards). *See supra* note 99 (listing categories). Although the Act also initially required agencies to adopt standards for criteria other than capital, non-capital standards were later made discretionary by the Riegle Community Development and Regulatory Improvement Act of 1994, Pub. L. No. 103-325, 108 Stat. 2160. INSPECTOR GENERAL REPORT, *supra* note 93, at 17. Studies have since noted that regulators made "little use of the section 39 provisions to correct problems before capital deterioration." *Id.* at 17, 64.

104. *See, e.g.*, David S. Jones & Kathleen Kuester King, *The Implementation of Prompt Corrective Action: An Assessment*, 19 J. BANKING & FIN. 491, 493 (1995) (finding PCA risk-based capital ratio a poor indicator for troubled banks and that "even if the current PCA framework had been in place, corrective actions by supervisors still would have been largely discretionary."); Joe Peek & Eric S. Rosengren, *The Use of Capital Ratios to Trigger Intervention*

bank health—such as asset quality and liquidity—are far better early indicators of bank distress, PCA's reliance on capital adequacy as a measure of bank health seems unfortunately misplaced.[105] As noted by one GAO report: "once a bank's capital has deteriorated to the undercapitalized level, it may be too late for the bank to recover."[106]

Given relatively healthy financial conditions that prevailed for over a decade after its creation, the PCA framework's effectiveness had not been tested prior to the Great Recession. When it was finally tested in 2007–2009, a congressionally-mandated report[107] found that "[u]se of the . . . PCA mechanism as an enforcement tool was . . . inconsistent,"[108] that the PCA did not prevent or minimize loss to the deposit insurance fund,[109] and that "[t]he vast majority of banks that underwent the PCA process from 2006 through the third quarter of 2010 had not returned to a condition of financial stability by the end of this period."[110] One explanation for the PCA framework's failure to significantly reduce regulators' exercise of discretion to forbear is that many of the so-called "mandatory" provisions included in the PCA framework include exceptions. Even the "mandatory" appointment of a receiver for critically undercapitalized institutions, for example, is subject to an exception allowing regulators to "take such other action as the agency determines to be appropriate in lieu of such appointment."[111] As a practical matter, such exceptions effectively convert so-called "mandatory" rules into mere "presumptive safeguards,"[112] leaving

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in Problem Banks: Too Little, Too Late, NEW ENG. ECON. REV., Sept.–Oct. 1996, at 49, 57 (1996) ("Reported capital ratios are lagging indicators of bank health, in part because some banks have not fully reflected likely future losses in their loan loss reserve."); *id.* at 51 ("Because capital is a lagging indicator and examiners utilize information beyond capital ratios when taking supervisory action, the PCA triggers rarely identify problem institutions before examiners.").

105. The PCA framework's over-emphasis on capital adequacy might be explained in light of its particular history. In passing the PCA provisions, Congress was more concerned with curbing regulatory forbearance, and preserving the solvency of the federal deposit insurance fund than it was in systemic risk.

106. GAO, PROMPT CORRECTIVE ACTION, *supra* note 38, at 23. The report further concludes that PCA's exclusive focus on capital adequacy "does not take full advantage of early warning signs of bank distress that other financial indicators . . . can provide." *Id.*

107. Dodd-Frank Act § 202(g)(2)(A), 124 Stat. 1449 (codified at 12 U.S.C. § 5382(g)(2)(A)) (requiring Comptroller General to study "effectiveness of implementation of prompt corrective action by the appropriate Federal banking agencies").

108. GAO, PROMPT CORRECTIVE ACTION, *supra* note 38, at 34. *See also* Kenneth Ayotte & David A. Skeel, Jr., *Bankruptcy or Bailouts?*, 35 J. CORP. L. 469, 472–73 (2010) (suggesting that regulators routinely suspended PCA rules when systemically important companies stumbled). *But cf.* INSPECTOR GENERAL REPORT, *supra* note 93, at 20 (finding that regulators generally implemented PCA provisions as required).

109. GAO, PROMPT CORRECTIVE ACTION, *supra* note 38, at 19.

110. *Id.* at 17.

111. FDICIA § 131(a), 105 Stat. 2253 (codified at 12 U.S.C. § 1831*o*(h)(3)(C)(ii)) (adding new § 38(h)(3)(C)(ii)).

112. *See* Richard Scott Carnell, *A Partial Antidote To Perverse Incentives: The FDIC Improvement Act of 1991*, ANN. REV. BANKING L. 317, 342 (1993) [hereinafter Carnell, *Partial Antidote*] (using the term "presumptive safeguards" to refer to "provisions that couple a

regulators with continued discretion to engage in regulatory forbearance. Even when regulators apply PCA rules as intended, another reason for the framework's limited effectiveness is that by the time PCA mandatory agency actions are triggered by capital-based measures of bank weakness, the troubled bank's condition may be so severe that it cannot be saved.[113]

In sum, regulators for many reasons face strong incentives to delay enforcement action with respect to large, interconnected banks.[114] Thus, regulators may not even exercise their *existing* authority to impose increasingly stringent prudential standards based on an increasing risk continuum. In the end, the PCA framework has failed to fulfill its promise of ensuring early regulatory intervention.[115] As subpart B below illustrates, similar dynamics prevail with respect to nonbank financial institutions. And, as I will argue below, Dodd-Frank reforms have done little to change these dynamics.[116]

B. PRUDENTIAL NONBANK FINANCIAL INSTITUTION REGULATORY LANDSCAPE BEFORE DODD-FRANK

1. Limited Early Intervention Provisions for Nonbank Financial Companies

As established in the preceding sections of this Article, bank regulators at least theoretically apply progressively stricter regulatory enforcement measures as bank health deteriorates. In principle, implementation of this risk-based prudential regulation regime should have the effect of reducing systemic risk. Prior to Dodd-Frank, however, federal regulators had little or no guidance or authority to address increasing systemic risks posed by various types of nonbank financial institutions. Given no explicit authority,[117] or, at best, limited and uncertain authority, regulators confronted with potential system-wide harms from the imminent collapse of

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mandatory rule with some regulatory authority to make exceptions . . ."). *See also* Carnell, *Culture of Discretion*, *supra* note 56, at 116 (describing PCA limits on agency forbearance as "hardly draconian," and noting that "[o]nly a few of the rules allow no exceptions").

113. *See supra* text accompanying notes 102–110, particularly *supra* note 104.

114. *See supra* text accompanying notes 43–69.

115. Moreover, evidence from the 2007–2009 crisis suggests that—despite PCA mandates—regulators sometimes choose not to implement PCA enforcement actions against the nation's largest banks in times of significant financial distress. *See supra* text accompanying notes 107–13.

116. *See infra* notes 158–59, 183–84, and 286–89 and accompanying text.

117. Certain 2008–2009 Federal Reserve and FDIC actions to assist struggling companies arguably were outside the scope of even their emergency authority. *See, e.g.*, Alexander Mehra, *Legal Authority in Unusual and Exigent Circumstances: The Federal Reserve and the Financial Crisis*, 13 U. PA J. BUS. L. 221 (2010); U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-10-100, FEDERAL DEPOSIT INSURANCE ACT: REGULATORS' USE OF SYSTEMIC RISK EXCEPTION RAISES MORAL HAZARD CONCERNS AND OPPORTUNITIES EXIST TO CLARIFY THE PROVISION, 43–60 (2010) [hereinafter GAO, SYSTEMIC RISK] (analysis of legal authority for FDIC emergency actions).

major nonbank financial institutions during the 2007–2009 crisis were left to develop ad hoc, emergency responses.[118] The Federal Reserve in 2008, for example, invoked emergency authority not used since the Great Depression to broker and facilitate JP Morgan's acquisition of investment bank Bear Stearns after concluding that the latter's "disorderly failure . . . would [threaten] overall financial stability and would most likely have significant adverse implications for the U.S. economy."[119] If Bear Stearns had been a commercial bank,[120] regulators would have had greater supervisory oversight, authority to take "prompt corrective action" when financial problems became apparent, clearer rules about which agency was responsible, and a more clearly defined range of authorized resolution options.[121] Shortly after the Bear Stearns rescue, the imminent collapse of insurance giant American International Group (AIG) posed similar potentially system-wide economic harm. In the absence of regulatory authority over insurance companies,[122] the Federal Reserve again developed

118. TREAS. REFORM REPORT, *supra* note 16, at 76 (noting that "the federal government's responses to impending bankruptcies . . . were complicated by the lack of a statutory framework for avoiding the disorderly failure of nonbank financial firms") *See also* Steven M. Davidoff & David Zaring, *Regulation by Deal: The Government's Response to the Financial Crisis*, 61 ADMIN. L. REV. 463 (2009).

119. BD. OF GOVERNORS OF THE FED. RESERVE SYS., MONETARY POLICY REPORT TO THE CONGRESS 50 (2009). JP Morgan agreed to the acquisition only after receiving a $29 billion non-recourse Federal Reserve loan, the practical effect of which was the federal government's guarantee to absorb $29 billion of losses on Bear Stearns' riskiest assets. For a description of negotiations and final terms of the Bear Stearns acquisition, see GARY SHORTER, CONG. RESEARCH SERV., RL34420, BEAR STEARNS: CRISIS AND "RESCUE" FOR A MAJOR PROVIDER OF MORTGAGE-RELATED PRODUCTS 3–7 (2008) [hereinafter SHORTER, BEAR STEARNS].

120. The Bear Stearns investment bank owned numerous broker-dealer subsidiaries. Although broker-dealers were then subject to Securities and Exchange Commission (SEC) oversight, there was no regulation requiring or authorizing SEC oversight of investment banks. Bear Stearns had elected to participate in the SEC's voluntary "Consolidated Supervised Entities" (CSE) program, however. *See Turmoil in the U.S. Credit Markets: Examining the Regulation of Investment Banks by the U.S. Securities and Exchange Commission: Hearing Before the Subcomm. on Securities and Insurance and Investment of the S. Comm. on Banking, Housing, and Urban Affairs*, 110th Cong. (2008) (testimony of Erik Sirri, Dir., Div. of Trading and Markets, SEC) (providing analysis of the CSE program and Bear Stearns). In any event, even though SEC oversight rules include capital adequacy standards, they differ from bank regulation and enforcement rules applicable to banks.

121. *See, e.g.*, *Risk Management and Its Implications for Systemic Risk: Hearing Before the Subcomm. on Securities and Insurance and Investment of the S. Comm. on Banking, Housing, and Urban Affairs*, 110th Cong. 26 (2008) (testimony of Professor Richard J. Herring) [hereinafter Herring] ("If Bear had been a bank, the Fed, working with the FDIC, actually would have had a highly appropriate tool for dealing with the problem.") *See also id.* ("with the hastily improvised bailout of Bear Stearns, it seems to me the Fed crossed a regulatory Rubicon without the right weapons.").

122. Congress declared in 1945 that regulation and taxation of insurance companies would be governed by state law. Act of March 9, 1945, ch. 20, § 1, 59 Stat. 33 (1945) (commonly known as the McCarran-Ferguson Act) (codified at 15 U.S.C. § 1011). Adopting a policy sometimes referred to as "reverse preemption," the Act provided that federal law would not be construed "to invalidate, impair, or supersede" state laws regulating insurance. *Id.* § 2 (codified at 15 U.S.C.

an ad hoc plan to rescue yet another firm considered too-big-to-fail.[123] These ad hoc responses were later supplemented with more systematic Treasury Department assistance authority provided by the Troubled Asset Relief Program (TARP), enacted as part of the Emergency Economic Stabilization Act of 2008 (EESA).[124]

2. Discount Window as a Substitute or Supplement to Forbearance

If regulators were powerless to take early intervention action as the financial health of *nonbank* financial institutions deteriorated, perhaps it is not surprising that regulators ultimately resorted to ad hoc emergency actions requiring apparently binary choices: rescue or no rescue. One option that *was* available during the recent crisis, however, was the Federal Reserve's authority to open its discount window to nonbank entities under "unusual and exigent circumstances."[125] Government lending to troubled financial institutions permits them to remain afloat longer, often simply delaying the institution's inevitable collapse. In the end, the impact of such discount window lending to nonbanks is similar to the discount window lending impact discussed earlier with respect to banks.[126] Additional losses incurred during the failing institutions' prolonged lives prior to their ultimate demise increase costs to the federal deposit insurance funds and ultimately to general taxpayers.

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§ 1012). Congress reiterated its commitment to state regulation of insurance in the Gramm-Leach-Bliley Act of 1999, Pub. L. No. 106-102, tit. I, § 104, 113 Stat. 1352 (codified at 15 U.S.C. § 6701) [hereinafter GLM Act] (declaring that McCarran-Ferguson Act "remains the law of the United States"). Recent legislation provides limited new federal authority to monitor and regulate insurance companies, including the creation of a Federal Insurance Office (FIO). Dodd-Frank Act § 502(a), 124 Stat. 1580 (codified at 31 U.S.C. § 301). Despite these changes, the legislation provides for "retention of existing state regulatory authority over the business of insurance. *Id.* (codified at 31 U.S.C. § 313(k)).

123. *See* CONG. OVERSIGHT PANEL, JUNE OVERSIGHT REPORT: THE AIG RESCUE, ITS IMPACT ON MARKETS, AND THE GOVERNMENT'S EXIT STRATEGY 79–83 (2010) [hereinafter OVERSIGHT PANEL, AIG RESCUE] (detailing emergency assistance to insurer, AIG).

124. Emergency Economic Stabilization Act of 2008 (EESA), Pub. L. No. 110-343, tit. I (Troubled Asset Relief Program), §§ 101–136, 122 Stat. 3765, 3767–3800 (codified at 12 U.S.C. §§ 5211–5241). EESA authorized the Treasury Department to purchase troubled assets with three "tranches" of funding totaling $700 billion. *Id.* §§ 101(a), 115(a). Originally scheduled to expire on December 31, 2009, TARP was extended through October 3, 2010, pursuant to EESA authority granted to the Treasury Secretary. *Id.* § 120(b). Total TARP authority was subsequently reduced by $1.24 billion to offset the costs of program changes. *See* Helping Families Save Their Homes Act of 2009, Pub. L. No. 111-22, § 202(b), 123 Stat. 1632, 1643, and further reduced to $475 billion by the Dodd-Frank Act § 1302, 124 Stat. 2133 (codified at 12 U.S.C. § 5225(a)).

125. *See supra* text accompanying notes 83–89 on the Federal Reserve's use of discount window lending during the 2007–2009 economic crisis.

126. *See supra* text accompanying notes 81–91. Moreover, for both banks and nonbanks, potential increased losses during periods of extended discount window lending to insolvent entities are similar to the increased losses incurred through delays from regulatory forbearance.

C. DODD-FRANK'S REGULATORY RESPONSE TO "SYSTEMIC RISK"

1. General Response to Regulatory Weaknesses Exposed by Crisis

Broadly considered, Dodd-Frank's systemic risk-related provisions respond to two general classes of financial regulatory system weakness exposed by the Great Recession. First, and perhaps most significant, the 2007–2009 economic crisis dramatically illustrated that the financial regulatory system's historic emphasis on monitoring, supervision, and regulation of *banks*,[127] had not kept up with modern financial markets.[128] As financial product innovations and deregulation over time dramatically altered the financial industry landscape, the U.S. regulatory structure did not substantially change.[129] To the extent that they have been regulated at all, U.S. nonbank financial institutions have generally been assigned to a primary regulator based upon entity classification or charter type.[130] At the

127. Commercial and depository banks historically have been subject to substantially more stringent regulation than other industries on the theory that banks are more sensitive than other industries to systemic financial risks.

> Given the overall importance of banks to the economy and the level of trust customers place in banks, few people would be surprised to find that governmental regulation and oversight extend to many aspects of banking. In fact, since banks first appeared in the United States, banking has been treated as an industry having strong public policy implications.

KENNETH SPONG, BANKING REGULATION: ITS PURPOSES, IMPLEMENTATION, AND EFFECTS 2 (5th ed. 2000)[hereinafter SPONG]. *See also* Robert R. Bliss & George G. Kaufman, *U.S. Corporate and Bank Insolvency Regimes: A Comparison and Evaluation,* 2 VA. L. & BUS. REV. 143, 145 (2007) [hereinafter Bliss & Kaufman] (explaining special bank insolvency rules in lieu of regular bankruptcy as based on the notion that "any interruption in [banking] activities . . . would have a more serious adverse impact on the economy of the insolvent bank's market area than any interruption in the operation of other insolvent firms").

128. *See, e.g.,* GAO, FINANCIAL REGULATION, *supra* note 24, at 48 ("The U.S. regulatory system . . . put into place over the past 150 years . . . has not kept pace with the major developments that have occurred in financial markets and products in recent decades."). *See also* MARK JICKLING, CONG. RESEARCH SERV., RL34412, AVERTING FINANCIAL CRISIS 13 (2008) ("No federal agency has direct supervisory authority over hedge funds, nonbank lenders, over-the-counters derivatives trading, private equity funds, all of which demand liquidity and can become the trigger for systemic instability."). Some of the then-existing gaps have been closed with recent legislation. *See, e.g.,* Dodd-Frank Act, tit. IV, 124 Stat. 1570–80 ("Regulation of Advisors to Hedge Funds and Others"); *id.* § 619, 124 Stat. 1620 (codified at 12 U.S.C § 1851) ("Prohibitions on Proprietary Trading and Certain Relationships with Hedge Funds and Private Equity Funds"); *id.* tit. VII, subtit. A, 124 Stat. 1641–1754 ("Regulation of Over-the-Counter Swaps Markets").

129. U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-05-61, FINANCIAL REGULATION: INDUSTRY CHANGES PROMPT NEED TO RECONSIDER U.S. REGULATORY STRUCTURE 6 (2004) [hereinafter GAO, REGULATORY STRUCTURE].

130. For example, depository and commercial banks are regulated by a number of different federal and state agencies, securities markets and broker-dealers by the Securities and Exchange Commission (SEC); futures markets by the Commodity Futures Trading Commission (CFTC); and insurance companies by the states. *See* U.S. DEP'T OF THE TREASURY, BLUEPRINT FOR A MODERNIZED FINANCIAL REGULATORY STRUCTURE 3172 (2008) [hereinafter TREASURY 2008 BLUEPRINT] (providing a description of the respective roles of various regulatory entities).

same time, financial institutions may be subject to supervision by multiple different regulators based upon particular functions, resulting in regulatory overlaps and duplication.[131]

Second, the Great Recession revealed the limitations of a prudential regulatory regime focused primarily on individual institutions with insufficient consideration of systemic risks.[132] Prudential bank regulation has traditionally emphasized "safety and soundness" rules, whose primary object is to "ensure the safe and sound practices and operations of individual banking institutions through regulation, supervision, and examination."[133] The result was a micro-prudential regulatory structure whose "field of vision" focused on "the financial conditions of individual institutions in isolation."[134] Despite the operationally firm-specific nature of micro-prudential financial standards, regulators historically were confident that firm-specific rules worked simultaneously to address potential *systemic* risk concerns, reasoning that they "make the system as a whole safe by simply trying to make sure that individual banks are safe."[135] In other words, general financial stability was thought to flow from the collective economic health of individual financial institutions.

131. TREASURY 2008 BLUEPRINT, *supra* note 130, at 5. *See also* GAO, REGULATORY STRUCTURE, *supra* note 129, at 10 ("competition among supervisory authorities poses the risk that financial firms may well engage in a form of regulatory arbitrage that involves the placement of particular financial services or products in that part of the financial conglomerate in which supervisory oversight is the least intrusive."); GROUP OF THIRTY, THE STRUCTURE OF FINANCIAL SUPERVISION: APPROACHES AND CHALLENGES IN A GLOBAL MARKETPLACE 32 (2008) *available at* http://www.group30.org/images/PDF/The%20Structure%20of%20Financial%20Supervision .pdf (describing the U.S. financial system as a complex "Functional Approach, with some institutional elements). Moreover, as the GAO and others noted, "no agency or mechanism ha[d] the responsibility for monitoring risks that cut more broadly across functional areas. . . . No agency ha[d] the responsibility for analyzing the risks to the financial system as a whole . . . ." GAO, REGULATORY STRUCTURE, *supra* note 129, at 9. This concern has since been at least partially addressed by Dodd-Frank's creation of a new Financial Stability Oversight Council. *See infra* text accompanying note 140.

132. *See, e.g.*, Samuel G. Hanson, Anil K. Kashyap & Jeremy C. Stein, *A Macroprudential Approach to Financial Regulation*, 25 J. ECON. PERSPECTIVES 3, 3 (2011) [hereinafter *A Macroprudential Approach*] ("the regulatory framework in place prior to the global financial crisis was deficient because it was largely 'microprudential' in nature."); Beverly Hirtle, Til Schuermann & Kevin Stiroh, *Macroprudential Supervision of Financial Institutions: Lessons from SCAP* 2 (Fed. Reserve Bank of N.Y., Staff Report No. 409) (2009) (noting how before the crisis, "many believed that the microprudential objective of strong individual institutions was sufficient to address what are now recognized as macroprudential goals related to financial stability.").

133. U.S. GEN. ACCOUNTING OFFICE, GAO/GGD-97-23, BANK OVERSIGHT STRUCTURE: U.S. AND FOREIGN EXPERIENCE MAY OFFER LESSONS FOR MODERNIZING U.S. STRUCTURE 28 (1996) [hereinafter GAO, BANK OVERSIGHT].

134. *A Macroprudential Approach*, s*upra* note 132, at 4.

135. MARKUS BRUNNERMEIER, ANDREW CROCKET, CHARLES GOODHART, AVINASH D. PERSAUD & HYUN SHIN, THE FUNDAMENTAL PRINCIPLES OF FINANCIAL REGULATION xv (2009).

2. Dodd-Frank's Regulatory Response to Systemic Risk: Commercial Banks

While Dodd-Frank focuses most of its systemic risk-based attention on expanded monitoring, supervision, and enforcement authority with respect to nonbank financial companies and BHCs, it also includes provisions applicable to regular commercial banks. For example, Dodd-Frank requires appropriate federal banking agencies to establish "minimum leverage capital requirements" and "minimum risk-based capital requirements."[136] Congress also responded to the demand for greater macro-prudential regulation by directing federal banking agencies to "develop capital requirements applicable to insured depository institutions . . . that address the risks that the activities of such institutions pose, not only to the institution engaging in the activity, but to other public and private stakeholders in the event of adverse performance, disruption, or failure of the institution or activity."[137] Perhaps the most obvious solution to systemic risks presented by large, interconnected institutions or TBTF institutions would be to limit the growth of such institutions, or even to require the break-up of existing large institutions. Dodd-Frank made modest moves in this direction by expanding the scope of deposit cap rules imposed on mergers and acquisitions involving FDIC-insured institutions, [138] and authorizing federal regulators to impose concentration limits with respect to mergers and acquisitions involving financial companies.[139]

3. Dodd-Frank's Regulatory Response to Systemic Risk: Nonbank Financial Institutions and Bank Holding Companies (BHCs)

a. Financial Stability Oversight Council (FSOC) and Heightened Regulation for "Covered" Financial Company Categories

At the heart of Dodd-Frank's prudential *regulatory response* to systemic risk was creation of an inter-agency Financial Stability Oversight Council (FSOC) with authority and resources to actively monitor financial markets, identify financial stability risks, designate certain financial entities as "systemically important" for purposes of imposing enhanced supervision,

136. Dodd-Frank Act § 171(b)(1)(2), 124 Stat. 1435 (codified at 12 U.S.C § 5371).
137. *Id.* § 171(b)(7).
138. *Id.* § 623. *But see* Wilmarth, *Dodd-Frank, supra* note 13, at 99091 (noting loopholes left open even after the new deposit cap rules).
139. Dodd-Frank Act § 622, 124 Stat. 1632 (codified at 12 U.S.C. § 1852). *But see* Wilmarth, *Dodd-Frank*, *supra* note 13, at 991 (noting exceptions likely to weaken the effectiveness of new concentration limits).

and make substantive recommendations for heightened prudential standards.[140]

Dodd-Frank's most expansive new systemic risk-related regulatory authority directs the Federal Reserve Board of Governors to impose enhanced supervision and early remediation requirements on large, interconnected financial entities, whose failures are thought to present significant potential threats to national financial stability.[141] While the Federal Reserve has substantial discretion with respect to design and implementation, the "high-risk" financial institutions to which its enhanced prudential regulations apply are explicitly limited by statute to include: (1) BHCs with $50 billion or more of total consolidated assets;[142] and (2) large, "interconnected financial institutions."[143] Although the Dodd-Frank Act itself does not adopt the term,[144] nonbank financial companies designated by the FSOC for enhanced supervision or early remediation are commonly referred to as "systemically important financial institutions" or "SIFIs." As noted in one recent Federal Reserve discussion paper, "the term 'SIFI' is now so widely used in discussions and analyses of the financial system that it has essentially taken on a generic status."[145] Consistent with terminology adopted in recently proposed regulations, this Article collectively refers to large BHCs and SIFIs governed by the new enhanced regulation and early

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140. Dodd-Frank Act § 111(a), 124 Stat. 1392 (codified at 12 U.S.C. § 5321) (establishing FSOC); § 112, 124 Stat. 1394 (codified at 12 U.S.C. § 5322) (FSOC purposes and duties); § 152(a), 124 Stat. 1413 (codified at 12 U.S.C. § 5342) (establishing Office of Financial Research (OFR)); § 153(a), 124 Stat. 1415 (codified at 12 U.S.C. § 5343) (noting OFR purpose as supporting FSOC). *See supra* notes 176–79 and accompanying text regarding FSOC designation of "systemically important" or "covered companies" for enhanced regulation.

141. *Id.* § 165; *id.* § 166.

142. *Id.* § 165(a)(1). Dodd-Frank explicitly defines a BHC as having the same meaning as in § 2 of the Bank Holding Company Act of 1956. *Id.* §§ 2(18)(B)(i), 102(a)(1) (both sections referring to BHC definition in 12 U.S.C. § 1841). *See infra* text accompanying notes 168–76 (discussing covered BHCs).

143. In addition to the enhanced supervision and early remediation mandates, separate Dodd-Frank provisions direct the Federal Reserve to prescribe risk management standards applicable to designated "systemically important financial market utilities" (SIFMUs). *See, e.g.*, Dodd-Frank Act § 805, 124 Stat. 1809 (codified at 12 U.S.C. § 5464). Although Title VIII, "Payment, Clearing, and Settlement Supervision," also addresses systemic risk, its specific emphasis is the "safety and efficiency" of clearing and settling payment arrangements, which are so critical to the proper functioning of financial markets. *Id.* § 802(a)(1). These Title VIII payment system provisions are beyond the scope of this Article.

144. *See* Dodd-Frank Act § 165, 124 Stat. 1423 (codified at 12 U.S.C. § 5365) (using the term "large, interconnected financial institutions"). *See also id.* § 805 (using the term "systemically important financial market utilities").

145. Daniel E. Nolle, *U.S. Domestic and International Financial Reform Policy: Are G20 Commitments and the Dodd-Frank Act in Sync?* 2 n.4 (Bd. of Governors of the Fed. Reserve Sys., International Finance Discussion Papers No. 1024, 2011) *available at* http://www.federalreserve.gov/pubs/ifdp/2011/1024/ifdp1024.pdf. *See also*, Wilmarth, *Dodd-Frank*, *supra* 13, at 994 ("Dodd-Frank does not use the term 'systemically important financial institution' to describe a nonbank financial company that is subject to the statute's systemic risk regime, but I will generally refer to such companies as SIFIs.").

remediation rules either as "covered companies"[146] or "systemically important" companies.

b. Enhanced Prudential Regulation and Early Remediation Mandates: Progressive Risk Principles

Two key mandates form the heart of Dodd-Frank's systemic risk-related prudential financial regulation reforms with respect to "covered companies." First, "in order to prevent or mitigate risks to the financial stability of the United States that could arise from the material financial distress or failure, or ongoing activities, of large, interconnected financial institutions," § 165 requires the Federal Reserve to establish *enhanced supervision and prudential standards* for covered companies.[147] Second, "in order to minimize the probability that the company will become insolvent and the potential harm of such insolvency to the financial stability of the United States,"[148] § 166 directs the Federal Reserve to establish regulations "to provide for the *early remediation* of financial distress" of such covered companies.[149]

These two sections include numerous explicit statutory references that reflect a continuum of risk-based approach.[150] For example, § 165 directs the Federal Reserve to establish prudential standards that are "*more stringent*" for covered companies than for others,[151] and that "*increase in stringency*" based on risk considerations.[152] Similarly § 166 refers to a "*series of specific remedial actions* to be taken by a nonbank financial

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146. Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies, 77 Fed. Reg. 594 (Jan. 5, 2011) (to be codified at 12 C.F.R. § 252), *available at* http://|www.federalreserve.gov/newsevents/press/bcreg/bcreg20111220a1.pdf.

147. Dodd-Frank Act § 165(a), 124 Stat. 1423 (codified at 12 U.S.C. § 5365) (emphasis added).

148. *Id.* § 166(b) (emphasis added).

149. *Id.* § 166(a) (emphasis added) (requiring Federal Reserve to prescribe early remediation regulations in consultation with the FSOC and FDIC). The Dodd-Frank early remediation (ER) rules bear some similarities to the 1991 PCA provisions. *See supra* notes 97–115 and accompanying text (discussion of PCA provisions), and *infra* notes 155–59 and accompanying text (discussion of parallels).

150. Regardless of its particular level of risk or "systemic importance," however, any institution designated for regulation under the special "systemically important" regime is required to prepare a "plan . . . for rapid and orderly resolution in the event of material financial distress or failure," Dodd-Frank Act § 165(d)(1), 12 Stat. 1432 (codified at 12 U.S.C. § 5365), frequently referred to as the "living will" requirement.

151. *Id.* § 165(a)(1)(A) (emphasis added).

152. *Id.* § 165(a)(1)(B) (emphasis added); § 165(b)(3) (listing considerations) (requiring Federal Reserve to include capital requirements and leverage limits). *See also* Daniel K. Tarullo, Member, Fed. Reserve Bd. of Governors, Remarks at the Peterson Inst. for Int'l Econ.: *Regulating Systemically Important Financial Firms* 5 (June 3, 2011), *available at* http://www.federalreserve.gov/newsevents/speech/tarullo20110603a.htm [hereinafter Tarullo Remarks] (describing Dodd-Frank mandate to establish progressive standards that "'increase in stringency' with the systemic footprint of the firm, though . . . giv[ing] the Federal Reserve Board discretion in deciding how to realize this goal.").

company . . . that is experiencing *increasing* financial distress."[153] More specifically, § 166 calls for requirements "that increase in stringency as the financial condition of the company declines," including requirements applicable during "initial stages" and other requirements applicable during "later stages of decline."[154]

Dodd-Frank's § 166 early remediation (ER) provisions have some parallels to the Federal Deposit Insurance Corporation Improvement Act of 1991's PCA requirements.[155] Both are designed to ensure regulatory intervention early in the process of the financial institution's apparent economic decline. Such early action presumably increases the likelihood that remedial measures will be effective in preventing the institution's failure. Quite unlike the PCA provisions, which *limit* regulator discretion by mandating specific actions with respect to banks that fall within statutorily defined risk categories,[156] Dodd-Frank's ER provisions merely require the Federal Reserve Board, in consultation with the FSOC and FDIC, to "define measures of the financial condition of the company," and "establish requirements that increase in stringency as the financial condition of the company declines."[157] These broad, and relatively vague, statutory directives offer minimal guidance regarding what these increasingly stringent early remediation requirements should include, thus leaving regulators with extraordinary discretion.[158]

Given that the PCA framework's *mandatory* early intervention provisions were ineffective in substantially limiting forbearance on the part

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153. Dodd-Frank Act § 166(b), 124 Stat. 1432 (codified at 12 U.S.C. § 5366) (emphasis added).

154. *Id.* § 166(c).

155. *See supra* notes 92–115 and accompanying text for discussion of FDICIA's PCA framework.

156. For example, bank regulators are required to appoint a receiver within 90 days of a bank's classification as "critically undercapitalized." *See supra* note 102, and accompany text. *See also supra* note 99 (describing five PCA risk-based classifications).

157. Dodd-Frank Act § 166(c)(1), 124 Stat. 1432 (codified at 12 U.S.C. § 5366) (financial condition measures should include "regulatory capital, liquidity measures, and other forward-looking indicators"). *Id.* § 166(c)(2) (requiring standards that increase in stringency).

158. *See id.* § 166(c)(2)(A), (B) (demanding only that the increasingly stringent measures include "requirements in the initial stages of financial decline, including limits on capital distributions, acquisitions and asset growth; and (B) requirements at the later stages of financial decline, including a capital restoration plan and capital-raising requirements, limits on transactions with affiliates, management changes, and asset sales."). One recent comment described this language as

> the biggest legislative punt in the Dodd-Frank Act. Almost twenty years earlier, Congress thoroughly created, in more than ten pages, a detailed system of actions and restrictions for a functionally similar system [referring to PCA]. In the Dodd-Frank Act, Congress provided—in half of a page—vague directions that can be directly traced to FDICIA's headers.

Jonathan M. Edwards, *FDICIA v. Dodd-Frank: Unlearned Lessons About Regulatory Forbearance*, 1 HARV. BUS. L. REV. 279, 290 (2011).

of regulators facing strong incentives not to act,[159] one suspects that Dodd-Frank's highly discretionary early remediation provisions may be even less effective. Here again, the theory of early intervention based on a risk-based continuum may conflict with reality. In other words, Dodd-Frank's enhanced prudential regulation and early remediation rules may not significantly alter the pre-Dodd-Frank forbearance dynamic with respect to systemically important institutions.

c. Entities Posing "Grave Threats" to Financial Stability

Dodd-Frank supplements the Federal Reserve's enhanced supervision and early remediation authority with the additional power to impose limits on specific activities of a covered company when the Federal Reserve Board determines that the company "poses a *grave* threat to the financial stability of the United States."[160] Consistent with a continuum of risk approach, this provision "ratchets up" the Federal Reserve's intervention powers as risks become more severe, and presumably more imminent. Restrictions that may be imposed on covered companies under this section include: limits to the company's ability to merge with or acquire another company, restrictions on the sale of financial products, conditions imposed on the manner of conducting one or more business activities, and, in the extreme, requirements that the company divest itself of assets or off-balance-sheet items to unaffiliated entities.[161] On the surface, this provision—together with enhanced supervision and early remediation—suggests promise for an effective, gradually increasing government regulatory response as systemic risk intensity heightens. Nonetheless, there are reasons to be skeptical that the promise will ultimately be realized. As Professor Arthur Wilmarth notes with respect to the divestiture rule, the provision is "unwieldy and constrained by stringent procedural requirements."[162] Procedural obstacles to regulatory action will be especially difficult to overcome for regulators who already face strong forces and incentives against enforcing stringent requirements.[163] Wilmarth further observes that the Federal Reserve already has similar authority to

159. *See supra* notes 107–15 and accompanying text.

160. Dodd-Frank Act § 121(a), 124 Stat. 1410 (codified at 12 U.S.C. § 5331) (emphasis added). The "grave threat" designation requires a 2/3 vote of the FSOC. *Id.* § 121(a). In addition, covered companies are entitled to notice and a hearing. *Id.* § 121(b).

161. *Id.* § 121(a)(1)–(5). Divestitures can only be required as a last resort, if the Board determines that the other restrictions listed in (a)(1)–(4) are "inadequate to mitigate a threat to the financial stability of the United States." *Id.* § 121(a)(5).

162. Wilmarth, *Dodd-Frank*, *supra* note 13, at 1024.

163. *See supra* notes 43–50, 54–70 and accompanying text. *See also* Thomas M. Hoening, Pres., Fed. Res. Bank of Kansas City, William Taylor Memorial Lecture: *It's Not Over 'Til It's Over: Leadership and Financial Regulation* 3 (Oct. 10, 2010), *available at* http://www.kc.frb.org /speechbio/hoenigpdf/william-taylor-hoenig-10-10-10.pdf (noting that regulatory authorities "almost certainly will find themselves facing an atomic force of resistance from those at risk").

require a BHC to divest itself of nonbank subsidiaries that pose serious "risk to the financial safety, soundness or stability of [its] banking subsidiaries."[164] Unlike the new Dodd-Frank "grave threat" provision, the previously existing BHC divestiture authority is not subject to stringent procedural requirements. Even without procedural obstacles, the Federal Reserve apparently has never successfully used the BHC divestiture provision.[165] Here again, the principle of financial regulation based on a risk-based continuum may not be realized in practical application of the new rules.

4. Covered Entities and "Cliff Effects"

a. BHCs

On the one hand, Dodd-Frank's enhanced regulation and early remediation regime explicitly call for the application of increasingly strict standards based upon a continuum of risk.[166] Thus, financial entities classified as "systemically important" should at least theoretically be subject to progressively more stringent rules within the enhanced regulation/early remediation framework. At the same time, by carving out "covered companies" deemed to be "systemically important" for purposes of enhanced regulation and early remediation, Congress has made an initial explicitly binary distinction. With respect to the "BHC covered company" category, Congress itself drew a fixed statutory $50 billion boundary separating entities that are subject to new heightened scrutiny from those that are not.

By automatically designating BHCs with $50 billion or more of total consolidated assets as subject to enhanced supervision and early remediation,[167] Congress has declared by fiat that such BHCs are systemically important, meaning that the failure of such a company would present significant potential threats to national financial stability. This definition—based upon size alone—appears inconsistent with current understandings, otherwise reflected in Dodd-Frank[168] that size itself is not determinative as a measure of potential systemic risks that might result from the firm's failure.[169] Another critical component of any systemic risk

164. Wilmarth, *Dodd -Frank supra* note 13, at 1025 (citing 12 U.S.C. § 1844(e)(1)).

165. *Id.* (citing Hoening, *supra* note 163).

166. *See supra* notes 147–58 and accompanying text.

167. Dodd-Frank Act § 165(a)(1), 124 Stat. 1423 (codified at 12 U.S.C. § 5365).

168. *Id.* § 112(a)(1)(A) ("The purposes of the [Financial Stability Oversight] Council are to identify risk to financial stability . . . that could arise from the material financial distress or failure, or ongoing activities, of large, *interconnected* bank holding companies or nonbank financial companies . . . .") (emphasis added).

169. As one economist observed, "[r]ecently, both policymakers and academicians have begun to distinguish the *size* of a financial institution from the *systemic importance* it has by introducing new terms focusing on what the potential systemic impact might be if that particular institution

assessment is the degree of the firm's interconnectedness with similar firms, counterparties, and other market participants.[170] One possible explanation for this limited focus on size may be the belief that the holding company structure itself already denotes an institution that is interconnected, and, in particular, that the BHC's large size suggests that it simultaneously bears other characteristics of systemic importance. In other words, BHC size is used as a proxy for interconnectedness and other factors relevant to determining systemic importance. On the other hand, some large BHC structures may be far more complex and interconnected than others. Thus, the "proxy" explanation for automatic BHC classification based on size is not entirely satisfactory; it fails to take differences among large BHCs into account.

A more serious concern is that the distinction between entities that fall on either side of the explicit $50 billion boundary is inconsistent with the notion of progressive regulation based upon a risk continuum. As Federal Reserve Board member Daniel Tarullo noted: "the *ideal approach would be a continuous function*, by which . . . additional requirement[s] would vary precisely with the measure of the firm's systemic importance," adding that that "[s]ystemic importance *is not a binary determination*, but one of degree."[171] Tarullo further notes that "it is generally better to avoid cliff effects, whereby significant regulatory consequences ensue based on relatively modest differences among firms."[172] Yet, this is *precisely* the effect of Dodd-Frank's automatic designation of BHCs with over $50 billion consolidated assets as subject to enhanced supervision and early remediation. A BHC with assets just in excess of the $50 billion threshold will be governed by the enhanced standards, while a comparable BHC with assets just below the threshold will not. Here again, progressive theory meets binary reality. Moreover, unlike the SIFI designation, the automatic

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fails." Chen Zhou, *Are Banks Too Big to Fail? Measuring Systemic Importance of Financial Institutions*, 6 INT'L J. OF CENT. BANKING 205, 206 (2010) (emphasis added).

170. *See, e.g.*, FIN. STABILITY BD., INT'L MONETARY FUND, AND BANK FOR INT'L SETTLEMENTS, GUIDANCE TO ASSESS THE SYSTEMIC IMPORTANCE OF FIN. INST, MKTS. AND INSTRUMENTS: INITIAL CONSIDERATIONS — BACKGROUND PAPER, REPORT TO THE G-20 FINANCE MINISTERS AND CENTRAL BANK GOVERNORS 5 (Oct. 2009) (reporting survey results of central banks and other governmental authorities concluding that after size, "[i]nterconnectedness is clearly the second most important" systemic importance factor); James B. Thomson, *On Systemically Important Financial Institutions and Progressive Systemic Mitigation*, 8 DEPAUL BUS. & COMM. L.J. 135, 144–45 [hereinafter Thomson] (proposing five categories of systemic risk, including size and interconnectedness as categories one and two, respectively).

171. Tarullo Remarks, *supra* note 152, at 5–6 (emphasis added). *See also* Thomson, *supra* note 171, at 136 (arguing that one should regard "systemic importance as a continuum rather than as a binary distinction").

172. Tarullo Remarks, *supra* note 152, at 6.

BHC classification based upon size is a binary distinction over which the FSOC and the Federal Reserve have no discretion.[173]

One result of this "cliff effect" is the incentive it provides for banks to remain just below the $50 billion threshold.[174] Tarullo acknowledges the "cliff effect," noting that there should not be significant differences for entities just over and under the $50 billion level. As a result, he concludes that "the supplemental capital requirement for a $50 billion firm is likely to be very modest." [175] If correct, Tarullo's assertion that heightened requirements on the systemic risk side of the magic $50 billion line are likely to be modest raises questions about the need for the special BHC classification in the first place.

b. Systemically Important Financial Institutions (SIFIs)

Unlike covered BHCs, classification of a nonbank financial company as subject to heightened Federal Reserve supervision is not automatic. Instead, Congress left discretion with the FSOC to designate a nonbank financial firm as a "covered company" based upon a determination by two-thirds vote of the FSOC "that material financial distress at the U.S. nonbank financial company, or the nature, scope, size, scale, concentration, interconnectedness, or mix of activities . . . could pose a threat to the financial stability of the United States."[176] For SIFIs, then, the magic line separating covered from uncovered entities is less clear, but nonetheless also creates a binary universe.

While the SIFI designation provision does not share the BHC classification's *size-based* cliff effect problem, the magic line separating SIFIs from non-SIFIs for purposes of Federal Reserve enhanced prudential regulation may present even more serious problems. Unlike BHCs, which

173. The FSOC is authorized, however, to recommend a threshold *higher* than $50 billion for the application of particular regulatory standards. Dodd-Frank Act § 115(a)(2)(B), 124 Stat. 1403 (codified at 12 U.S.C. § 5325).

174. For similar observations, see Viral V. Acharya, *Systemic Risk and Macro-Prudential Regulation*, N.Y.U. Stern School of Business, Center for Economic Policy Research, & N.B.E.R. Working Paper 7 (March 2011), *available at* http://pages.stern.nyu.edu/~sternfin/vacharya/public_html/ADB%20Systemic%20Risk%20and%20Macroprudential%20Regulation%20-%20Final%20-%20March%202011.pdf (noting incentives for "larger banks [to] simply break themselves up yet retain pretty close in terms of their exposures to some common aggregate risky asset . . ."). Acharya further notes that a group of "individually small but collectively exposed" institutions would not be considered systemically important under the $50 billion cut-off rule even though it may present the same systemic risk as a similar business structured as a single BHC). *Id.*

175. Tarullo Remarks, *supra* note 152, at 6.

176. Dodd-Frank Act § 113(a)(1)–(2), 124 Stat. 1398 (codified at 12 U.S.C. § 5323) (factors for FSOC consideration). In a preamble to proposed regulations, the FSOC interpreted the statutory language as a two-part determination: whether material distress of the company *or* the nature, scope, size, scale, concentration, interconnectedness, or mix of activities could pose a threat to U.S. financial stability. Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies, 76 Fed. Reg. 64264, 64268 (proposed Oct. 18, 2011) (to be codified at 12 C.F.R. tit. 1310).

are subject to regular Federal Reserve Board supervision and enforcement even if they fall below the $50 billion threshold, some nonbank financial companies, such as investment banks and broker-dealers, for example, absent a SIFI designation would be subject to varying degrees of supervision and regulation by the SEC, and not the Federal Reserve.[177] Insurance companies generally are subject to state rather than federal regulation,[178] and still other nonbank financial companies have been subject to limited or no regulation.[179] For some nonbank financial institutions, a SIFI designation can mean the difference between enhanced federal prudential regulation and little or no regulation at all. Such an approach is inconsistent with regulatory principles based on a risk continuum.

D. REGULATORY RESPONSE SUMMARY: RISK-CONTINUUM PRINCIPLES VERSUS BINARY REALITY

At least in theory, prudential bank regulation is based upon continuum of risk principles. Bank examiners and regulators have substantial discretion to intervene in numerous different ways ranging from informal agreements with bank managers to formal enforcement requirements that bank managers take specific remedial actions as examiners and regulators become aware of management control concerns or excessive risk problems resulting from poor investment decisions. By definition, however, regulatory discretion generally includes the exercise of discretion *not* to act. Despite even the 1991 FDICIA "mandatory" PCA framework designed to force early regulatory responses to bank problems before they become too severe, regulators continue to face perhaps the most powerful pressures *not* to act precisely when potential system-wide harm from forbearance are likely to be *highest*. Even with the PCA "mandatory" framework in place, regulators remain reluctant to take enforcement actions against—and may even face pressures to assist—large struggling banks as problems emerge.[180] As large bank failures loom further along the timeline, regulators ultimately face inverse pressures—sometimes referred to as the TBTF dilemma—to act quickly to save the economy from imminent peril.[181] A related "pressure not to act" phenomenon, illustrated by the 1980s and 1990s savings and loan crisis, is the "too-many-to-fail" case, in which

177. *See supra* note 130.

178. *See supra* note 122.

179. *See* GEN. ACCOUNTABILITY OFFICE, FINANCIAL REGULATION: A FRAMEWORK FOR CRAFTING AND ASSESSING PROPOSALS TO MODERNIZE THE OUTDATED U.S. FINANCIAL REGULATORY SYSTEM 23, GAO-09-216 (2009) (referring to unregulated or less regulated nonbank financial entities).

180. These forbearance issues are not raised in the case of crises that emerge suddenly and without any economic warning.

181. Despite congressional declarations to the contrary, TBTF policies have stubbornly survived. For a discussion of TBTF and its continued life even after the congressional TBTF death certificate, see *infra* notes 243–63 and accompanying text.

regulators may not be inclined to take enforcement actions when too many banks confront problems simultaneously. In the end, the long-run budget cost of inaction can far exceed the immediate cost of enforcement action in either the TBTF or "too-many-to-fail" scenario.[182] Although prudential bank regulators have a continuum of risk-based enforcement *tools*, the practical problem is providing them with incentives to *use* the available tools in appropriate cases at earlier stages. Otherwise, in a subsequent emergency setting, regulators ultimately face a binary choice in any event: allow the bank to fail or intervene with some type of government assistance.

With respect to systemically important *nonbank* financial companies and BHCs, Dodd-Frank at least provides some type of risk-based regulatory infrastructure for certain financial entities that were not previously subject to clear financial regulation. Although Dodd-Frank generally adopts a continuum of risk-based principles, it nonetheless also incorporates unfortunate "cliff effects" that are inconsistent with the continuum approach.[183] Dodd-Frank also leaves many details to agency discretion and imposes many procedural hurdles for regulatory action. At the same time, Dodd-Frank does not substantially alter the dynamics that historically have led to regulatory forbearance. Thus, regulatory forbearance is likely to continue—or perhaps even increase.[184]

The next section of this Article turns from regulation to resolution. Notably unlike the regulatory response, which is theoretically based on a continuum of risk principles but often binary in operation, the *resolution* response has a binary surface appearance, but in fact reflects more of a continuum approach than is generally acknowledged. After first identifying characteristics that distinguish regulation from resolution, and examining alternative definitions of the term resolution, Part II explores several specific resolution response issues. Part III develops the notion of a private-public risk allocation continuum, first simply to acknowledge and highlight the many—sometime more hidden existing mechanisms through which the government may intervene in resolution-related allocations of risk. At a minimum, I argue that transparency and equity concerns make it important to acknowledge these mechanisms instead of allowing anti-bailout fervor to force them further underground. Rather than outright prohibition against

182. *See supra* note 96 and accompanying text (estimated S&L crisis costs attributed to regulatory forbearance).

183. *See supra* notes 166–75 and accompanying text.

184. A recent empirical study of capital regulation enforcement actions from 1993 to 2010 may have some bearing on the forbearance issue. The study found variations in enforcement levels among bank regulation agencies, finding in particular that the Federal Reserve was more lax than other regulators. Hill, *supra* note 36, at 689. As Professor Hill herself notes, the Federal Reserve's lower enforcement rates cannot definitively be attributed to regulatory forbearance. *Id.* Without overstating the case, I argue simply that Dodd-Frank's enhanced supervision and early remediation efforts are less likely to be effective to the extent Federal Reserve is more inclined to forbearance than other agencies.

certain regulatory actions,[185] the next policy step should be to distinguish government resolution responses that have policy value from those that do not, and to implement rules to ensure that those with value are implemented fairly. Finally, identifying existing continuum-based resolution mechanisms will permit more informed policy assessments of the types of government risk-allocation management devices that might be appropriate under different categories of circumstances.

II. THE RESOLUTION AUTHORITY RESPONSE TO SYSTEMIC RISK

A. RESOLUTION DEFINED

1. Prudential Regulation and Resolution Compared

Systemic risk-oriented prudential regulation of large, interconnected financial institutions focuses on *preventing*, *limiting* or *mitigating* system-wide harm through ex ante supervision and enforcement standards. In addition to supervision and enforcement, ex ante prudential rules may limit growth and concentration of exceptionally large banks by restricting acquisitions.[186] Finally, regulators may broadly address systemic risks by adopting a more macro-economically focused approach, taking the entire system into account rather than limiting its emphasis to individual institutions.[187]

Financial regulators have flexibility—and in some cases mandates—to "ratchet up" supervision and enforcement as the regulated firm's financial health deteriorates.[188] When the financial circumstances of a financial entity become sufficiently dire, regulators switch from regulation to resolution mode.[189] In this ex post *resolution* phase, federal bank regulators are

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185. One illustration is Dodd-Frank's explicit ban on the FDIC authority to acquire preferred stock in the orderly liquidation resolution process. Dodd-Frank Act § 206(6), 124 Stat. 1459 (codified at 12 U.S.C. § 5386).

186. *See supra* notes 138–39 and accompanying text.

187. A focus on more system-wide concerns is especially evident in Dodd-Frank's macroprudentially-focused regulatory reforms. *See* discussion at *supra* notes 136–79 and accompanying text.

188. *See, e.g.*, discussion of mandatory PCA measures, *supra* notes 97–115 and accompanying text.

189. The Federal Reserve Board commented on the distinction between prudential regulation and resolution in an introduction to proposed Dodd-Frank regulations, noting that the recent crisis "demonstrated weaknesses in the existing framework for supervising, regulating, and otherwise containing the risks of major financial companies [regulation], *as well as* deficiencies in the government's toolkit for managing their failure [resolution]." Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies, 77 Fed. Reg. 594, 595 (proposed Jan. 5, 2012) (to be codified at 12 C.F.R. pt. 252) (introduction to proposed regulations implementing Dodd-Frank § 165 enhanced regulation and early remediation rules) (emphasis added).

authorized to close banks and place them in receivership,[190] at the same time taking care to limit or mitigate any system-wide economic shocks that might be triggered by the resolution process.

Banks in the United States include a wide variety of institutional structures; they may be state or federally chartered, and may or may not be Federal Reserve System member banks. Based on their particular charters and structures, banks are *prudentially* regulated by a complex mix of state and federal regulatory agencies.[191] Regardless of their primary prudential regulator, insured banking institutions are *resolved* by the FDIC. The bank resolution process technically begins when the insured bank's chartering institution or primary regulator sends a "failing bank letter" advising the FDIC of the institution's imminent failure,[192] or when the FDIC exercises its independent authority to seize a failing bank and appoint itself as conservator or receiver.[193]

The FDIC defines "resolution" as "the *disposition plan* for a failed institution, designed to (1) protect insured depositors and (2) minimize losses to the relevant insurance fund, which are expected from covering insured deposits and *disposing of the institution's assets*."[194] As Professor David Zaring more colorfully describes it, "[r]esolution authority is the polite term for seizing failing financial institutions and either shutting them down or selling them off for the best possible price."[195] So described, the resolution process appears as a type of hospice care; the function of bank resolution authority is to manage the dying process, keeping the patient, its stakeholders, and the regional or national economy reasonably safe and comfortable until the failing company's inevitable demise. This strict notion of resolution appears to leave no room for rehabilitation.

"Resolution" need not be so narrowly defined, however. After a comprehensive global survey of resolution regimes, the Basel Committee on Banking Supervision noted that

190. Unlike bankruptcy, bank resolution is not a voluntary or elective process. The decision to place a financial institution in receivership rests entirely with bank regulating agencies.

191. *See supra* note 24 and accompanying text. Despite its many changes, Dodd-Frank did little to alter the underlying unwieldy and complex U.S. bank regulatory structure. For critical commentary, see Saule T. Omarova, *The Dodd-Frank Act: A New Deal for a New Age?* 15 N.C. BANKING INST. 83, 87–90 (2011).

192. For a description of the "failing bank letter" process, see FDIC., MANAGING THE CRISIS: THE FDIC AND RTC EXPERIENCE 1980–1994 56–57 (1998) [hereinafter FDIC, MANAGING CRISIS], *available at* http://www.fdic.gov/bank/historical/managing/history1-02.pdf.

193. 12 U.S.C. § 1821(c)(4). With respect to nonbank financial entities, the resolution process is triggered by a formal "systemic risk determination." Dodd-Frank Act § 203, 124 Stat. 1450 (codified at 12 U.S.C. § 5383) (procedural mechanisms for systemic risk determination with respect to struggling nonbank "covered company"). For discussion of substantive and procedural requirements for "systemic risk determinations," see *infra* notes 275–86 and accompanying text.

194. FDIC, RESOLUTIONS HANDBOOK 89, 97 (Glossary) [hereinafter FDIC, HANDBOOK] (emphasis added), *available at* http://www.fdic.gov/bank/historical/reshandbook (lasted updated Apr. 2, 2003).

195. David Zaring, *A Lack of Resolution*, 60 EMORY L. J. 97, 99 (2010).

> [t]he terms 'resolution' and 'resolution regime' are understood as referring to any action by a national authority, with or without private sector involvement, *intended to maintain financial stability and/or address serious problems in a financial institution that imperil its viability . . . where, absent resolution, the institution is no longer viable and there is no reasonable prospect of it becoming so*.[196]

The Basel Committee further reported that "[m]ost countries responded that they have resolution regimes for failing financial institutions, although . . . the term seems to have been interpreted in different ways. Consequently, the scope and content of what countries refer to as their resolution regimes vary considerably."[197]

To my mind, the distinction between regulation and resolution in the broadest sense is that the former primarily addresses risk limitation or mitigation, whereas the latter focuses on the government's role in making risk *allocation* determinations. "Resolution," for purposes of this Article, refers broadly to the government's involvement in managing the allocation of otherwise private risk, with particular emphasis on government responses to actual or threatened failure of one or more financial institutions. Government involvement in private risk allocation can be plotted on a rough private-public continuum, along which government intervention becomes increasingly "public" as the government's role changes from mere background presence, to referee, to active participant in determining *who* should bear the risk of loss from the business failures, to actual *bearer* of loss.

In an interesting contribution to the literature, Professor Gelpern suggested isolating a distinct financial law and policy space for a category that she labels "containment," arguing that what is really "[c]ontainment is often conflated with financial regulation, crisis prevention and resolution."[198] Gelpern argues that governments enforce regulations under ordinary circumstances, but that ordinary enforcement may become impossible during extraordinary moments of crisis.[199] To paraphrase the argument, major financial crisis shifts the financial regulatory system away from normal space into paranormal "containment" space. In this alternate realm, "much of what appears as rule-breaking . . . is neither good nor bad, but unavoidable."[200]

Gelpern correctly notes the distinction between loss *limitation* (which I refer to as regulation) and loss *distribution*, noting that containment

196. BASEL COMM. ON BANKING SUPERVISION, BANK FOR INSTITUTIONAL SETTLEMENTS, RESOLUTION POLICIES AND FRAMEWORKS – PROGRESS SO FAR 7 (2011) (II, ¶ 31) (emphasis added), *available at* http://www.bis.org/publ/bcbs200.pdf.

197. *Id.* at 7–8.

198. Gelpern, *supra* note 60, at 1055.

199. *Id.* at 1057 (observing that during a crisis, "strictly enforcing capital and accounting rules may mean shutting down most banks and cutting off the credit essential to recovery").

200. *Id.*

episodes entail the latter. For purposes of distinguishing containment from resolution, however, Gelpern adopts a different—and, I think, less common—definition of resolution as referring to the general economic rebuilding and regulatory "reform" that often follows in the aftermath of economic crisis.[201] I quite agree that government emergency or "containment" efforts to stop the bleeding are distinct from rebuilding or "resolution" as she defines it. For purposes of this Article, "resolution" includes both what Gelpern refers to as "containment" and other government risk allocation-type interventions, perhaps even in noncritical circumstances.

In the end, I share the sentiment and conclusion that rule-breaking may be inevitable under emergency circumstances, and that there is value in efforts "to carve out that part of emergency response whose operational content can be described in advance."[202] On the other hand, to carve out "containment" as a distinct category of government risk allocation involvement would require yet another binary distinction, this time identifying the magic boundary line separating the normal from paranormal mode. The separate space for "containment" Gelpern suggests would require knowing the point at which struggling becomes true systemic emergency.

2. Fuzzy Boundaries

a. Early Fuzzy Boundaries Between Regulation and Resolution

Although the FDIC Handbook definition suggests a definition of resolution that may not envision rehabilitation,[203] statutory language and common usage of the term "resolution" among regulators and commentators often broadly includes a variety of regulatory actions that may facilitate continued operation of the failing bank. In other words, although "regulation" and "resolution" are distinct phases and concepts, the practical differences between the two can sometimes be fuzzy. One illustration of this blurred boundary is regulatory forbearance, whereby government officials exercise their prudential regulatory enforcement discretion as a resolution tool to provide relief to large, failing financial firms.[204]

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201. *See, e.g.*, Gelpern, *supra* note 60, at 1067. ("Resolution refers broadly to the restructuring and reregulation that happen in the aftermath of financial collapse-after panic has abated, but before the economy has returned to normal.").

202. *Id.* at 1069. In fact, I have previously argued that Congress should establish certain ex ante substantive standards and a procedural infrastructure for government interventions with respect to private enterprise failure. Cheryl D. Block, *Overt and Covert Bailouts: Developing a Public Bailout Policy*, 67 IND. L. J. 951, 1008–30 (1992) [hereinafter Block, *Overt and Covert Bailouts*].

203. *See supra* notes 194–95 and accompanying text.

204. *See supra* notes 44–68, and *infra* notes 391–404.

Another illustration of resolution boundary "fuzziness" is the distinction between conservatorship and receivership. Even though conservators and receivers serve different functions, federal deposit insurance laws often use the terms together, leaving perhaps the impression that they share a common meaning. Unlike receivers, who are responsible for liquidating or winding up a failed institution, conservators may be "appointed to operate the institution, conserve its resources, and restore it to viability."[205] In fact, bank regulatory agencies acting as conservators originally had broad power to take action "necessary to put the insured depository institution in a sound and solvent condition," and "appropriate to carry on the business of the institution and preserve and conserve [its] assets and property. . . ."[206] Moreover, unlike a receivership, a conservatorship could be terminated and the previously struggling bank permitted to "resume the transaction of its business" if regulators were satisfied that this could "be [safely] done and that it would be in the public interest. . . ."[207]

Despite the potentially "life" and "death" differences between conservatorship and receivership, the statutory grounds for appointing either a conservator or a receiver are the same. Perhaps most notably, the grounds for appointing either a conservator or receiver do not require that the institution technically be insolvent or actually in default. For example, a conservator or receiver can be appointed on the grounds of "[inability] to pay its obligations or meet its depositors' demands"[208] (i.e., a bank with liquidity rather than insolvency issues), or "unsafe or unsound condition[s] to transact business."[209] To the extent that there is a shared theme binding the various grounds for appointing a conservator or receiver, it might colloquially be described as "trouble brewing." Some "troubles" might be resolved by careful monitoring and enforcement (i.e., regulation), without moving into what might be considered true "resolution" mode. Though conservators were common during the Great Depression, they were rarely used thereafter until the 1980s, when Congress again turned to conservatorships in response to the savings and loan (S&L) crisis.[210] While

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205. *See* DAVID H. CARPENTER & M. MAUREEN MURPHY, CONG. RESEARCH SERV., RL34657, FINANCIAL INSTITUTION INSOLVENCY: FEDERAL AUTHORITY OVER FANNIE MAE, FREDDIE MAC, AND DEPOSITORY INSTITUTIONS 5 (2008) [hereinafter CRS, FINANCIAL INSTITUTION INSOLVENCY].

206. 12 U.S.C. § 1821(d)(2)(D). Exercise of conservatorship authority has been substantially limited, however, by Least Cost Resolution (LCR) restrictions. FDICIA § 141(a), 105 Stat. 2273 (codified at 12 U.S.C. § 1823(c)(4)).

207. 12 U.S.C. § 205(a).

208. 12 U.S.C. § 1821(c)(5)(F).

209. 12 U.S.C. § 1821(c)(5)(C).

210. *See, e.g.*, FDIC, MANAGING CRISIS, *supra* note 192, at 116 ("conservatorship was used almost exclusively . . . in the resolution of thrifts"). *Id.* at 125 ("Initially, the RTC had so many S&Ls in conservatorship, it had to set priorities in its resolution schedule.").

conservatorship authority remains on the "statute books,"[211] restrictions imposed by subsequent statutory amendments make it very difficult, if not impossible, to use for purposes of rehabilitating a failing bank.

b. Ex Ante Rules with Ex Post Components and Ex Post Rules with Ex Ante Effect

Viewed in the broad sense, resolution rules may be implemented through ex ante *or* ex post programs, or a combination of the two. In some cases, ex ante programs can serve ex post functions. Government-mandated federal deposit insurance, for example, can be seen as an ex ante government risk allocation or resolution program.[212] Moreover, even though largely designed for preventive purposes, certain ex ante regulations may also serve ex post resolution functions. Risk-based capital adequacy requirements, for example, work ex ante "to discourage excessive risk-taking by making it more costly for the regulated firms. Ex post, they seek to ensure that each firm has the capital cushion to withstand economic shocks."[213]

At the same time, some ex post programs or regimes can have significant ex ante effects. For example, well-informed investors make decisions about whether to invest and the types of stakeholder interest they will purchase based on the claim status of their investment in the event of an ultimate bankruptcy. As such, bankruptcy rules can serve the ex ante function of shaping private investment behavior in directions preferred by government policy makers. In fact, one advantage of private bankruptcy over Dodd-Frank's new orderly liquidation regime as a risk allocation mechanism may be the greater certainty it provides regarding the status of claims.

B. MANAGING THE BANK RESOLUTION PROCESS

1. The Need for Resolution Flexibility

Under the narrow view of resolution as the process of winding up failed institutions and paying off secured depositor claims, the most immediately obvious response to bank failure is for the FDIC to oversee the sale of bank assets and payments to secured creditors, followed by distribution of any remaining proceeds, supplemented as necessary by federal deposit insurance funds and general revenue, to cover all insured depositor claims. The concern with this limited approach, however, is that a hurried, forced sale of failed bank assets might not command the highest possible prices. In

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211. 12 U.S.C. § 1821(c), (d) (appointment and powers of conservator); 12 U.S.C. § 205 (termination of conservatorship).

212. *See infra* notes 358–69 and accompanying text.

213. Gelpern, *supra* note 60, at 1064.

the end, the losses from such a "fire sale" would be additional cost to the federal deposit insurance funds, and potential burdens imposed on general taxpayers.[214] Aware that a straightforward bank liquidation and "fire sale" might prove more costly to the deposit insurance system than finding a buyer to acquire the bank, Congress historically has authorized the FDIC to resolve failed banks through a mechanism referred to as a purchase and assumption (P&A) or other alternative transaction structures.[215]

2. Basic FDIC Bank Resolution Methods

Insolvent depository banks are not eligible to file for bankruptcy under federal bankruptcy laws applicable to most other businesses.[216] Given special concern for the unique and potentially broad economic impact of bank failures,[217] insolvent depository bank resolutions and liquidations instead are governed by a separate FDIC-administered regime.[218] The FDIC's three basic resolution methods include: (1) deposit payoffs, in which the "FDIC as insurer pays all of the failed institution's depositors with insured funds the full amount of their insured deposits";[219] (2) insured deposit transfers, in which the FDIC makes arrangements "with a healthy institution that is willing to act as agent for the FDIC and to pay insured deposits to customers of the failed institution";[220] and (3) P&A transactions "in which a healthy institution purchases some or all of the assets of a failed bank or thrift and assumes some or all of the liabilities, including all insured deposits."[221] A P&A transaction can be structured so that the healthy bank

214. Because federal deposit insurance is backed by the "full faith and credit" of the U.S. government, 12 U.S.C. § 1828(a)(1)(B), any shortfalls in the deposit insurance fund would be covered with general revenue.

215. *See infra* notes 219–36 and accompanying text.

216. 11 U.S.C. § 109(b), (d).

217. *See, e.g.*, David A. Skeel, Jr., *The Law and Finance of Bank and Insurance Insolvency Regulation*, 76 TEX. L. REV. 723 (1998) (noting the pivotal role of banks as justification for government control of bank and thrift insolvencies instead of regular bankruptcy); Richard M. Hynes & Steven D. Walt, *Why Banks are Not Allowed in Bankruptcy*, 67 WASH. & LEE L. REV. 985, 986–87 (2010) [hereinafter Hynes & Walt].

218. 12 U.S.C. § 1811 *et. seq.*

219. FDIC, HANDBOOK, *supra* note 194, at 5.

220. *Id.* at 41. Prior to 1991, the FDIC also had broad discretion to use "open bank assistance" (OBA) as another of its basic bank resolution methods. *See* FINAN. STABILITY OVERSIGHT COUNCIL, REPORT TO THE CONGRESS ON SECURED CREDITORS HAIRCUTS 22 (2011) [hereinafter FINAN. STABILITY OVERSIGHT COUNCIL]. OBA resolution authority permitted the "FDIC as insurer [to] provide financial assistance to an operating insured bank or thrift determined to be in danger of failing." FDIC, HANDBOOK, *supra* note 194, at 5. *See infra* notes 232–39 and accompanying text regarding open bank assistance.

221. FDIC, HANDBOOK, *supra* note 194, at 19. In arranging P&A transactions, the FDIC often historically facilitated or provided incentives for healthy bank acquisitions of failed banks through loans, loan guarantees, assumptions of certain liabilities, or other assistance. *Id.* at 19–40.

assumes all deposit liabilities, including even those that are uninsured.[222] Of these resolution methods, P&A transactions are the most common.[223] For example, of the approximately 140 FDIC-insured institutions closed in 2010, about 94 percent were resolved through P&A transactions in which the FDIC arranged for a presumably healthy bank to acquire assets and liabilities of a failed bank.[224] Only one of the banks closed in 2010 was resolved by insured deposit transfer, and six were resolved by insured deposit payoff.[225]

The key challenge for the FDIC in implementing P&A resolutions is locating healthy banks willing to purchase the failing bank's assets and assume their liabilities.[226] Not surprisingly, healthy banks are often reluctant to assume risks associated with acquiring a failing bank. To overcome this obstacle, P&A resolution rules authorize the FDIC to use a variety of techniques to facilitate the acquisition. For example, P&A arrangements may include federal loans or loan guarantees to support the healthy bank's acquisition of the failing bank.[227] A more substantial acquisition incentive is the FDIC's authority to incorporate "loss sharing" provisions into the P&A transaction. Pursuant to these loss sharing agreements, the FDIC agrees to absorb a significant proportion of "[any] losses the acquirer experiences in servicing and disposing of [a failed institution's] assets purchased and covered under the loss-share agreement."[228] To the extent that bank regulators negotiating the P&A influence or pick and choose among losses to share, the transaction begins to take on bailout characteristics. The aura of bailout increases to the extent that the FDIC provides loans, loan guarantees, or loss sharing arrangements to entice or assist the acquiring bank, which, in turn, assumes any of the failed bank's uninsured deposits or liabilities. Potential government costs resulting from such loss sharing agreements are risks first to the federal deposit insurance fund, and ultimately to the general taxpayer. In these

222. *Id.* at 20. ("In a P&A transaction, acquirers may assume *all* deposits, thereby providing 100 percent protection to all depositors.") Some limitations to this approach may result from the requirement that costs are required to meet least cost resolution (LCR) requirements.

223. FDIC, 2010 ANNUAL REPORT 42 (2010) [hereinafter FDIC, 2010 ANNUAL REPORT]. *See also* GEN. ACCOUNTABILITY OFFICE, FDIC MANAGEMENT REPORT 2010 4, n.6, GAO-11-687R (2011) [hereinafter GAO, MANAGEMENT REPORT].

224. Data derived from FDIC, 2010 ANNUAL REPORT, *supra* note 223, at 140–47 (FDIC-Insured Institutions Closed During 2010) (app.).

225. *Id.* at 146–47. One 2010 bank closure was resolved by combining a deposit transfer with a P&A. *Id.* at 147. The FDIC reports that "[d]eposit payoffs are only executed if a bid for a P&A transaction does not meet the least-cost test or if no bids are received." *Id.* at 42.

226. The FDIC is empowered to take over activities of the bank in the interim, operating the bank as a "bridge bank" until a P&A transaction can be arranged. 12 U.S.C. § 1821(n).

227. 12 U.S.C. § 1823(c)(2).

228. GEN. ACCOUNTABILITY OFFICE, FINANCIAL AUDIT, FDIC CORPORATION FUNDS 2010 & 2009 FINANCIAL STATEMENTS, GAO-11-4122 (March 2011) at 7. *See also* FDIC, MANAGING CRISIS, *supra* note 192, at 193 (describing loss sharing as "a vehicle that allows FDIC to better manage some of the unique problems associated with marketing large banks").

cases, uninsured investors arguably receive "bailout"-type assistance at the expense of the insurance fund or the public.

C. SYSTEMIC RISK AND BANK FAILURES

1. Conflicting FDIC Policy Tensions

Though small failing bank resolutions are reasonably straightforward, conflicting policy considerations can complicate large, interconnected bank resolutions. On the one hand, the FDIC is not specifically charged with responsibility for preventing bank failures.[229] Rather, its primary obligation is to protect insured depositors as required under the federal deposit insurance system,[230] and to manage and protect the federal deposit insurance fund.[231] Yet, if the FDIC limits its concerns *strictly* to paying all insured depositor claims at the lowest cost to the deposit insurance fund, it risks failing to meet one of the most important broad underlying objectives of federal deposit insurance: preserving public confidence in the banking system. Thus, the FDIC would limit or prevent contagion effects or "bank runs" that might otherwise break out upon public word of a particular bank's failure. In other words, tension arises when the resolution method that best satisfies the FDIC's responsibility to satisfy insured depositor claims and minimize costs to the federal deposit insurance fund conflicts with the public's interest in avoiding financial instability created by system-wide harm. In certain cases, regulators have determined that the public interest would be better served by providing assistance to allow the failing bank to continue operations or by satisfying not only insured, but also even uninsured claims. Although the rules have ebbed and flowed over time, Congress has responded to this tension with provisions authorizing "resolution" actions, including "open bank assistance (OBA)," not otherwise strictly consistent with mere protection of insured depositors and the insurance fund.[232]

229. K.A. Randall, *The Federal Deposit Insurance Corporation: Regulatory Functions and Philosophy*, 31 LAW AND CONTEMP. PROBLEMS 696, 702–03 (1966) [hereinafter Randall].

230. The FDIC, established by the Banking Act of 1933, Pub. L. No. 73-66, 48 Stat. 162, provides insurance for accounts maintained at insured depository institutions. 12 U.S.C. § 1821 (2006). In 2008, Congress increased the maximum insurance coverage per account from $100,000 to $250,000. Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, § 136, 122 Stat. 3765, 3799. Although initially scheduled to expire at the end of 2009, the increased $250,000 coverage cap was extended through the end of 2013, Helping Families Save Their Homes Act of 2009, Pub. L. No. 111-22, § 204(a)(1), 123 Stat. 1632, 1648–49, and later made permanent by the Dodd-Frank Act § 335, 124 Stat. 1540 (codified as amended at 12 U.S.C. § 1821(a)(1)(E)).

231. 12 U.S.C. §§ 1821(a)(4), 1823.

232. *See, e.g.*, Randall, *supra* note 229, at 699 (referring to bank assistance as incidental to the overriding public interest).

2. Open Bank Assistance and the Evolution of Too-Big-to-Fail

a. Essential to the Community Determinations

Legislation enacted in 1950 provided FDIC discretion to extend OBA in the form of loans, deposits, or asset purchases upon an FDIC determination that continued bank operations were "*essential to provide adequate depository services in its community*,"[233] often referred to as an "essentiality finding." In 1982, Congress further extended the FDIC's authority to provide open bank assistance to failing banks rather than force them to liquidate, subject only to the limitation that the assistance costs could not exceed amounts that would have been reasonably necessary to liquidate and pay off the banks' insured depositors.[234] Even these cost constraints were lifted if the FDIC made an "essentiality determination" with respect to a particular bank.

As a practical matter, the pre-1991 cost limitations on FDIC authority were easily overcome through liberal application of the "essentiality rule."[235] During the 1970s and 1980s, for example, both the FDIC and the Federal Reserve Bank liberally intervened to provide assistance to failing banks. For its part, the FDIC used the "essential to the community" exception as legal authority for assistance to at least four struggling banks.[236] Irvine Sprague, an FDIC Board member and Chair who

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233. An Act to Amend the Federal Deposit Insurance Act, Pub. L. No. 81-797, ch. 967, § 13(c), 64 Stat. 873, 888 (1950) (repealed 1991) (emphasis added). For discussion of the history and evolution of OBA, see FDIC, MANAGING CRISIS, *supra* note 192, at 151–69.

234. Garn St-Germaine Depository Institutions Act of 1982, Pub. L. No. 97-320, § 111, 96 Stat. 1469, 1470 ("No assistance shall be provided . . . in an amount in excess of that amount . . . reasonably necessary to save the cost of liquidating, including paying . . . insured accounts."). Statutory language still "on the books" appears to continue FDIC discretion to provide OBA. 12 U.S.C. § 1823(c)(1) (FDIC authority to make loans, purchase assets, assume liabilities, or make contributions "to prevent default," restore an institution in default to normal operation, or "when severe financial conditions exist which threaten the stability of a significant number of insured depository institutions or of [such] institutions possessing significant financial resources, . . . to lessen the risk to the [FDIC] posed . . . under such threat of instability"). As a practical matter, however, subsequently enacted statutory restrictions virtually eliminate OBA. *See infra* notes 264–74 and accompanying text.

235. According to one report, the FDIC protected over 99 percent of uninsured deposits in failed institutions between 1985 and 1990. H.R. Rep. No. 330, 9, 102d Cong., 1st Sess. 93 (1991). These cases were not necessarily predicated on an "essentiality finding," however; the FDIC was authorized to protect unsecured depositors if doing so would be less costly than a liquidation and payoff of secured depositors.

236. FDIC, MANAGING CRISIS, *supra* note 192, at ch. 5, 154. (noting FDIC essentiality declarations for Unity Bank and Trust Company of Boston (1971); Bank of the Commonwealth of Detroit (1972); First Pennsylvania Bank of Philadelphia (1980); and Continental Illinois National Bank and Trust Company of Chicago (1984)). The FDIC's liberal interpretation was vindicated by a court order dismissing a First Pennsylvania shareholder's claim that the agency's "essentiality finding" exceeded its statutory authority. Zinman v. FDIC, 567 F. Supp. 243, 247–48 (E.D. Pa. 1983) (concluding that "Congress intended [the essentiality exception] to be construed liberally to effectuate the purposes of the Act and achieve stability in the banking community for sake of the

participated in many "essentiality" determinations described the "essentiality" option as "life-or-death bailout authority,"[237] providing the Board with "sole discretion to prevent a bank from failing, at whatever cost."[238] Government assistance to keep a struggling bank alive effectively extended protection beyond insured depositors to cover equity investors and unsecured creditors.[239] By "whatever cost," Sprague clearly was referring to the use of general tax revenue to protect such unsecured creditors, stockholders, or other equity investors.

b. The Birth of Too-Big-to-Fail

The so-called "too-big-to-fail" policy was born in this period of relatively liberal Federal Reserve and FDIC bank "rescue" operations. Common use of the TBTF moniker reputedly originated with 1984 House hearings to investigate the Continental Illinois National Bank and Trust Company "bailout," then "the most significant bank failure resolution in the history of the Federal Deposit Insurance Corporation."[240] Reacting to the Comptroller of the Currency's testimony that regulators would not allow the nation's largest "money center banks" to fail, Representative Stewart McKinney interjected: "[L]et us not bandy words. We have a new kind of bank. It is called too big to fail. TBTF, and it is a wonderful bank."[241] Describing this colloquy, the Financial Crisis Inquiry Commission recently reported: "This was a new regulatory principle, and within moments it had a catchy name."[242] In addition to being catchy, the pithy TBTF moniker grew

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nation's economy. The exercise of authority by the FDIC here was consistent with the flexibility authorized by Congress.").

237. IRVINE H. SPRAGUE, BAILOUT: AN INSIDER'S ACCOUNT OF BANK FAILURES AND RESCUES 28 (1986). Sprague reports that although the law and legislative history provided no directions for the FDIC's exercise of its "essentiality" discretion, "[c]learly, . . . this authority was not intended for widespread use." *Id.* According to Sprague, the FDIC first applied the essentiality doctrine in 1971. *Id.* at 35 (1971 Unity Bank of Boston bailout).

238. *Id.* at 27.

239. *Id*. at 29 ("[i]f the bank is not allowed to fail, it is impossible to structure a transaction that does not provide at least the possibility of some residual value to stockholders and creditors of the failing institution.")

240. FDIC, MANAGING CRISIS, *supra* note 192, at 545.

241. *Inquiry into Continental Illinois Corp. and Continental Illinois National Bank: Hearings Before the Subcomm. on Financial Institutions Supervision, Regulation and Insurance of the H. Comm. on Banking, Finance, and Urban Affairs*, 98th Cong. 300 (1984). In his opening remarks, Representative McKinney said that he wanted "to find out what the regulators feel they have done, No. 1, by creating a new class of bank . . ., a TBTF – too big to fail." *Id.* at 89.

242. FIN. CRISIS INQUIRY COMM'N, FINANCIAL CRISIS INQUIRY REPORT 37 (2011) [hereinafter FINANCIAL CRISIS INQUIRY REPORT]. The Commission is surely correct about the "catchy name," but incorrect in referring to TBTF as a "new regulatory principle." Although the modern term was coined later, evidence of TBTF-like thinking appears as early as the Great Depression. For example, some have described railroads during the 1930s as TBTF both because of their critical infrastructure functions and the major role of railroad securities in the overall economy. *See, e.g.*, Joseph R. Mason and Daniel A. Schiffman, *Too Big To Fail, Government Bailouts, and Managerial Incentives: The Case of the Reconstruction Finance Corporation Assistance to the*

in political salience as a shorthand focal point for public "anti-bailout" sentiment, ultimately spurring congressional determination to put an end to any hint of a government TBTF policy.

3. Statutory "Systemic Risk" Rules and the Purported Death of TBTF

After addressing the immediate S&L and thrift industry crisis with rescue legislation in 1989,[243] Congress subsequently enacted the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA),[244] which included both prudential regulation and resolution reform responses. As noted earlier, Congress responded to public anger over regulators' lax supervision and excessive forbearance leading up to the S&L disaster, in part by enacting a mandatory PCA framework designed to limit regulators' nonenforcement discretion.[245] In a parallel response to public anger over taxpayer-funded bank rescues, the FDICIA also imposed new restrictions on regulators' *resolution* authority to provide assistance to failing banks.[246] As he introduced the FDICIA, Senator Riegle explained that the bill's central purpose was "to put an end to the too-big-to-fail policy by eliminating the practices that give rise to it."[247] Perhaps foremost on this part of the agenda was eliminating the "essentiality" exception, which many saw as a key culprit behind the TBTF monster.[248] In addition, the 1991 legislation required the FDIC to exercise its resolution authority only as necessary to provide coverage for *insured* deposits,[249] to choose the resolution method that was least costly to the deposit insurance fund in providing coverage for insured depositors,[250] referred to as the least cost resolution (LCR) test, and not to choose any resolution alternative that would protect uninsured depositors or other creditors at the expense of the federal deposit insurance fund.[251] These cost restrictions were distinctly tougher than the prior rule requiring only that resolution costs not exceed

Railroad Industry During the Great Depression, *in* TOO BIG TO FAIL: POLICIES AND PRACTICES IN GOVERNMENT BAILOUTS 49, 49–54 (Benton E. Gup ed., 2004).

243. Financial Institutions Reform, Recovery, and Enforcement Act of 1989, Pub. L. No. 101-73, 103 Stat. 183 (1989) [hereinafter FIRREA].

244. FDICIA § 131(a), 105 Stat. 2253 (codified at 12 U.S.C. § 1831).

245. *See supra* notes 97–115 and accompanying text.

246. FDICIA, § 141, 105 Stat. 2273 (codified at 12 U.S.C. § 1823).

247. 137 CONG. REC. S2744 (daily ed. Mar. 6, 1991) (statement of Sen. Riegle).

248. FDICIA § 141(a), 105 Stat. 2273 (codified at 12 U.S.C § 1823) (repealing "essentiality rule"). For discussion and analysis of the "essentiality rule," see *supra* notes 233–39 and accompanying text.

249. *Id.* (codified at 12 U.S.C. § 1823(c)(4)(A)(i)) (emphasis added).

250. *Id.* (codified at 12 U.S.C. § 1823(c)(4)(A)(ii)). These resolution authority restrictions are generally referred to the "least cost resolution" (LCR) rules.

251. *Id.* (codified at 12 U.S.C. § 1823(c)(4)(E)).

those that would have been reasonably necessary to liquidate the failed bank and pay off insured depositors.[252]

In order not to tie regulators' hands completely, however, the 1991 legislation adopted a *new* "systemic risk" exception.[253] While it included some remnants of the old essentiality rule, the 1991 "systemic risk" exception made it both substantively and procedurally more difficult to bypass otherwise applicable resolution authority restrictions.[254] Such restrictions could be avoided only after a determination that compliance with LCR and other such restrictions on agency resolution structure discretion "with respect to an insured depository institution for which the Corporation has been appointed receiver would have serious adverse effects on economic conditions or financial stability."[255] Once a systemic risk determination was made in accordance with the new and more onerous procedural requirements, the agency was authorized to "take other action or provide assistance . . . as necessary to avoid or mitigate such effects."[256] Given the shared perception of many that the old "essentiality rule" was simply TBTF in disguise, House and Senate sponsors of the FDICIA felt compelled to make a joint statement after the legislation's passage clarifying that "[t]he systemic risk exception is not intended to perpetuate the practices commonly known as 'too big to fail'; the legislation responds to and largely ends those practices."[257]

4. Premature Reports of the Death of TBTF

Market perceptions of a public TBTF policy stubbornly persisted even after passage of the 1991 LCR rules and other restrictions. In private markets, companies perceived as TBTF continued to benefit from lower capital ratios, lower cost of funds, and preferential treatment from credit rating agencies.[258] If anything, federal TBTF policies were expanded during the 2007–2008 economic crisis. In 2008, for example, the FDIC used its emergency systemic risk authority to create its Temporary Liquidity Guarantee Program (TLGP), which guaranteed senior unsecured debt

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252. *See supra* notes 233–34 and accompanying text.

253. FDICIA § 141(a), 105 Stat. 2273 (codified at 12 U.S.C. § 1823(c)(4)(G)).

254. *Id.* Procedurally, the old "essentiality" rule could be exercised simply by FDIC Board majority vote, whereas the 1991 systemic risk exception required a recommendation to the Treasury Secretary based upon a two-thirds vote of both the FDIC and the Federal Reserve Boards. A systemic risk determination could then be made by the Secretary in consultation with the President. *Id.*

255. FDICIA § 141(a), 105 Stat. 2273 (codified at 12 U.S.C. § 1823(c)(4)(G)(i)(II)).

256. *Id.* § 141(a) (codified as amended at 12 U.S.C. § 1823(c)(4)(G)).

257. *Joint Statement on Systemic Risk Exception to Least Cost Resolution FDICIA*, 137 CONG. REC. S18819-02 (daily ed. Dec. 18, 1991) (statement of Sen. Donald W. Riegle, Congressmen Henry Gonzolez, and Bruce Vento).

258. *See generally* Wilmarth, *Reforming Financial Regulation*, *supra* note 67, at 743–44; STERN & FELDMAN, *supra* note 55, at 30–37.

instruments.[259] In his 2009 testimony about proposed stress tests planned for the nation's largest nineteen banks, Federal Reserve Board Chair, Ben Bernanke, emphasized that capital support would be available to sustain the nation's nineteen largest banks.[260]

Moreover, though prior applications of a TBTF policy were focused primarily on large commercial banking institutions, such policies were effectively expanded during the 2007–2009 crisis to provide "rescue" assistance to large struggling nonbank financial institutions.[261] A substantial portion of the federal "rescue" assistance to financial firms during the 2007–2008 economic crisis was not from the FDIC, but instead from Federal Reserve bank lending.[262] In fact—and oddly inconsistent with the 1991 FDICIA legislation's overall restrictive spirit—the FDICIA actually *expanded* the Federal Reserve's emergency authority to lend to nonbanks, allowing them to use the same types of collateral used by depository institutions.[263]

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259. *See* Temporary Liquidity Guarantee Program, 12 C.F.R. § 370 (2008); *see also* DARRYL E. GETTER & OSCAR R. GONZALES, CONG. RESEARCH SERV., R40413, THE FEDERAL DEPOSIT INSURANCE CORPORATION (FDIC): EFFORTS TO SUPPORT FINANCIAL AND HOUSING MARKETS 4–5 (2009); FDIC, 2008 ANNUAL REPORT 25–26 (2009). This was apparently the first time the FDIC guaranteed bank and bank holding company debt. OFFICE OF MGMT. & BUDGET, EXEC. OFFICE OF THE PRESIDENT, ANALYTICAL PERSPECTIVES: BUDGET OF THE U.S. GOVERNMENT FISCAL YEAR 2011 28 (2010). The FDIC also provided similar assistance to Citigroup and Bank of America jointly with the Treasury Department and Federal Reserve. *See* CONG. OVERSIGHT PANEL, NOVEMBER 2009 OVERSIGHT REPORT: GUARANTEES AND CONTINGENT PAYMENTS IN TARP AND RELATED PROGRAMS 16–27 (2009).

260. *Federal Reserve's First Monetary Policy Report for 2009: Hearing Before the S. Comm. on Banking, Housing and Urban Affairs*, 111th CONG. 22 (2009) (statement of Ben S. Bernanke, Chairman, Bd. of Governors of the Fed. Reserve) ("[W]e are committed to ensuring the viability of all the major financial institutions."); *see also* Wilmarth, *Reforming Financial Regulation*, *supra* note 67, at 1050 n.449.

261. For example, federal loan guarantees were used to ensure the successful acquisition of failing investment bank Bear Stearns. *Legal Developments: Second Quarter, 2008*, Federal Reserve Bulletin 73, 78–81 (Aug., 2008); *see also* SHORTER, BEAR STEARNS, *supra* note 119. In addition, struggling insurance giant, AIG, received direct government loans through the Federal Reserve. *See* Press Release, Bd. of Governors of the Fed. Reserve Sys. (Sept. 16, 2008). AIG also received assistance through the Troubled Asset Relief Program (TARP), enacted as part of the Emergency Stabilization Act of 2008. Pub. L. No. 110-343, tit. I, §§ 101–-136, 122 Stat. 3765 (codified at 12 U.S.C. §§ 5211–-5241); *see also* BAIRD WEBEL, CONG. RESEARCH SERV., R40438, ONGOING GOVERNMENT ASSISTANCE FOR AMERICAN INTERNATIONAL GROUP (AIG) (Mar. 16, 2009) [hereinafter WEBEL].

262. *See supra* note 261.

263. FDICIA § 473, 105 Stat. 2386 (codified at 12 U.S.C. § 343). For a discussion of implications and relative contradictory spirit to the rest of the legislation *See* Walker F. Todd, *FDICIA's Emergency Liquidity Provisions*, 1993 ECON. REV. 16, 19–21 (1993).

D. DODD-FRANK RESOLUTION REFORMS

1. Federal Reserve Discount Window Lending Authority

Although Dodd-Frank significantly expanded regulation and resolution authority with respect to nonbank financial institutions,[264] it simultaneously imposed several new restrictions on regulators' flexibility to respond to failing financial institutions. For example, Dodd-Frank severely constrains the Federal Reserve's previously available emergency authority to lend to any "individual, partnership, or corporation" under "unusual and exigent circumstances," subject only to the condition that such loans be collateralized to the Federal Reserve's "satisfaction."[265] Under new rules, the Federal Reserve is authorized to extend emergency loans only to "participant[s] in any program or facility with broad-based eligibility."[266] Moreover, any such Federal Reserve emergency lending program or facility now requires prior approval from the Treasury Secretary.[267] These restrictions were clearly designed to prohibit the Federal Reserve from extending emergency loans to specific institutions, as it did during the 2007–2009 economic crisis, for example, with respect to AIG.[268]

This new restriction will surely make it more difficult for the Federal Reserve to make loans to large insurance companies such as AIG. On the other hand, the Federal Reserve retains its regular authority to open its discount window to financial institutions, including BHCs. Though Dodd-Frank includes rules regarding financial entities that *cease* to be BHCs,[269] there are no rules regarding companies that elect to *become* BHCs in order to obtain access to discount window borrowing.

2. Restrictions on FDIC Systemic Risk Exception Flexibility

Dodd-Frank also substantially limits FDIC discretion under the systemic risk exception to the LCR requirements. An FDIC emergency systemic risk declaration no longer authorizes the FDIC to take other action or provide assistance *as necessary to avoid or mitigate* "*serious adverse*

264. *See supra* notes 140–79, and *infra* notes 275–89 and accompanying text.

265. 12 U.S.C. § 343 (prior to amendment).

266. Dodd-Frank Act § 1101(a), 124 Stat. 2113 (codified at 12 U.S.C. § 343(A)).

267. *Id.* (codified at 12 U.S.C. § 343(B)(iv)). Dodd-Frank further directed the Federal Reserve to establish policies and procedures to "ensure that any emergency lending program or facility is for the purpose of providing liquidity to the financial system, and not to aid a failing financial company, and that the security for emergency loans is sufficient to protect taxpayers from losses. . . ." *Id.* (codified at 12 U.S.C. § 343(B)(i)).

268. *See* OVERSIGHT PANEL, AIG RESCUE, *supra* note 123.

269. Dodd-Frank Act § 117, 124 Stat. 1406 (codified at 12 U.S.C. § 5327) (emphasis added). This provision presumably is designed to prevent BHCs with over $50 billion in assets, which would have been subject to Federal Reserve enhanced supervision, from avoiding such supervision by ceasing to be a BHCs.

effects on economic conditions or financial stability."[270] Instead, the FDIC's systemic risk exception to LCR requirements, as amended, authorizes the FDIC to take other action or provide assistance only "*for purposes of winding up the insured depository institution* . . . as necessary to avoid or mitigate such [serious adverse] effects [on economic conditions or financial stability]."[271] In other words, the FDIC is no longer permitted to provide specifically targeted assistance to individual banks in danger of default. The underlying logic here is to diminish government regulator opportunities to single out isolated "winners," thus making it more difficult for those with greater access to obtain special "rescue" treatment when they fall on hard times.

As a substitute for previously available techniques for providing OBA to individual banks, Dodd-Frank added a complex procedure through which the FDIC and Federal Reserve may formally declare a "liquidity event."[272] Such a determination would then authorize the FDIC to "create a widely available program to guarantee obligations of *solvent insured depository institutions* . . . during times of severe economic distress."[273] Even after it establishes such a program, however, the FDIC remains unauthorized to issue any guarantees until after the Treasury Secretary, in consultation with the President, makes a request of Congress for a specified loan guarantee amount, and Congress approves the request by joint resolution.[274] These procedural obstacles will make it extremely difficult for the FDIC to move quickly to provide any type of transparent individual bank assistance under emergency circumstances. Instead, it may encourage the use of less transparent forms of assistance.

3. Dodd-Frank Resolution Response to Systemic Risk

a. Systemic Risk Determinations and Orderly Liquidation Authority (OLA)

Prior to Dodd-Frank, the FDIC's resolution authority was limited to banks. Among the most dramatic Dodd-Frank features is a new OLA regime, which operates as a substitute for the federal bankruptcy rules that would otherwise apply to certain failing financial companies[275] including

270. 12 U.S.C. § 1823(c)(4)(G) (emphasis added) (as constructed prior to amendment by Dodd-Frank).

271. 12 U.S.C. § 1823(c)(4)(G), *amended by* Dodd-Frank Act (2011) (emphasis added).

272. Dodd-Frank Act § 1104(a)–(b), 124 Stat. 2120 (codified at 12 U.S.C. § 5611) (requiring a two-thirds vote of the Federal Reserve Board of Governors and the FDIC).

273. *Id.* § 1105(a) (emphasis added).

274. *Id.* § 1105(c).

275. For purposes of OLA, "financial company" includes: (1) bank holding companies (without regard to size); (2) systemically important financial companies supervised by the Federal Reserve Board; (3) companies engaged predominantly in activities determined to be financial in nature or incidental thereto by the Federal Reserve Board under the Bank Holding Company Act of 1956;

BHCs and broker-dealers [276] Dodd-Frank's OLA provisions create procedures, beginning with a formal "systemic risk determination," for appointing the FDIC as receiver with authority to resolve nonbank financial entities for which such a determination is made.[277] Not surprisingly, the OLA regime includes many parallels to the federal banking rules applicable to failing depository bank resolutions.[278] After all, one of the major concerns motivating Dodd-Frank's resolution response reforms was the out-dated nature of federal banking regulation, which had not kept pace with the modern financial markets.[279] Expansion of the FDIC's jurisdiction to resolve designated large nonbank financial institutions recognizes the "bank-like" services and financial instruments now offered by nonbank financial entities and the potential risks to overall financial stability that might result in the event of such a nonbank entity's failure.At the same time, practical implementation of the OLA regime is constrained by numerous procedural obstacles. First, the process for financial companies must begin with a written "systemic risk determination" recommendation to the Treasury Department Secretary, based upon a two-thirds vote of the FDIC board of directors and a separate two-thirds vote of the Federal Reserve Board, that the Secretary appoint the FDIC as receiver for the failing institution.[280] Second, the determination recommendation must specifically address statutorily enumerated factors, including: whether the

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and (4) certain subsidiaries of these three types of entities. Dodd-Frank Act § 201(a)(11), 124 Stat. 1442 (codified at 12 U.S.C. § 5381).

276. Insurance company insolvencies were - and continue to be - resolved on a state-by-state basis pursuant to each state's particular insurance insolvency rules. *See infra* notes 372–74 and accompanying text.

277. Dodd-Frank Act § 203(a), 124 Stat. 1450 (codified at 12 U.S.C. § 5383). For OLA purposes, "financial company" is defined to include: (1) bank holding companies (without regard to size); (2) systemically important financial companies supervised by the Federal Reserve Board; (3) companies engaged predominantly in activities determined to be financial in nature or incidental thereto by the Federal Reserve Board under the Bank Holding Company Act of 1956; and (4) certain subsidiaries of these three types of entities. *Id.* § 201(a)(11).

278. *See supra* notes 216–28. The FDIC noted these parallels in its introductory summary to proposed OLA regulations. 75 Fed. Reg. 64173, 64175 (proposed Oct. 19, 2010) ("Notice of Proposed Rulemaking Implementing Certain Orderly Liquidation Authority Provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act") ("Parties who are familiar with the liquidation of insured depository institutions under the FDI . . . will recognize many parallel provisions in Title II [OLA]."), *subsequently finalized*, at 76 Fed. Reg. 41626, 41644 (July 11, 2011). For comparison of FDIC ordinary bank resolution and OLA authority, see generally Hollace T. Cohen, *Orderly Liquidation Authority: A New Insolvency Regime to Address Systemic Risk*, 45 U. RICH. L. REV. 1143 (2012). For a comparison of OLA to ordinary bankruptcy, see Douglas G. Baird & Edward R. Morrison, *Dodd-Frank for Bankruptcy Lawyers*, 19 AM. BANK. INST. L. REV. 287 (2011) [hereinafter Baird & Morrison].

279. *See supra* notes 127–31.

280. Dodd-Frank Act § 203(a)(1)(A), 124 Stat. 1450 (codified at 12 U.S.C. § 5383). Broker-dealer systemic risk recommendations require similar two-thirds votes of the Federal Reserve Board and members of the Securities and Exchange Commission. *Id.* § 203(a)(1)(B). Insurance company determinations require a two-thirds Federal Reserve Board vote and approval of the Federal Insurance Office Director, in consultation with the FDIC. *Id.* § 203(a)(1)(C).

failing institution is in default or danger of default; a description of the impact such default would have on U.S. financial stability; the likelihood of a private sector alternative to federal receivership to prevent default; and, an evaluation of why resolution under the regular bankruptcy regime would be inadequate.[281] Third, the Treasury Secretary, in consultation with the President, must begin the process of appointing the FDIC as receiver after making his or her *own* statutorily enumerated determinations, including: a finding that the "financial company is in default or danger of default";[282] a finding that the "failure of the financial company and its resolution under other applicable . . . law would have *serious adverse effects on financial stability in the United States*";[283] and finding that orderly liquidation action would avoid or mitigate such adverse effects. . . ."[284] In making these determinations, the Treasury Secretary in instructed to "tak[e] into consideration the effectiveness of the action in mitigating potential adverse effects on the financial system, the cost to the general fund of the Treasury, and the potential to increase excessive risk taking on the part of creditors, counterparties, and shareholders in the financial company."[285] In other words, the Treasury Secretary's systemic risk determination should balance considerations of the systemic harm that would result from resolving the failing institution under the regular bankruptcy process against potential orderly liquidation costs and moral hazard costs that could be triggered by resolution rather than private bankruptcy. Finally, the OLA regime provides procedural protections, which include the failing institution's opportunity for a confidential federal district court hearing to oppose the government's receivership petition.[286]

These significant mandatory procedural hurdles are likely to hinder regulators' ability to move quickly in response to rapidly emerging system-wide threats to financial stability. The particular irony of OLA's procedural obstacles is that one of the important underlying arguments for subjecting banks—and presumably also nonbank financial companies—to a special FDIC-administered insolvency regime in lieu of bankruptcy is the need for speedy resolution in emergency circumstances "to expedite the resolution process for banks and thus maintain confidence in the banking system."[287]

281. *Id.* § 203(a)(2).

282. *Id.* § 203(b)(1).

283. *Id.* § 203(b)(2) (emphasis added).

284. *Id.* § 203(b)(5).

285. *Id.*

286. Once the systemic risk determination is made for a failing company, the company either consents to the FDIC's appointment as receiver or the Treasury Secretary will petition the District Court for an order to place the company under FDIC receivership. *Id.* § 202(a)(1)(A)(i). The failing financial company can oppose the government's receivership petition through a confidential federal district court hearing. *Id.* § 202(a)(1)(A)(iii).

287. Rosalind L. Bennett, *Failure Resolution and Asset Liquidation: Results of an International Survey of Deposit Insurers*, 14 FDIC BANKING REV. 1, 7 (2001). *See also id.* ("When resolution of a failed bank is performed quickly and smoothly, benefits accrue to the economy and the

In any event, past experience with PCA rules has shown that regulators often fail to act even in response to gradually emerging risks and without procedural obstacles.[288] OLA's required procedures may make regulatory forbearance even more likely.[289]

b. Funding Orderly Liquidations

FDIC costs incurred in implementing the OLA are not to be funded by general tax revenue, but instead from a separate "Orderly Liquidation Fund." [290] This special fund is to be supported by covered financial company repayments to the FDIC, as well as interest and other earnings from the fund's investments. [291] In addition, the FDIC is authorized to borrow by issuing obligations for purchase by the Treasury Secretary.[292] Lest there be any doubt about the future of taxpayer-funded bailouts, the statute repeatedly says: "no more." [293] In the event that the orderly liquidation fund is insufficient to repay loans from the Treasury Department, the FDIC is authorized to charge assessments against nonbank financial companies supervised by the Federal Reserve and BHCs with total combined assets of $50 billion or more.[294] Thus, cost burdens of the FDIC's orderly liquidation activities ultimately should be imposed not upon general taxpayers, but instead upon a narrower subset of taxpayers—large financial institutions—thought to disproportionately benefit from regulatory protection against systemic risks.[295]

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financial system."); Hynes & Walt, *supra* note 217, at 990 (noting speed as a reason for extraordinary FDIC control over bank resolutions).

288. *See supra* notes 102–15 and accompanying text.

289. Another possible reason that the OLA regime may not often be implemented in practice is the harshness of its mandatory liquidation rules. *See* Mark A. McDermott and David R. Turetsky, *Restructuring Large, Systemically-Important Financial Companies: An Analysis of the Orderly Liquidation Authority, Title II of the Dodd-Frank Wall Street and Consumer Protection Act*, 19 AM. BANKR. INST. L. REV. 401, 404 (2011).

290. Dodd-Frank Act § 210(n)(1), 124 Stat. 1506 (codified at 12 U.S.C. § 5390) (establishing "Orderly Liquidation Fund").

291. *Id.* § 210(n)(2).

292. *Id.* § 210(n)(5).

293. *See, e.g.*, *id.* at Preamble; *id.* § 112(a)(1)(B) (council's purpose to eliminate expectations that government will shield companies from loss in the event of failure); *id.* § 166 (authorizing regulations for early remediation of a Federal Reserve-supervised bank holding company "except that nothing in this subsection authorizes the provision of financial assistance from the Federal Government"); *id.* § 204(a)(1) (orderly liquidation authority to be exercised so that "creditors and shareholders will bear the losses of the financial company"); *id.* § 214(c) ("Taxpayers shall bear no losses from the exercise of any authority under this title.").

294. *Id.* § 210(o)(1) (providing for risk-based assessments on bank holding companies with total consolidated assets equal to or greater than $50 billion and on certain nonbank financial companies).

295. In earlier work on bailouts, I classified similar funding through a subset of taxpayers regarded as receiving disproportionate benefits as "special fund bailouts." *See* Block, *Measuring Bailout Cost*, *supra* note 8, at 165–66; *see also* Block, *Overt and Covert Bailouts*, *supra* note 202, at 963–64.

c. Limiting Resolution Authority: Mandatory Liquidation

Once the systemic risk determination is made and the FDIC appoints a receiver in accordance with statutory procedures, there is no turning back; the only resolution for a financial entity in the event of a "systemic risk determination" is liquidation. As Dodd-Frank makes clear, the OLA's purpose is "to provide the necessary authority *to liquidate failing financial companies* that pose a significant risk to the financial stability of the United States in a manner that mitigates such risk and minimizes moral hazard."[296] The FDIC has largely been stripped of its "quasi resolution" authority to provide assistance to banks in danger of default, and instead is limited to winding up and liquidating banks and nonbank financial institutions subject to its resolution authority. Simply put, regulators are authorized only to manage the patient's death.

Though orderly liquidation is mandatory once a financial institution is placed in receivership pursuant to a systemic risk determination, the FDIC retains substantial discretion to manage the winding up process and otherwise structure the liquidation. For example, the FDIC is authorized to make loans to the receivership estate, purchase its debt obligations, assume or guarantee debts, and to arrange P&A-type transactions, which may include loss sharing agreements.[297] The FDIC is also authorized to establish and fund a bridge institution to continue operations of the failed financial company in receivership.[298] In addition, though subject to restrictions designed to limit its authority to give preferential treatment to long-term stakeholders, the FDIC has "discretion, upon appropriate determination, to make payments or credit amounts . . . to or for some creditors but not others similarly situated at the same level of payment priority."[299] Professor Wilmarth argues that such authority to provide preferential treatment to short-term creditors will create "at least two perverse results," including "(1) provide an implicit subsidy to short-term creditors of SIFIs and (2) encourage[ment for] SIFIs to rely even *more* heavily on vulnerable, short-term funding strategies."[300] Despite its "no more bailout" claims, Wilmarth also argues that this type of discretion "gives the FDIC considerable leeway

296. Dodd-Frank Act § 204(a), 124 Stat. 1454–55 (codified at 12 U.S.C. § 5384) (emphasis added).

297. *Id.*; *id.* § 210(a)(1)(G) (General Powers). *See supra* notes 221–29 and accompanying text for discussion of P&A transactions.

298. Dodd-Frank Act § 210(h), 124 Stat. 1496 (codified at 12 U.S.C. § 5385). *Compare* 12 U.S.C. § 1821(n) (similar FDIC authority for ordinary bank resolutions).

299. Certain Orderly Liquidation Authority Provisions under Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act, 76 Fed. Reg. 41,626, 41,644 (July 15, 2011) (to be codified at 12 C.F.R. pt. 380) (final regulations implementing certain OLA provisions). The regulations explicitly provide, however, that the FDIC cannot use its discretion to "give preferential treatment to certain long-term senior debt . . . , and that subordinated debt and equity will never qualify for preferential treatment." *Id.* at 41,628.

300. Wilmarth, *supra* note 13, at 998–99.

to provide de facto bailouts for favored creditors of failed SIFIs."[301] Such de facto bailouts, which favor some creditors over others, are potentially more discriminatory than direct assistance to prevent the failure of a failing financial institution. In contrast to a preferential treatment de facto bailout, a direct assistance bailout that successfully prevents the financial institution's collapse presumably treats all stakeholders equally.

III. THE PRIVATE-PUBLIC RESOLUTION CONTINUUM

A. INTRODUCTION

A bizarre twist in the principle-reality divide with respect to the regulation and resolution of systemically important financial institutions is that prudential regulation theoretically envisions increasingly strict enforcement along a risk-based continuum, but regulators in practice often fail to implement such incremental enforcement with respect to large, interconnected financial institutions. In contrast, resolution rules have increasingly restricted regulators' discretion to assist struggling systemically important financial institutions, yet regulators in practice have often found ways to by-pass such restrictions. What the public—and perhaps Congress itself—fails to appreciate is the extent of the government's existing involvement in making allocation of risk determinations with respect to private business failures. In fact, allocation of risk devices can be plotted along a private-public continuum. Some government interventions along this continuum cost real tax dollars. Others threaten general tax revenues only to the extent that government involvement requires federal employee time and other administrative resources. Collective hackles go up when the public perceives government-funded assistance or "bailouts" to large, private firms. Yet, regulatory forbearance or other less visible forms of "bailout-type" intervention can provide comparable assistance to struggling firms at equal or perhaps even greater federal budgetary expense. The public and legislative obsession with prohibiting "bailouts" makes it more difficult to ask the right questions in choosing appropriate resolution mechanisms along this continuum. In the end, simply declaring an "end to bailouts" may cause some bailout-like activity to go underground. Moreover, when truly dire emergency looms, Congress is likely to renege on its "no more bailout" promise in any event.

The sections that follow develop a taxonomy or classification system for risk allocation mechanisms along a private-public continuum. At a minimum, classification systems can provide the satisfaction of apparent order in an otherwise chaotic world. Still, unless the resulting classifications suggest different policy responses or offer greater clarity of analysis, the categorization, labeling, or placement of any particular phenomenon on a

301. *Id.* at 999.

grid or continuum adds little. Thus, an important first step before moving forward with any risk allocation classification is to consider the significance of the "bailout" label or of a particular risk allocation device's location on the private-public continuum. First—and most important—attaching the "bailout" label to a particular intervention is an indication that government is making an allocative judgment with regard to actual or potential business loss; in other words, an exception to the general free-market norm. As such, it suggests that a particular business or industry is receiving preferential treatment. To the extent that government assistance is funded with general revenues, businesses that are large or integrated enough to have a potentially systemic economic impact receive assistance at the expense of general taxpayers, including smaller businesses facing similar economic woes. Even if significant government funds are not ultimately used, so-called "private" bailouts that have been brokered or otherwise facilitated by government officials provide preferential treatment to assisted entities, which benefit from government-provided services that are not generally available to other struggling businesses.

Such preferential treatment is not necessarily wrong, and may even be necessary in particular emergency circumstances.[302] The challenge is that by its very nature, a bailout externalizes risk in the interest of a greater common good; it may protect those who do not deserve protection.[303] At a minimum, such preferential treatment requires special sensitivity to procedures ensuring that benefits received by the failing business and burdens imposed upon those asked to bear the costs are equitably distributed. Sensitivity to equitable allocation of burdens should be required whether this risk externalization takes the form of direct federal expenditures, regulatory forbearance, or other more covert forms of government assistance.

B. THE PRIVATE END OF THE RISK ALLOCATION CONTINUUM

1. No Risk Allocation Mechanism is Purely Private

Before briefly exploring the range of private risk allocation alternatives, one should begin by acknowledging that the notion of a *purely* private risk allocation regime is a myth.[304] Even so-called "private" devices for

302. This is where Professor Anna Gelpern's point about "containment" policy sometimes requiring that rules be broken becomes relevant. *See supra* notes 198–200 and accompanying text.

303. As one Federal Reserve official conceded in connection with the bailout of Franklin National Bank in the mid-1970s, sometimes "intervention in the interests of the public and the economy as a whole can have the incidental effect of protecting large depositors from the proper consequences of their risk-taking." James H. Oltman, *Failing Banks—The Role of the Fed*, 27 ADMIN. L. REV. 317, 317, 319 (1975).

304. Describing what he refers to as "[t]he myth of laissez-faire," for example, Cass Sunstein observes that "[f]ree markets depend for their existence on law. . . . [M]arkets should be understood as a legal construct, to be evaluated on the basis of whether they promote human

allocating risk depend upon a background political system and infrastructure to support a stable environment in which markets can flourish, and a background legal system through which private parties can assert claims and resolve disputes. In addition to simply providing the necessary infrastructure to support otherwise purely private risk allocations, the government's background presence is also ubiquitous as a risk allocation manager with regard to many specific types of otherwise private transactions.[305] Examples of government as risk manager include: (1) corporate law, which generally entitles shareholders to limited liability;[306] (2) the bankruptcy regime, which establishes ex ante a hierarchy of stakeholder claims against the debtor in the event of business failure; (3) workers' insurance; and (4) product liability laws. Thus, even the "private" allocation devices discussed in the subsections that follow must necessarily fall at least slightly to the right of the purely private end on the private-public continuum.

2. Ex Ante Private Risk Allocation

a. Private Insurance

Aside from specific private contract risk-allocation clauses, the allocation device that perhaps falls closest to the private end of the risk-allocation continuum is private insurance. Private insurance pools risk by collecting premiums from a group of policyholders, using the aggregate proceeds to cover losses incurred by individual members of the group. Members of the group with lower than average losses effectively subsidize others with higher than average losses, thus permitting loss spreading within the private insured group. Unlike most other financial institutions subject to government regulation, private insurers are regulated almost exclusively by individual states, as opposed to the federal government.[307]

b. Hedging and Derivatives

Hedging and derivative transactions can be extremely useful risk allocation vehicles to protect businesses against price or other changes that may significantly affect profitability. Early generation derivative transactions were primarily used by agricultural businesses to protect

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interests, rather than as a part of nature and the natural order, or as a simple way of promoting voluntary interactions." CASS R. SUNSTEIN, FREE MARKETS AND SOCIAL JUSTICE 5 (1997).

305. For an overview of the many different government systems or regimes that serve risk allocation functions, see generally DAVID A. MOSS, WHEN ALL ELSE FAILS: GOVERNMENT AS THE ULTIMATE RISK MANAGER (2002).

306. Similar limited liability is provided to the limited partners in a limited partnership, investors in limited liability companies (LLCs), and investors in other permissible limited liability business structures.

307. *See supra* note 122 (describing state regulation of insurance).

themselves against changes in commodity prices. A cereal manufacturer needing access to raw corn for manufacturing purposes, for example, would enter into a derivative contract to offset potential corn price increases. If prices increased, gain from the derivative contact could be used to offset "loss" or additional expense incurred from the increased production expense.[308]

Modern financial hedging and derivatives contracts include gambles on innumerable assets, financial indicators, or events in which the investors often have no direct interest.[309] Over the past decade, the volume and variety of derivatives-type financial instruments has grown dramatically.[310] Although contracts sold on exchanges were regulated prior to the recent economic crisis, over-the-counter (OTC) derivatives and credit-default swap markets were not. In 2008, SEC Chairman, Christopher Cox, complained that "[t]he regulatory black hole for credit default swaps is one of the most significant issues we are confronting in the current credit crisis."[311] Dodd-Frank's more extensive ex ante prudential regulation of derivatives markets will be important in protecting investors[312] Nonetheless, the government's involvement in risk allocation is very limited with respect to hedging and derivatives contracts, leaving such transactions near the private end of the private-public risk continuum.

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308. Both the farmer, who is "helpless before the risks of weather and insects," and the food processor, "who faces the opposite risk" may benefit from a hedging-type exchange, thus lowering "total risk in the economy." PETER L. BERNSTEIN, AGAINST THE GODS: THE REMARKABLE STORY OF RISK 306 (1998). The Commodity Exchange Act of 1936 created the Commodity Exchange Authority (CEA) to regulate domestic agricultural product futures exchanges. Commodity Exchange, ch. 545 § 1, 49 Stat. 1491, 1491 (1936) (codified as amended in scattered sections of 7 U.S.C. (1974)). In 1974, Congress created the Commodity Future Trading Commission (CFTC), and expanded authority to regulate virtually all commodities, including financial instruments, traded on commodities markets. Commodity Futures Trading Act of 1974, Pub. L. No. 93-463, §§ 101(a), 201(b), 88 Stat. 1389 (codified as amended in scattered sections of 7 U.S.C. (1974)).

309. *See generally* Adam H. Rosenzweig, *Imperfect Financial Markets and the Hidden Costs of a Modern Income Tax*, 62 S.M.U. L. REV. 239 (2009) (describing financial derivatives as "permit[ing] willing counterparties to bet on a risky asset without investing capital in the asset itself because [they] are nothing more than executory contracts between two parties based on the value of some reference. . . . , the contract has no inherent financial value but rather derives its value from the underlying reference."); GEN. ACCOUNTING OFFICE, FINANCIAL DERIVATIVES: ACTIONS NEEDED TO PROTECT THE FINANCIAL SYSTEM 20–26 (describing basic derivatives, including forward, futures, options, and swaps).

310. Some attribute the explosive growth in derivatives markets to substantial deregulation by the Commodity Futures Modernization Act of 2000, Pub. L. No. 106-554, app. E, tit. I, 114 Stat. 2763, 2763A465. *See, e.g.*, FINANCIAL CRISIS INQUIRY REPORT, *supra* note 242, at 48.

311. Christopher Cox, Chairman, Sec. & Exch. Comm'n, Opening Remarks at SEC Roundtable on Modernizing the Securities and Exchange Commission's Disclosure System (Oct. 8, 2008) (transcript available at http://www.sec.gov/news/speech/2008/spch100808cc.htm).

312. Dodd-Frank Act at tit. IV, 124 Stat. 1570–80 (codified in scattered sections of 15 U.S.C.) (Regulation of Advisers to Hedge Funds) (§§ 401–419), and derivatives and other swap markets, *id.* at tit. VII (Regulation of Swap Markets) (§§ 721–774).

c. Securitization

Securitization involves the bundling of loans from different banks or lenders into packages for sale to investors. Pooling the loans into one investment effectively diversifies risk or minimizes the impact of occasional defaults. Among the most common securitization devices is the pooling of multiple mortgage loans into mortgage-backed securities (MSBs). In effect, mortgage-backed securities are a type of derivative. They can diversify not only default risk, but also interest rate volatility risk. In fact, the opportunity to diversify interest rate risk may be one major reason for the growth of MBS markets.[313]

Unfortunately, securitization transactions evolved to include complex financial instruments in which increasingly risky loans could be hidden, making such instruments difficult to understand and value.[314] As the Financial Crisis Inquiry Commission noted in its report on factors contributing to the recent Great Recession, securitization became "a boon for commercial banks [and] investment banks."[315] This boon quickly turned to economic crisis when real estate markets collapsed during the Great Recession.[316] Prior to Dodd-Frank, securitization instruments including mortgage and other asset-backed securities were largely unregulated. Though it falls far short of establishing a comprehensive regulatory regime, Dodd-Frank includes modest reforms regarding regulation of securitization instruments.[317] Like hedging and derivatives trading, securitization functions as a private risk allocation device, which belongs close to the private end of the allocation of risk continuum.

313. *See* Darryl E. Getter, Mark Jicking, Marc Labonte, & Edward V. Murphy, Cong. Research Serv., RL34182, Financial Crisis? The Liquidity Crunch of August 2007 (explaining development of MBS market "in part because long-term fixed interest rate mortgages held in banks' portfolios place banks at significant risk if interest rates rise in which case the banks' interest costs could exceed their mortgage interest earnings.").

314. Hedging, and other involvement with MBS transactions played a significant part in the downfall of investment bank, Bear Stearns, when the housing market began to collapse in 2007. *See* BEAR STEARNS, *supra* note 119, at 2 (describing Bear Stearn's "vertically integrated involvement that ranged from purchase and operation of residential mortgage originators to packaging and underwriting vast pools of mortgages into . . . MBS.")

315. FINANCIAL CRISIS INQUIRY REPORT, *supra* note 242, at 44.

316. *See supra* notes 314–15.

317. For example, in a provision colloquially described as a "skin in the game" rule, Dodd-Frank requires banking agencies to prescribe regulations "to require any securitizer to retain an economic interest in a portion of the credit risk for any asset that the securitizer, through the issuance of an asset-backed security, transfers, sells, or conveys to a third party." Dodd-Frank Act § 941(b), 124 Stat. 1376, 1891 (codified at 15 U.S.C. § 78a). *See also id.* § 942 (requiring disclosures and reporting for asset-backed securities).

3. Ex Post Private Allocations

a. Private Rescue Efforts by Stakeholders

Private "rescue groups" may sometimes coalesce with little or no outside prompting to save struggling businesses in which the groups have a financial interest. Direct stakeholders in a troubled business understandably may wish to cooperate in rescue efforts so as to protect their own creditor interests. As a result, they may agree to provide emergency loans or otherwise privately negotiate a restructuring of the struggling company's obligations to forestall the company's bankruptcy. In 2009, for example, CIT Group, a company specializing in financial advice and lending to small and middle-market businesses, found itself struggling despite its initial receipt of assistance through the U.S. Treasury Department TARP program.[318] Unable to obtain additional TARP funding, CIT instead received $3 billion in emergency loans from bondholders "willing to throw the foundering lender a financial lifeline" to forestall an imminent bankruptcy.[319] As it continued teetering towards bankruptcy, CIT received another $4.5 billion in emergency loans from investors.[320] CIT stakeholders in this case made an ultimately unsuccessful attempt to arrange what is referred to as an "informal workout," which operates effectively as a private bankruptcy arrangement.

b. Rescues by Competitors or Other Private Parties

Perhaps surprisingly, private rescue groups may form even among competitors with no direct financial stake in the struggling enterprise. Given the interlocking nature of many business activities and financial investments, the failure of one institution can lead to "financial contagion." Thus, it may be in competitors' interests to help one another in order to avoid severe economic harm to a particular industry.[321] During the early period before creation of the Federal Reserve System in 1913, the rescuing hero role was often played by influential private bankers, such as J.P. Morgan, Sr. and Jr. according to one historical report, "[w]hen the banking

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318. The Treasury Department's Office of Financial Stability ("OFS") invested $2.3 billion in exchange for CIT senior preferred stock under the TARP Capital Purchase Program. U.S. DEP'T OF TREAS., OFFICE OF FINAN. STABILITY, AGENCY FINANCIAL REPORT FISCAL YEAR 2009, at 97.

319. Binyamin Appelbaum, *CIT Group Strikes Deal With Creditors to Avoid Bankruptcy*, WASH. POST, Jul. 21, 2009, at A11; Michael J. de la Merced, *CIT to Get Financing From Bondholders*, N.Y. TIMES, Jul. 21, 2009, at B7.

320. *See* Michael J. de la Merced, *CIT Rejects Icahn Offer; Its Creditors Extend Loan*, N.Y. TIMES, Oct. 29, 2009, at B3.

321. Some economists even suggest that in certain cases, a linked network "may be optimal both because of and despite the potential for contagion." Yaron Leitner, *Financial Networks: Contagion, Commitment, and Private Sector Bailouts*, 60 J. FIN. 2925, 2925 (2005). They argue that the very threat of contagion can "motivate banks to help one another, even in cases in which they could not precommit to do so." *Id.* at 2926.

system was swept with panic and illiquidity, it was Morgan who organized the loan syndicates among major banks that came to the rescue. Morgan and his men made the choices about which banks would be saved and which ones allowed to fail."[322] In fact, the House of Morgan played a major role in responding to virtually all of the significant economic crises of the era.[323]

Even if individual businesses share a common interest in avoiding contagion, a large group will not contribute towards a collective good unless it can overcome what is now commonly referred to as the collective action problem. Although individual banks would probably be delighted to "free-ride" off assistance to a troubled bank provided by fellow competitors, no one bank has the incentive to assist a weaker competitor by itself. In his work on collective action, Mancur Olson observed that large groups may fail to act collectively without coercion or outside inducements. Members of such large groups have insufficient incentives to contribute because they presume that others are already participating and that their failure to contribute will go unnoticed.[324] Even in the case of intermediate-sized groups—a situation in which a member's absence would be noticed—Olson argues that "no collective good may ever be obtained without some group coordination or organization."[325] Thus, the problem sometimes standing in the way of privately organized rescues is the lack of a central facilitator or coordinator.

Before the Federal Reserve Bank was established in 1913, private banks themselves formed clearing houses, which under normal circumstances were used to settle accounts among banks. In times of crisis, however, the clearing house acted as lender of last resort and provided other assistance to weaker members of the group on "life support." During bank panics in the early twentieth century, for example, the New York Clearing House not only provided emergency funding to members, but also to non-member banks and trusts.[326] When economic crisis occurred, the existing clearing house provided a ready structure, thus overcoming the collective action problem that might otherwise have prevented banks from coming together to provide emergency assistance to their competitors. The clearing house thus played an important role as facilitator and coordinator—a role today

322. WILLIAM GREIDER, SECRETS OF THE TEMPLE: HOW THE FEDERAL RESERVE RUNS THE COUNTRY 269 (1987).

323. During the 1907 panic, for example, J.P. Morgan, Sr. not only assisted with his own funds, but reportedly locked all of New York City's major bank and trust presidents in his library until they could come up with a pool of resources to rescue the Trust Company of America, Lincoln Trust, and Moore & Schley. RON CHERNOW, THE HOUSE OF MORGAN: AN AMERICAN BANKING DYNASTY AND THE RISE OF MODERN FINANCE 127–28 (Atlantic Monthly Press, NY, 4th prtg. 1990); JEAN STROUSE, MORGAN: AMERICAN FINANCIER 586–87 (HarperPerennial 2000)).

324. MANCUR OLSON, THE LOGIC OF COLLECTIVE ACTION: PUBLIC GOODS AND THE THEORY OF GROUPS 50–51 (1965).

325. *Id.* at 50.

326. *See* ROBERT F. BRUNER & SEAN D. CARR, THE PANIC OF 1907: LESSONS LEARNED FROM THE MARKET'S PERFECT STORM 57–64 (2007); FRIEDMAN & SCHWARTZ, *supra* note 78, at 159.

played by the Federal Reserve Bank, the FDIC, and sometimes the U.S. Treasury Department.[327]

C. Quasi-Public Risk Allocation Mechanisms

1. The Private Tort Regime Versus Government Criminal and Civil Collection Efforts

a. Private Tort Litigants

Under the common law tort system, the burden of loss for wrongful acts is placed on the wrongdoer. Unless parties agree to settle their claims without litigation, the government is at least minimally involved in resolving the dispute. Other than court administration costs, however, no government funds are used or risked. If the plaintiff is successful, the disputed loss is allocated to the defendant; if not, it remains with the plaintiff. Although the court is involved in choosing winners and losers, its role in a tort action is to act as a fair and impartial arbiter of disputes between the parties; it does not exercise allocative discretion, and is not taking broader governmental or societal interests into account in its decision making. Also, the court cannot choose its plaintiffs, nor can it turn any away; the courthouse door is open to all. The government's limited administrative presence is the feature that converts what would otherwise be a purely private allocation vehicle into one that is "quasi-public."

b. Government as Litigator

Financial crisis can sometimes be triggered or fueled by the fraud, manipulation, or other wrongdoing of private parties. Much of the 1980s savings and loan crisis, for example, was allegedly attributed to "outright fraud and insider abuse."[328] Banking and securities regulators have authority to pursue criminal charges for bank and securities fraud, and may seek to collect penalties or damages to be held as general revenue.[329] Government litigators may also pursue civil actions against wrongdoers to recoup losses on behalf of defrauded investors.[330] The government's

327. For discussion of government brokered or facilitated "rescues," see *infra* notes 347–58 and accompanying text.

328. H.R. REP. NO. 101-54, pt. 1, at 294 (1989), *reprinted in* 1989 U.S.C.C.A.N. 86, 90 (House Report on the Financial Institutions Reform, Recovery and Enforcement Act of 1989).

329. For example, Wall Street arbitrager, Ivan Boesky "[pled] guilty to insider trading . . . and agreed to pay [a] $100 million" fine, setting up a special compensation fund for defrauded investors. Bloomberg Business News, *Boesky Payout to Investors*, N.Y. TIMES, Jun. 12, 1993, at sec. 1, p. 39. *See also* Richard W. Stevenson, *Keating Convicted of Securities Fraud in S & L's Collapse*, N.Y. TIMES, Dec. 5, 1991, at 1 (Charles Keating convicted on bank fraud charges in connection with the Lincoln Savings and Loan Association failure).

330. *See generally* Adam S. Zimmerman, *Distributing Justice*, 86 N.Y.U. L. REV. 500 (2011) (analyzing the conflicting interests and concerns of regulatory agency, private class action, and

involvement in such litigation places this type of risk allocation device further along the private-public continuum than tort litigation initiated by private plaintiffs. And, such action imposes the "prosecution" costs upon general taxpayers. Still, to the extent that the government is successful in such cases, at least a substantial portion of the burden of loss is allocated "privately" to parties ultimately held responsible.

Emergency circumstances understandably require quick action, suggesting that the criminal law and the tort model are not viable tools for regulators faced with imminent potential systemic risk. Nonetheless, subsequent government collection action can supplement any initial emergency response, ultimately imposing costs on wrongdoers. The question for government regulators and officials is whether they should dedicate public resources to such "clawback" collection efforts against wrongdoers. From a purely general revenue perspective, the answer depends on a cost-benefit analysis of anticipated government collections. More broadly, the assessment should consider deterrent effects resulting from forcing wrongdoers to internalize costs. Even if government-collected funds are not added to general revenues, successful collection on behalf of others would presumably promote valuable public confidence and goodwill.

2. Private Bankruptcy Regime: Private Creditors

Like tort actions, bankruptcy proceedings are court-supervised resolutions of private financial matters. In both cases, government funds are not spent or risked other than those needed to administer the system, a system publicly available to all. If successful, Chapter 11 bankruptcy reorganization is essentially a court supervised, but privately funded, "rescue" of the insolvent debtor. Despite initial similarities, the government's more substantial role in bankruptcy-related risk allocation determinations places private bankruptcy to the "public" side of torts on the private-public risk allocation continuum. Unlike the common law tort system, the bankruptcy regime is administered by special bankruptcy courts governed by a statutory federal bankruptcy code. As an initial matter, the mere fact of a bankruptcy code in itself suggests the government's greater involvement in making allocation of risk or loss decisions in private bankruptcy matters. Moreover, though the code does not predetermine the status of all claimants, to the extent that the bankruptcy code does establish a predefined hierarchy of creditor rights, Congress is making decisions about relative distribution of losses.[331] In addition, the bankruptcy code

bankruptcy as tools for allocating compensation to victims of financial fraud). *Id.* at 500–03 (discussing various actions to recoup assets from Bernard L. Madoff to compensate victims of Madoff's massive Ponzi scheme).

331. To the extent that the bankruptcy code's allocation hierarchy is publicized ex ante, those extending credit presumably are better informed regarding risk, and the market may be better able

requires court approval of reorganization plans, major assets sales, and other significant business decisions of the bankruptcy trustee or the bankrupt "debtor-in-possession" during the bankruptcy process. Though bankruptcy judges are bound to exercise their authority according to code-specified standards,[332] they retain significant autonomy and discretion. Thus, judges in bankruptcy are more directly involved in substantive allocations of private loss than judges in tort matters.

The U.S. Bankruptcy Code explicitly provides rules for two major types of business bankruptcy: (1) Chapter 7 liquidations, which terminate the debtor's business after selling off assets to satisfy creditor claims;[333] and (2) Chapter 11 reorganizations, which permit restructuring and potential rehabilitation of the company.[334] Perhaps the most significant Chapter 11 reorganization policy challenge is balancing the public interest in restructuring the debtor's business as a viable concern against creditors' interests in a fair distribution of payments under circumstances in which the debtor is unlikely to satisfy all creditor claims in full. With respect to the former, debtors are entitled to certain benefits through the process, including the ability to raise capital by issuing new "debtor-in-possession" equity to investors who will take priority over other creditors,[335] to sell assets free of liens and liabilities, subject to notice and hearing requirements,[336] and an "automatic stay" against most collection efforts and other legal claims.[337]

The traditional path through Chapter 11 envisions a formal "plan of reorganization," which must meet statutorily enumerated requirements designed to protect and prioritize different classes of claimants.[338] Chapter

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to value debt and equity instruments. This assumes investor confidence that the bankruptcy code's claim priority rules will be enforced.

332. *See, e.g.*, 11 U.S.C. §§ 363(b), 1129.

333. 11 U.S.C. §§ 701–784 (2006) (Chapter 7—Liquidation). The Code also includes special bankruptcy rules for municipalities (11 U.S.C. §§ 901–946), family farms (11 U.S.C. §§ 1201–1231 (2006)), and individuals with regular income (11 U.S.C. §§ 1301–1330 (2006)). Certain classes of business debtors are not covered at all by the regular bankruptcy rules. These distinct categories are considered at *infra* notes 372–90 and accompanying text.

334. 11 U.S.C. §§ 1101–1174 (2006) (Chapter 11—Reorganization). Chapter 11's legislative history reflects its purpose to permit a business to restructure "so that it may continue to operate, provide its employees with jobs, pay its creditors, and produce a return for its shareholders" on the premise that "assets that are used for production in the industry for which they were designed are more valuable than those same assets sold for scrap." H.R. REP. NO. 95-595, at 220 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6179.

335. 11 U.S.C. § 364 (2006); For a general discussion of debtor-in-possession (DIP) financing, see David A. Skeel, Jr., *The Past, Present, and Future of Debtor-in-Possession Financing*, 25 CARDOZO L. REV. 1905, 1905 n.2 (2004).

336. *See* 11 U.S.C. § 363 (2006).

337. *See* 11 U.S.C. § 362(a) (2006).

338. 11 U.S.C. § 1129(a) (listing fourteen requirements for court approval of liquidation plan). *See also* 11 U.S.C. § 1123 (required contents of reorganization plan). The bankruptcy code requires only that claims *within* each class be "substantially similar." 11 U.S.C. § 1122(a). It does not require that all "substantially similar" claims be included within one class. Unless the holder

11 calls for the appointment of various creditor committees, with the idea that these committees will adequately and fairly represent the interests of different types of claim holders.[339] Ideally, the goal is for all classes of claim holders to approve the plan of reorganization.[340] Once the plan has been accepted by all classes of creditors, the plan must still be approved or "confirmed" by bankruptcy court order.[341] A reorganization plan—sometimes referred to as a "cram-down"—can be approved over the objections of dissenting classes of creditors, however, if it "does not discriminate unfairly, and is fair and equitable with respect to each class of claims . . . that is impaired under, and has not accepted, the plan."[342]

As an alternative to the "plan of reorganization" path through Chapter 11, debtors have increasingly turned to a procedure permitted under Bankruptcy Code § 363, which allows the bankruptcy trustee—subject to a statutory notice and hearing requirement—to sell or lease the debtor's assets "other than in the ordinary course of business."[343] Although this "§ 363 sale" provision can be used by the debtor to sell selected assets during the bankruptcy process, the trend of interest for purposes of this Article is the increasing use of "§ 363 sales" to dispose of the entire insolvent debtor's business.[344] One concern with the lump-sum "§ 363 sale" is that it might be used as device to by-pass Chapter 11 creditor protections and

agrees to less favorable treatment, the reorganization plan must treat all claims within a particular class alike. 11 U.S.C. § 1123(a)(4).

339. The process generally begins with appointment of an unsecured creditors committee, 11 U.S.C. § 1102(a)(1), and by court order "on request of a party in interest" additional committees, "if necessary to assure adequate representation of creditors or of equity security holders." 11 U.S.C. § 1102(a)(2). The committee is ordinarily made up of "persons willing to serve, that hold the seven largest claims against the debtor of the kinds represented on the committee." 11 U.S.C. § 1102(b)(1) (committee of creditors). *See also* § 1102(b)(2) (similar language for equity security holder committees).

340. 11 U.S.C. § 1126 (requirements for approval by classes of claims).

341. 11 U.S.C. § 1129(a) (listing fourteen requirements for court approval).

342. 11 U.S.C. § 1129(b)(1). *See also* 11 U.S.C. § 1129(b)(2) (requirements of a "fair and equitable" plan).

343. 11 U.S.C. § 363(b) (2006). This provision is also used for sales of selected debtor assets. According to the UCLA-LoPucki Bankruptcy Research Data Base, which tracks bankruptcy trends, § 363 sales of large public bankruptcies represented 9 percent and 2 percent of total such bankruptcies in 1991 and 1992 respectively, becoming increasingly popular in the latter part the decade, and increasing into the current decade to a high of 38 percent. The data show a drop, however, in 2009–2010. *363 Sales of All or Substantially All Assets in Large, Public Company Bankruptcies, as a Percentage of all Cases Disposed, by Year of Case Disposition*, UCLA LoPucki Bankr. Res. Database, http://lopucki.law.ucla.edu/tables_and_graphs/363_sale _percentage_graph_1_19_2012.pdf (last visited Apr. 12, 2012). The trend has been greeted by the academic bankruptcy community with mixed reviews. *See* Daniel Keating, *Automobile Bankruptcies, Retiree Benefits, and the Futility of Springing Priorities in Chapter 11 Reorganizations*, 96 IOWA L. REV. 261, 261 (2010); George W. Kuney, *Let's Make It Official: Adding an Explicit Preplan Sale Process as an Alternative Exit from Bankruptcy*, 40 HOUS. L. REV. 1265, 1266 (2004).

344. Despite some differences, sales in bankruptcy under § 363 are the private equivalent of publicly-structured bank resolutions by purchase and assumption (P&A). *See supra* notes 221-28 and accompanying text.

required court confirmation of the plan of reorganization; in other words, the purported "sale" might be a "plan of reorganization" in disguise—a plan *sub rosa*.[345] Pre-packaged "§ 363 sales" were very important in structuring the Chrysler and General Motors (GM) bankruptcies in 2009. In fact, the government's involvement was so pervasive that the recent auto industry Chapter 11 reorganizations represent allocation of loss mechanisms much further in the public direction along the private-public risk allocation continuum. As such, they are considered in a separate section below.[346]

3. Publicly Brokered or Facilitated Private Risk Allocation

It is almost impossible today to imagine any one private person with the wealth, power, and force of personality to coordinate massive privately-funded emergency financial assistance as the House of Morgan did during the late nineteenth and early twentieth centuries.[347] In the absence of such powerhouses, federal government officials have sometimes stepped in at times of crisis—not to provide funding or assume any risk—but simply to facilitate or broker private solutions. One notable illustration is the 1980 silver speculation and market scandal involving brothers, Nelson Baker and William Herbert Hunt. The Hunts' imminent default on silver investment debts threatened to trigger massive silver position liquidations and a potentially dramatic systemic chain reaction. Late night negotiations ultimately led to a $1.1 billion emergency loan to the Hunts from a consortium of private banks.[348] According to one telling of the story, Federal Reserve Chairman Volcker was infuriated at reports of his participation in negotiations through the night, "mainly because of the suggestion that he had bailed out the Hunts, but also because of the suggestion that so august a central banker should have been wandering about in his pajamas."[349] Volcker later testified that his involvement was limited to keeping informed of developments. He insisted that "neither I nor any Federal Reserve or Government official instigated or guided the negotiation of the credit."[350] Directly contradicting Volcker's description of

345. The first apparent judicial reference to a "§ 363 sale" as a potential "plan *sub rosa*," was in Pension Benefit Guar. Corp. v. Braniff Airways, Inc., 700 F.2d 935, 940 (5th Cir. 1983) ("The debtor and the Bankruptcy Court should not be able to short circuit the requirements of Chapter 11 for confirmation of a reorganization plan by establishing the terms of the plan *sub rosa* in connection with the sale of assets.").

346. *See infra* notes 433–68 and accompanying text.

347. *See supra* notes 323–24 and accompanying text.

348. For a colorful description of events, see STEPHEN FAY, BEYOND GREED: HOW THE TWO RICHEST FAMILIES IN THE WORLD, THE HUNTS OF TEXAS AND THE HOUSE OF SAUD, TRIED TO CORNER THE SILVER MARKET–HOW THEY FAILED, WHO STOPPED THEM, AND WHY IT COULD HAPPEN AGAIN 225–42 (1982).

349. *Id.* at 229.

350. *Silver Prices and the Adequacy of Federal Actions in the Marketplace, 1979–80: Hearings Before the House Subcomm. on Commerce, Consumer, and Monetary Affairs of the H. Comm. on*

events, Andrew Brimmer, a Commodity Exchange director at the time, reported that Volcker "played a key role" in negotiations and "approved the arrangement." [351] Brimmer, in fact, included the silver crisis as an illustration of intervention by the Federal Reserve that successfully "forestalled the collapse of several broker-dealer firms, and . . . averted significant loan losses by a number of banks."[352]

Whatever the accuracy of reports that government officials were involved in negotiating private loans for the Hunts, additional evidence suggests that the silver episode involved more than a purely private rescue. As structured, the emergency loan to the Hunts apparently violated special credit restraint rules imposed by the Federal Reserve in order to slow the volume of borrowing for speculative purposes. Volcker's approval was necessary to bypass those rules.[353] This type of regulatory forbearance is an illustration of what might be referred to as a covert bailout.[354]

Another modern instance of the government-facilitated private rescue was the Federal Reserve's 1998 intervention to broker a private rescue plan for major U.S. hedge fund, Long Term Capital Management (LTCM).[355] Given substantial intersecting relationships among LTCM and other banks and financial firms, federal officials were concerned that LTCM's bankruptcy would have a disastrous impact on the economy. William McDonough, President of the New York Federal Reserve Bank, worked with domestic and international bankers to broker the terms of a private deal.[356]

Publicly brokered, but privately funded, rescues of failing companies do not involve substantial federal budget expenditures. Even so, public spending is not a necessary characteristic of bailouts; some are even "profitable bailouts."[357] One difference between government-facilitated and profitable bailouts is that even though the latter impose no ultimate financial burden on the taxpayer, they do put taxpayers at risk in ways that merely government-facilitated bailouts do not. Had economic circumstances

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Gov't Operations, 96th Cong. 210 (1980) (statement of Paul A. Volcker, Chairman, Board of Governors, Federal Reserve System).

351. Andrew F. Brimmer, *Distinguished Lecture on Economics in Government: Central Banking and Systemic Risks in Capital Markets*, 3 J. ECON. PERSP., Spring 1989, at 3, 5, 10–11.

352. *Id.* at 16.

353. *See, e.g.*, *id.* at 11 (explaining that the Hunt lending agreement violated Federal Reserve credit restraint guidelines; thus, such agreement could not have occurred without the Federal Reserve Chair's approval).

354. *See* Block, *Overt and Covert Bailouts*, *supra* note 202, at 968–72 (explaining the various forms of covert bailouts); *see also* Block, *Measuring Bailout Cost*, *supra* note 8, at 206–28 (outlining the costs of covert or hidden bailouts).

355. STEPHEN H. AXILROD, INSIDE THE FED: MONETARY POLICY AND ITS MANAGEMENT, MARTIN THROUGH GREENSPAN TO BERNANKE 145–50 (2009) (describing Federal Reserve involvement in efforts to save LTCM).

356. For a colorful report on LTCM's rise and fall, *see* ROGER LOWENSTEIN, WHEN GENIUS FAILED: THE RISE AND FALL OF LONG-TERM CAPITAL MANAGEMENT (2000).

357. Block, *Measuring Bailout Cost*, *supra* note 8, at 163–64.

been different in the profitable bailout case, the result might have been significant federal revenue losses. How does a private rescue become a public bailout simply because the government has facilitated the transaction? And, does it really matter what we call it? The answer depends in part on the concern behind the labeling. If the concern is simply federal budget cost, then perhaps a government-facilitated rescue is not a bailout. My concern, though, is not limited to the risk of loss, but also the risk of differential treatment. Unless the government always acts as facilitator in cases of similarly situated companies or industries faced with economic distress, the mere decision to intervene in the first instance involves the government in picking specific winners and losers. The government's choice to facilitate the rescue of one company, but not another, is effectively redistributive or reallocative. I contend that government decisions to selectively facilitate or broker even privately funded rescues of firms or industries are bailout-like interventions.[358] To the extent that government officials influence outcomes by engaging in negotiations, the government exercises control over redistributive or reallocative decision making, moving the government's actions further in the public direction along the private-public continuum.

D. Substantially More Public Risk Allocation Devices

1. Ex Ante Risk Allocation Through Mandatory Federal Deposit Insurance

The federal deposit insurance system was perhaps the most significant legislative reform enacted in response to the Great Depression.[359] Rhetoric in the legislative history emphasized ensuring safe banks in which "citizens may place their hard earnings with reasonable expectation of being able to get them out again on demand."[360] Called upon to interpret the statutory meaning of "deposit" for purposes of federal deposit insurance rules, the Supreme Court similarly noted that "Congress wanted to ensure that someone who put tangible assets into a bank could always get those assets back."[361] In other words, federal deposit insurance serves a "depositor protection" function even in the case of an isolated bank failure with no anticipated systemic spillover effects. Absent deposit insurance, a single failure

358. In earlier work, I defined "bailout" as "a form of government assistance or intervention specifically designed or intended to assist enterprises facing financial distress and to prevent enterprise failure." Block, *Overt and Covert Bailouts*, *supra* note 202, at 960.

359. Banking Act of 1933, Pub. L. No. 73-66, ch. 89, § 8, 48 Stat. 162, 168 (creating the FDIC). Despite some revisions over time, the federal deposit insurance system today retains its original 1933 structure.

360. 77 CONG. REC. 3837 (1933) (statement of Rep. Henry Steagall, Banking Act co-sponsor).

361. FDIC v. Phila. Gear Corp., 476 U.S. 426, 435 (1986).

could potentially destroy individual financial lives.[362] In addition, the actual, threatened, or even merely rumored failure of any one bank has the potential to trigger "bank runs" even on healthy banks. Thus, federal deposit insurance was established in the aftermath of the Great Depression to restore public confidence and to maintain financial stability.[363]

Even though insurance provides direct assistance only to depositors, insured banks themselves are surely indirect beneficiaries. As a result, the federal deposit insurance might be regarded as a type of "ex ante bailout." Taxpayers are perhaps more tolerant of federal deposit insurance than other kinds of government-sponsored private business "rescues" because claims are funded not with general tax revenues, but from insurance pools collected through assessments on participating banks.[364] When insurance pool funds are insufficient, the FDIC is authorized to impose additional "systemic risk special assessments" on insured institutions, including even prepaid assessments,[365] and also has "backstop" authority to borrow up to $100 billion from the Treasury Department.[366] Even if general revenues are not used to cover depositor losses, mandatory federal deposit insurance belongs much further in the public direction on the private-public risk allocation continuum than publicly-brokered private rescues. Given that banks are not free to opt out, the government in the case of deposit insurance is significantly involved in making allocative choices.

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362. *But see* Carter H. Golembe, *The Deposit Insurance Legislation of 1933: An Examination of Its Antecedents and Its Purposes,* 75 POL.SCI.Q.181, 189 (1960) (arguing that "protection of the small creditor against loss is incidental to the achievement of the primary objective": to restore "circulating medium to the community").

363. *See* FDIC, HISTORY OF THE EIGHTIES, *supra* note 46, at 3 (contribution of federal deposit insurance was "the restoration of public confidence in banks"); *id.* (FDIC mission over five decades has been "to insure bank deposits and reduce the economic disruptions caused by bank failures"). *See also* Gail Otsuka Ayabe, *The "Brokered Deposit" Regulation: A Response to the FDIC's and the FHLBB's Efforts to Limit Deposit Insurance,* 33 UCLA L. REV. 594, 604–08 (discussing depositor protection and financial stability/public confidence purposes of federal deposit insurance).

364. 12 U.S.C. § 1817(b) (2006) (FDIC's risk-based assessment rules). The FDIC maintains a Deposit Insurance Fund (DIF) available to depositors in the event that one of its insured banks fails. 12 U.S.C. § 1815(d) (2006). The FDIC is also authorized to use fund resources to cover other expenses in connection with liquidation or resolution of an insured depository institution.

365. 12 U.S.C. § 1817(b)(5). *See, e.g.*, 74 Fed. Reg. 25, 689 (Special Assessments) (May 29, 2009). One report described a recently FDIC-imposed $45 billion in prepaid annual assessments as a "plan financed by the industry to rescue the ailing insurance fund that protects bank depositors" (i.e., a bailout of the FDIC itself). Stephen Labaton, *Banks to Rescue Depleted F.D.I.C.*, N.Y. TIMES, Sept. 30, 2009, at A1.

366. 12 U.S.C. § 1824(a)(1). Given explicit statutory assurances in Dodd-Frank that its provisions are not to be construed as limiting the FDIC's § 1824(a) borrowing authority, Dodd-Frank Act § 210(n)(8)(A), 124 Stat. 1507 (codified at 12 U.S.C. 5390), Professor Arthur Wilmarth argues that "the FDIC could conceivably assert authority to borrow up to $100 billion from the Treasury under § 1824(a) for . . . financing an orderly liquidation of a SIFI outside the funding parameters of the OLA." If so, notwithstanding Dodd-Frank, the FDIC might be able "to protect a SIFI's uninsured and unsecured creditors as long as such protection 'maximizes' the value of the SIFI's assets or 'mitigates the potential for serious adverse effects to the financial system.'" Wilmarth, *Dodd-Frank, supra* note 13, at 1000–01.

One additional characteristic establishing the federal deposit insurance system's place even further along the private-public continuum is that taxpayer revenues are potentially at risk in the event that bank assessments are insufficient to cover depositor claims or to repay FDIC loans from the Treasury Department. General revenues are at risk first because FDIC insurance obligations are backed by "full faith and credit" of the federal government,[367] and second, because even uninsured investors believe that they have implicit government guarantees in the event of substantial loss. Several precedents give investors good reason to assume this implicit guarantee. For example, Congress responded to the savings & loan crisis by providing direct assistance to failing banks and covering the losses of uninsured as well as insured claimants.[368] More recently investors' persistent belief in implicit guarantees with respect to GSEs Fannie Mae and Freddie Mac, ultimately proved to be accurate when the government placed the two mortgage giants in conservatorship and took preferred stock interests in the companies.[369]

2. Mandatory Contingent Capital

Mandatory contingent capital is a new concept receiving increased attention as a way to avoid pressures for publicly-funded bailouts by more directly imposing risk of loss from large systemic institutions on stakeholders.[370] Unlike ordinary corporate debt instruments, which provide investors with absolute claims against the corporation, contingent capital instruments would be structured as convertible subordinated debt. These subordinated debt instruments are designed to automatically convert into common stock based upon certain pre-defined indicators of financial distress. For example, contingent capital might automatically convert to common stock when the financial entity or bank is designated as "critically undercapitalized." The triggering event would effectively change contingent

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367. *See supra* text accompanying note 59.

368. FIRREA, 103 Stat. 183 (codified in scattered sections of the 12 U.S.C.A.).

369. Press Release, U.S. Dep't of the Treasury, Statement by Secretary Henry M. Paulson, Jr., on Treasury and Federal Housing Finance Agency Action to Protect Financial Markets and Taxpayers (Sept. 7, 2008), *available at* http://ustreas.gov/press/releases/hp1129.htm; *see also* N. ERIC WEISS, CONG. RESEARCH SERV., RL34661, FANNIE MAE'S AND FREDDIE MAC'S FINANCIAL PROBLEMS: FREQUENTLY ASKED QUESTIONS 1−2 (2008). For general discussion of the implicit GSE guarantee, see Carol J. Perry, Note, *Rethinking Fannie and Freddie's New Insolvency Regime*, 109 COLUM. L. REV. 1752, 1760–61 (2009); *see also* David Reiss, *The Federal Government's Implied Guarantee of Fannie Mae and Freddie Mac's Obligations: Uncle Sam Will Pick Up the Tab*, 42 GA. L. REV. 1019 (2008).

370. Dodd-Frank reflects this increased congressional interest in contingent capital. Though it imposes no contingent capital requirements, Dodd-Frank mandates an FSOC study of "the feasibility, benefits, costs, and structure of a contingent capital requirement . . . ." Dodd-Frank Act § 115(c), 124 Stat. 1376, 1404 (codified at 12 U.S.C. § 5325 (2010)). *See also id.* § 115(b)(1)(F) (authorizing FSOC to make prudential standard recommendations, including a contingent capital requirement). For an excellent article arguing the case for contingent capital, see Coffee, *supra* note 13.

capital investors' status from debtors with claims against the failing institutions to equity owners who bear the speculative down-side risk of loss upon corporate failure.[371]

3. Insolvencies Not Subject to Private Bankruptcy Regime

a. Insurance Company Insolvencies

Congress has identified distinct categories of business debtors entitled to use only limited parts of the regular federal bankruptcy code, or not entitled to file for federal bankruptcy at all. For example, although Dodd-Frank added some new federal government regulatory jurisdiction over designated "systemically important" insurance companies,[372] the Act nonetheless left primary regulatory authority over the insurance to the states.[373] Similarly, Dodd-Frank preserves primary state government jurisdiction over insurance company insolvencies, with the exception that the FDIC has backup authority to place an insurance company into orderly liquidation if the appropriate state agency has not filed appropriate judicial action to liquidate an insurance company within sixty days of a "systemic risk determination."[374]

b. Bank Resolution Principles

Like insurance companies, insolvent banks are not eligible to file for bankruptcy under either the Chapter 7 or Chapter 11 federal bankruptcy laws applicable to other businesses.[375] Unlike most insurance company insolvencies, which are generally governed by state law, bank insolvencies are governed by a special federal insolvency regime, which functions as an alternative to the federal bankruptcy code.[376] Special insolvency rules for banks are often justified as necessary because of the unique and vital role that banks play in providing access to liquid funds, extending credit, and serving as clearinghouse for processing employee paychecks and other payments in connection with financial transactions upon which the economy depends. The underlying fear is that "any interruption in

371. *But see* Wilmarth, *Reforming Financial Regulation*, *supra* note 67, at 760–61 (arguing that investors would be reluctant to invest in contingent capital, but suggesting that such requirements might be more feasible if used to compensate senior managers and other key employees).

372. Pursuant to Dodd-Frank procedures, insurance companies can be classified as SIFIs subject to enhanced prudential regulation by the Federal Reserve.-

373. Dodd-Frank Act § 502(a), 124 Stat. 1585 (codified at 31 U.S.C. § 313(k)) (noting "retention of existing state regulatory authority over the business of insurance"). *See also supra* note 279.

374. Dodd-Frank Act § 203(e), 124 Stat. 1454 (codified at 12 U.S.C. § 5383).

375. 11 U.S.C. § 109(b), (d).

376. *See supra* notes 216–28 (discussion of FDIC resolution methods). The U.S. two-regime approach differs from many European countries, which resolve all business failures through one insolvency regime. *See* Bliss & Kaufman, *supra* note 126, at 144. Some domestic commentators question the need for separate regimes in the U.S. *See, e.g.*, Hynes & Steven Walt, *supra* note 218.

[banking] activities, . . . would have a more serious adverse impact on the economy of the insolvent bank's market area than any interruption in the operation of other insolvent firms."[377] In addition, special FDIC-administered bank insolvency rules are arguably justified by the FDIC's unique responsibility to preserve the federal deposit insurance fund, its particular banking expertise, and its status as the dominant creditor in most bank failures.[378]

c. FDIC Resolutions or "Public Bankruptcies"[379]

Separate insolvency mechanisms established for distinct classes of business involve substantially more government intervention than other quasi-public risk allocation devices.[380] In the case of banks, the most significant difference between the special FDIC-administered resolution regime and the private bankruptcy regime is the level of government control. Although the private bankruptcy process is supervised by the federal courts, the judge's role is limited to that of referee. Bankruptcy judges have the power to approve or disapprove various transactions and hear claims to settle disputes among claimants based on statutory priority of claim rules, but they do not have authority to make substantive decisions about how losses should be allocated among stakeholders.

Perhaps the most significant evidence of the government's greater control with regard to bank insolvencies is the requirement that bank resolutions be government initiated; a bank cannot choose to file for bankruptcy. The FDIC has authority to take receivership interests in failed banks,[381] establish and operate "bridge banks" using the failed banks' assets, and ultimately transfer ownership of the "bridge banks" to new private owners.[382] Unlike a bankruptcy trustee, the FDIC as receiver has authority to arrange a P&A transaction without seeking court approval,[383] and to make judgments about claims with minimal judicial oversight.[384] As

377. Bliss & Kaufman, *supra* note 127, at 145.

378. *See* Peter P. Swire, *Bank Insolvency Law Now that it Matters Again*, 42 DUKE L. J. 469, 475 (1992). *See also id.* 478–81 (describing history of the U.S. special bank insolvency regime).

379. Given that banks are ineligible to file under the federal bankruptcy code, the term "bankruptcy" technically cannot apply to them. The analogous label for purposes of the bank insolvency regime is "resolution." I sometimes loosely refer to these resolutions as "public bankruptcies," thus distinguishing them from "private bankruptcies" governed by the federal bankruptcy code.

380. *See supra* notes 329–43 for discussion of private bankruptcy and its place on the private-public continuum.

381. 12 U.S.C. § 1819(a).

382. 12 U.S.C. § 1821(m), (n).

383. Hynes & Walt, for example, note that the FDIC in a bank resolution can complete a P&A transaction "long before a judge can conceivably hear an objection. Even if a creditor's objection is timely, the law significantly restricts the grounds upon which a creditor can complain about the sale." Hynes & Walt, *supra* note 218, at 989.

384. *See id.* at 998–99.

some have observed, the "FDIC enjoys a level of control that a dominant creditor could only dream of obtaining in bankruptcy."[385]

Dodd-Frank has now expanded the FDIC's resolution authority to cover not only banks, but also nonbank financial companies if the Treasury Secretary ultimately makes a "systemic risk determination" with respect to such a company.[386] Though there are technical differences, the OLA process triggered by the "systemic risk determination" is generally modeled after the FDIC's bank resolution regime.[387] In other words, the FDIC as receiver now has substantially more control over such nonbank financial company insolvencies than a trustee in bankruptcy or a bankruptcy judge. One particular concern with respect to the new OLA authority is that it leaves room for the FDIC to prefer some claimholders over others.[388] Despite the general statutory requirement that similarly situated claimants be treated alike, the FDIC has discretion to violate this requirement if necessary in order to maximize asset value, maximize present value return or minimize loss from the sale of any assets, or initiate or continue operations essential to the receivership or any bridge financial company.[389] As Professor Arthur Wilmarth concludes, these essentially discretionary statutory exceptions to the "equal treatment" of claimants rule provide the FDIC with significant "leeway to provide de facto bailouts for favored creditors."[390]

E. TOWARD THE PUBLIC END OF THE PRIVATE-PUBLIC CONTINUUM

1. Forbearance and Exemptions from Statutory and Regulatory Requirements

Ordinarily, statutory and regulatory prudential rules function as forward-looking mechanisms to maintain economic stability and mitigate or prevent substantial economic harm. As a practical matter, however, Congress sometimes enacts statutory exceptions—and regulators sometimes exercise their authority to grant exceptions or their discretion not to enforce otherwise applicable regulations—as ex post response tools to assist struggling firms whose failures might pose threats to the overall

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385. Hynes & Walt, *supra* note 218, at 989.

386. *See supra* notes 277–89.

387. *See supra* notes 218–32. A detailed discussion of specific differences is beyond the scope of this Article.

388. *See, e.g.*, Wilmarth, *Dodd-Frank*, *supra* note 13, at 997–98 ("FDIC may give preferential treatment to certain creditors as long as every creditor receives at least the amount she would have recovered in a liquidation proceeding under Chapter 7 of the federal Bankruptcy Code"); Baird & Morrison, *supra* note 278, at 304 (FDIC "has broad authority to favor some creditors over others with equal priority").

389. Dodd-Frank Act § 210(b)(4), 124 Stat. 1476 (codified at 12 U.S.C. 5390).

390. Wilmarth, *Dodd-Frank*, *supra* note 13, at 999.

economy.[391] Such exemptions or regulatory forbearance potentially offer just as much government publicly funded assistance as the more direct "bailouts" that have so angered the public. For example, exempting regulated entities from otherwise required taxes or fees results in immediate government costs measurable in foregone revenue.[392]

Though they involve no immediate general revenue expenditure, other types of regulatory forbearance or exemption can also effectively function as "covert" bailouts with significant budgetary impact. For example, deliberate decisions not to enforce minimum capital and related prudential bank requirements against certain banks during the late 1980s S&L crisis facilitated the continued operation of many banks otherwise doomed to fail in any event. The additional losses incurred by these banks while on "life support" added substantially to the ultimate budget cost of the subsequent government S&L rescue.[393]

Assuming that prudential rules promote a legitimate public interest, the failure to enforce them necessarily deprives the public of the regulations' intended benefits. Though the price sometimes may not be obvious or readily measured, this denial of public benefits, in itself, imposes real costs. Imposing such costs cannot be justified as a policy matter when regulatory inaction stems from regulators' perverse incentives not to act even when regulatory enforcement would better promote the public interest. On the other hand, regulators sometimes in good faith determine that countervailing public values from non-enforcement exceed the public interest otherwise served by the regulation. In other words, rule breaking under emergency circumstances may be necessary to protect against potentially devastating harm that would exceed the public interest value otherwise served by the regulation.[394]

I contend that nonenforcement or explicit exemptions, even those supported by government officials' plausible, good faith judgments, are government interventions that belong toward the public end of the risk allocation continuum. Statutory rules purporting to end bailouts and TBTF by restricting the more direct or open types of government assistance in times of economic crisis may simply result in shifting such assistance to more "covert" forms.

Even when the public interest argument is legitimate, government officials' use of discretion to forbear, grant explicit exemptions, or offer special treatment nonetheless empowers such officials to choose winners and losers. Recognizing this type of action (or inaction) to assist private failing firms as bailout-type government interventions would be an

391. *See, e.g.*, *supra* notes 44–68 and accompanying text.

392. *See infra* notes 422–29 and accompanying text on tax forbearance.

393. *See supra* note 96 (budgetary costs of savings & loan forbearance actions).

394. *See supra* notes 199–202 and accompanying text for discussion of emergency "containment" measures.

important first step toward greater transparency. Such transparency, in turn, should lead to greater scrutiny of regulators' decisions to assist particular private businesses, allowing the public to raise questions about the equities involved with respect to particular winners and losers. In addition, an accurate assessment of aggregate budget costs from "bailout type" interventions should include consideration of these more indirect or hidden forms of assistance. The sections that follow explore instances of indirect government assistance through special treatment or exemptions.

2. Special Treatment or Exemptions from Banking and Securities Rules

a. Conversions to Bank Holding Company (BHC) Status

In addition to providing support via regulatory inaction, regulators sometimes assist failing firms with measures that are more proactive, yet still opaque, relative to more direct "bailouts."[395] One example from the Great Recession is the Federal Reserve's expedited approval of investment or noncommercial banks' requests to become BHCs.[396] Ironically, such firms had previously been careful to *avoid* BHC classification because it would subject them to full supervision by the Federal Reserve Board of Governors, limit permissible activities to those "closely related to banking,"[397] and restrict certain transactions among the BHC and its affiliates.

The Gramm-Leach-Bliley Act (GLB), enacted in 1999, dramatically expanded permissible BHC nonbanking activities with a new provision allowing BHCs to elect to be financial holding companies (FHCs).[398] As reported by the Federal Reserve Board, the new FHC rules removed legal barriers "that had previously constrained the ability of banking

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395. *See, e.g.*, *supra* notes 352–54 and accompanying text (Federal Reserve approval of private "rescue loan" for silver investors, Nelson Baker and William Herbert Hunt, after speculation scandal even though the loan otherwise violated special credit restraints designed to slow speculative trading volume).

396. A BHC is defined simply as a company, generally referred to as a parent, with control over at least one bank. 12 U.S.C. § 1841(a)(1). Although a BHC can be a single corporation with control over a single bank, BHCs are often large conglomerates of multiple affiliated businesses.

397. *See* 12 U.S.C. § 1843(a)(1) (prohibiting BHC from acquiring a voting interest in any company that is not a bank). An existing entity that becomes a BHC must divest itself of nonbank voting interests within two years. *Id.* § 1843(a)(2). In addition, the Federal Reserve Board was directed to promulgate regulations identifying permissible activities "so closely related to banking as to be a proper incident thereto." 12 U.S. C. § 1843(c)(8). *See* Bank Holding Companies and Change in Bank Control (Regulation Y) 12 C.F.R. § 225.28(b) (regulations listing permissible closely related nonbanking activities). *See also* Financial Crisis Inquiry Report, *supra* note 244, at 362–63 (noting Goldman Sach's thirty-year history of opposing Federal Reserve supervision).

398. Gramm-Leach-Bliley Financial Modernization Act of 1999, Pub. L. No. 102-106, § 103(a), 113 Stat. 1338, 1346 (codified in part at 12 U.S.C. § 1843*l*(1)(C)(BHC election to become a FHC).

organizations, securities firms, and insurance companies to affiliate and compete with each other."[399]

While this expansion of permissible activities made BHC classification somewhat more attractive, a noncommercial or investment bank's conversion still came at a price. Even if the newly-converted BHC elected to become a FHC, its activities would still be restricted to those activities considered "to be financial in nature or incidental to such financial activity."[400] In addition, the new BHC would become subject to Federal Reserve Board supervision and restrictions on transactions between bank and nonbank members of the BHC group. Notwithstanding these constraints, several investment banks and other financial conglomerates during the 2007–2009 crisis, most notably Morgan Stanley and Goldman Sachs, made expedited requests to become BHCs so that they could borrow from the Federal Reserve discount window and be eligible to participate in other government assistance programs.[401] The Federal Reserve's rapid approval of these requests was widely regarded as a signal that Morgan Stanley and Goldman Sachs would not be allowed to fail.[402]

Another BHC conversion approval during the recent crisis was for the General Motors Acceptance Corporation (GMAC), once a General Motors (GM) in-house lending arm, but later an independent corporation, which served as the primary lender to GM customers and dealers. The Federal Reserve notably approved GMAC's request to become a BHC even though it fell short of the minimum regulatory capital initially demanded by the Federal Reserve as a condition of approval.[403] Moreover, the Federal

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399. Bd. of Governors of the Fed. Reserve Sys., Report to Congress on Financial Holding companies under the Gramm-Leach-Bliley Act 1 (2003).

400. 12 U.S.C. § 1841(k)(1)(A). *See also id* § 1841(k)(4) (identifying specific activities considered financial in nature). The Federal Reserve Board may even permit an FHC to engage in nonfinancial activity that "is complimentary to a financial activity and does not pose a substantial risk to the safety or soundness of depository institutions or the financial system generally." *Id.* § 1841(k)(1)(B).

401. Fed. Reserve Sys., Press Release, *available at* http://www.federalreserve.gov/newsevents /press/bcreg/20080921a.htm (Sept. 21, 2008) (citing "unusual and exigent circumstances" and "emergency conditions" to explain expedited approval of Goldman Sachs and Morgan Stanley BHC conversions).

402. *See, e.g.*, FINANCIAL CRISIS INQUIRY REPORT, *supra* note 244, at 362–63 (describing Federal Reserve's speedy BHC conversion approvals as sending signal that Morgan Stanley and Goldman Sachs would survive); Saule T. Omarova, *Adaption and Resiliency in Legal System: From Gramm-Leach-Bliley to Dodd-Frank: The Unfulfilled Promise of Section 23A of the Federal Reserve Act*, 89 N.C. L. REV. 1683, 1750–57 (2011) [hereinafter Omarova, *Gramm-Leach-Bliley*] (describing conversions of investment banks Morgan Stanley, Goldman Sachs, and GMAC into bank holding companies). *See also* DAVID WESSEL, IN FED WE TRUST: BEN BERNANKE'S WAR ON THE GREAT PANIC 217 (2009) (describing Morgan Stanley and Goldman's Sachs makeover as BHCs, which "gave them the Fed's promise of protection and a permanent source of lending in a crisis").

403. Order Approving Formation of Bank Holding Companies and Notice to Engage in Certain Nonbanking Activities, http://www.federalreserve.gov/newsevents/press/orders/orders20081224a1

Reserve clearly indicated that it considered GMAC's conversion to BHC status as part of the larger overall rescue plan for GM.[404]

b. Transactions Between BHC-Owned Banks and Their Nonbank Affiliates: Exceptions to Federal Reserve Act Restrictions

One concern with the Federal Reserve's BHC conversion request approvals during the Great Recession was potential threat to safety and soundness of the federal deposit insurance fund. To the extent that an uninsured, nonbank member of the BHC group engages in higher-risk business activities, transactions between the uninsured BHC affiliate and the FDIC-insured BHC bank increase the latter's exposure to potential loss. As a practical matter, the nonbank's relationship with the insured bank affiliate provides the nonbank with access to the federal deposit insurance "safety net."[405] One long-standing statutory "line of defense" or "firewall" created to prevent this extension of the federal "safety net" to nonbank affiliates of insured depository institutions is Federal Reserve Act § 23A,[406] which restricts specified "covered transactions" between BHC bank subsidiaries and their nonbank affiliates. These include, for example, BHC bank subsidiary loans or extensions of credit to nonbank affiliates or BHC bank purchases of securities issued by nonbank affiliates.[407] As one

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.pdf (Dec. 24, 2008) [hereinafter GMAC Approval Order] (approved GMAC BHC conversion request). *See also* CONG. OVERSIGHT PANEL, MARCH OVERSIGHT REPORT: THE UNIQUE TREATMENT OF GMAC UNDER TARP 23 (2010) [hereinafter OVERSIGHT PANEL, GMAC REP.].

404. GMAC Approval Order, *supra* note 4073, at 4 (noting unique issues raised by GMAC's historical relationship with GM and its role as the primary source of GM customer and dealer financing); *id.* at 5 (noting Federal Reserve's considering "steps taken by the Department of Treasury to provide assistance to GM and thereby help ensure the viability of a major business partner of GMAC and GMAC bank."). *See also infra* notes 453–59, and accompanying notes (Treasury Department assistance to GMAC as part of larger GM "bankruptcy bailout").

405. *See* Transactions Between Member Banks and Their Affiliates, 67 Fed. Reg. 76, 560 (Dec. 12, 2002) (codified, as amended, at 12 C.F.R. pt. 223) (introduction to Federal Reserve Act § 23 regulations, noting that the provision is "designed to protect against a depository institution suffering losses in transactions with affiliates . . . [and to] limit the ability of a depository institution to transfer to its affiliates the subsidy arising from the institutions access to the Federal safety net"). Another purpose of the provision is "to promote competition by reducing the likelihood that banks would favor certain customers over others." OVERSIGHT PANEL, GMAC REP., *supra* note 403, at 24.

406. Banking Act of 1933 § 13, 48 Stat. 183 (amending 1913 Federal Reserve Act to add § 23A) (codified, as amended, at 12 U.S.C. § 371c). In 1987, Congress added § 23B, which requires transactions between bank members of the BHC group and its affiliates transactions to be on market terms. CEBA, *supra* note 48, at tit. I, § 102(a), 101 Stat. 564 (amending 1913 Federal Reserve Act to add § 23B) (codified, as amended, at 12 U.S.C. § 371c-1).

407. 12 U.S.C. § 371c(b)(7). More generally, see § 371c(a)(1) (restrictions on transactions). *See also, id.* § 371c(b)(1),(2)(definition of "affiliate"). In a significant change of prior policy, Dodd-Frank explicitly added derivatives transactions with affiliates to the "covered transaction" definition "to the extent that the transaction causes a member bank or subsidiary to have credit exposure to the affiliate." Dodd-Frank Act § 608(a)(1)(B), 124 Stat. 1608 (codified at 12 U.S.C.

commentator noted, after the 1999 GLB Act's dramatic expansion of permissible BHC nonbank affiliations and activities, "section 23A effectively became the principal statutory firewall protecting the depository system from subsidizing potentially risky activities of nondepository financial institutions, and in a broader sense, safeguarding the foundational U.S. principle of separation of banking and commerce."[408]

An important component of the federal government's rescue assistance during the 2007–2009 economic crisis, which received far less public attention than the more direct ad hoc rescues and Treasury Department TARP "bailouts,"[409] was the Federal Reserve Board's extensive exercise of its statutory authority to exempt BHC "covered transactions" from the strictures of § 23A.[410] In other words, the Federal Reserve used its § 23A exemptive authority during the crisis to breach the firewall otherwise protecting FDIC-insured banks against the losses of nonbank affiliates. One illustration from early in the Great Recession is the Federal Reserve's use of emergency lending authority to facilitate JP Morgan's acquisition of the failing investment bank, Bear Stearns.[411] One challenge to the acquisition structure was that it involved several § 23A prohibited "covered transactions," including JP Morgan Bank extensions of credit to nonbank Bear Stearns, and JP Morgan Bank purchases of Bear Stearns's derivatives portfolio and associated hedges. Thus, an additional integral element of the negotiated acquisition agreement, without which JP Morgan would not have purchased Bear Stearns, was the Federal Reserve's agreement to provide JP Morgan with the necessary § 23A exemptions.[412]

In fact, the Federal Reserve quietly used its § 23A exemptive authority throughout the 2007–2009 crisis, intervening to provide what I refer to as "covert" bailout-type assistance to numerous large financial firms. Among others, the Federal Reserve granted § 23A exemptions to Citigroup, Bank of America, and Wachovia, thereby permitting bank subsidiaries to engage in

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§ 371c(b)(7)(G)). A more detailed analysis of covered transactions between affiliates is beyond the scope of this Article.

408. Omarova, *Gramm-Leach-Bliley, supra* note 402, at 1687. In response to this concern, the 1999 GLB Act amended the "covered transaction" definition to include transactions between FHC banks and their financial affiliates. For a discussion of these provisions, see *id.* at 1696–97.

409. *See supra* notes 117–23 and accompanying text.

410. 12 U.S.C. § 371c(f)(2) (authorizing the Federal Reserve Board to grant exemptions upon "finding the exemption to be in the public interest and consistent with the purposes [of § 23A]").

411. 12 U.S.C. § 343 (Federal Reserve "unusual and exigent circumstances" lending authority). An Examination of the Extraordinary Efforts by the Federal Reserve Bank to Provide Liquidity in the Current Financial Crisis: Hearing Before the H. Comm. on Financial Servs., 111th Cong. 8 (2009) (statement of Ben S. Bernanke, Chairman, Bd. of Governors of the Fed. Reserve Sys.). (testifying about Bear Stearns, noting that "prior to 2008, credit had not been extended under this [unusual and exigent circumstances] authority since the 1930's"). For further discussion of the Bear Stearns "rescue," see supra notes 118–21 and accompanying text.

412. *See* Omarova, *Gramm-Leach-Bliley, supra* note 402, at 1746–48 (describing Federal Reserve grant of three separate JP Morgan § 23A exemption requests in connection with Bear Stearns acquisition).

securities financing transactions with broker-dealer affiliates, or to purchase auction-rate securities (ARS) from nonbank affiliates.[413] Another illustration is the Federal Reserve's grant of several § 23A exemptions allowing FDIC-insured GMAC (subsequently renamed Ally Bank) to fund automobile company affiliates' business activities through transactions that would otherwise have been prohibited by § 23A.[414] Remarkably, the Federal Reserve granted one of these GMAC exemptions without imposing collateral requirements or duration limits usually demanded as conditions for § 23A exemptions, arguably making "it clear that the macro-economic goal of saving the U.S. automotive industry justified a complete override of section 23A."[415]

The Dodd-Frank Act included several provisions designed to expand and strengthen § 23A restrictions on transactions between FDIC-insured banks and their nonbank affiliates.[416] Under the new rules, the Federal Reserve Board's finding that a § 23A exemption is in the public interest and consistent with the purposes of § 23A[417] will not ultimately result in an exemption unless the Board notifies the FDIC of its finding, and the latter fails to object within sixty days on the grounds that the "exemption presents an unacceptable risk to the Deposit Insurance Fund."[418] In other words, the FDIC has effective veto power over Federal Reserve Board § 23A exemptions.

Despite these new statutory hurdles, the Federal Reserve retains its basic § 23A exemptive authority. As a practical matter, these new limitations are unlikely to substantially restrain regulators' future use of

§ 23A exemptions as a tool to provide indirect bailout-type assistance in times of severe economic distress. As Professor Saule Omarova observes, to the extent the § 23A firewall "inevitably disappears in time of

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413. *See, e.g.*, Letter from Robert deV. Frierson, Deputy Sec'y of the Bd., Fed. Reserve Bd. to Carl Howard, Gen. Counsel, Citigroup (Oct. 23, 2007), *available at* http://www.federalreserve.gov/boarddocs/legalint/FederalReserveAct/2007/20071023/20071023.pdf (Citigroup § 23A exemption to engage in securities financing transactions); Letter from Robert deV. Frierson, Deputy Sec'y of the Bd., Fed. Reserve Bd. to H. R Rodgin Cohen, Esq. (Dec. 29, 2008), *available at* http://www.federalreserve.gov/boarddocs/legalint/FederalReserveAct/2008/20081229/20081229.pdf (Wachovia Bank § 23A exemption to purchase auction-rate securities for affiliate, noting that proposal is a "result of ongoing turmoil in financial markets"); Letter from Jennifer J. Johnson, Sec'y of the Bd. Fed. Reserve Bd to Patrick S. Antrim, Esq., Ass't Gen. Counsel (Jan. 23, 2007), *available at*, http://www.federalreserve.gov/boarddocs/legalint/FederalReserveAct/2007/20070123/20070123.pdf (Bank of America § 23A exemption for securities lending program with broker-dealer affiliate)

414. *See, e.g.*, Letter from Robert deV. Frierson, Deputy Sec'y of the Bd., Fed. Reserve Bd. to Richard K. Kim, Esq. (May 21, 2009), *available at* http://www.federalreserve.gov/boarddocs/legalint/federalreserveact/2009/20090521/20090521.pdf (Ally Bank § 23A exemption to permit customer loans to purchase automobiles from unaffiliated dealers).

415. Omarova, *Gramm-Leach-Bliley*, *supra* note 402, at 1760.

416. For a general description of these changes, see *id.*, at 1763–68.

417. 12 U.S.C. § 371c(f)(2) (required Federal Reserve finding for § 23A exemptions).

418. Dodd-Frank Act § 608(a)(4)(A), 124 Stat. 1610 (codified at 12 U.S.C. § 371c(f)(2)).

financial stress, tightening individual requirements of the statute is not likely to make the firewall strong enough to withstand the next crisis."[419]

3. Tax Forbearance

Forbearance actions with the potential to impose measurable budgetary cost are not limited to financial regulators. When the government intervenes in private markets in times of financial distress by extending tax breaks to struggling businesses or investors, the "costs" in revenue foregone are just as real as comparable direct government expenditures. To the extent that the government relinquishes its claim to tax revenues, the government itself is effectively assuming a portion of the otherwise private risk of loss. Although they received far less public attention, tax breaks were an important part of the government's response to the Great Recession. For example, financial institutions with significant losses from sales of Fannie Mae and Freddie Mac preferred stock were given special tax breaks allowing them to deduct such losses from their ordinary income, a deduction that was not otherwise permissible under the regular tax rules.[420]

Another substantial tax break used to assist struggling firms during the recent crisis was a dramatic loosening of rules otherwise restricting an acquiring company's ability after an "ownership change" to offset income with the net operating losses (NOLs)[421] of an acquired company.[422] Absent special tax relief, for example, the transfer of old GM stock to new GM, a new entity created for purposes of GM's restructuring in bankruptcy,[423] would have been considered an "ownership change," triggering Internal Revenue Code § 382 loss limitation rules, thus preventing new GM from using old GM's losses. Congress responded with a statutory amendment permitting new GM to use old GM's NOLs.[424]

419. Omarova, *Gramm-Leach-Bliley*, *supra* note 402, at 1691.

420. Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, § 301(a), 122 Stat. 3765, 3802 (codified at 12 U.S.C. § 5261 (2006)); *see also id.* § 301(b)(2) (defining eligible preferred stock to include Fannie Mae and Freddie Mac stock held by a qualified financial institution on September 6, 2008, or sold or exchanged on or after January 1, 2008, and before September 7, 2008).

421. *See* 26 U.S.C. § 172(c) (defining NOL as "the excess of the deductions allowed . . . over gross income"); *id.* § 172(a) (general rule permitting two-year NOL carryback and twenty-year NOL carryforward).

422. 26 U.S.C. § 382(a), (b). *See also id.* § 382(g) (defining "ownership change" as any increase by more than fifty percentage points of any five percent shareholder, within a specified testing period).

423. *See infra* notes 453–63 for further discussion of General Motors bankruptcy.

424. American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, § 1262, 123 Stat. 115, 225, 343–44 (loss limitation not applicable to ownership change "pursuant to a restructuring plan" that was "required under a loan agreement or a commitment for a line of credit entered into with the Department of Treasury" under EESA). Though the statute did not mention GM by name, its narrow terms made it clear that it was drafted to provide additional General Motors bailout-type relief. *See, e.g.*, David M. Herszenhorn, *Even After the Deal, Tinkering Goes On*, N.Y. TIMES, Feb. 13, 2009, at A20 (reporting new "tax break specifically intended for the failing auto

The Treasury Department also provided substantial assistance to struggling companies through liberal use of its authority to interpret the § 382 NOL limitation rules. One such IRS notice, apparently written with Citigroup in mind, liberally interpreted § 382 to allow NOL deductions that otherwise would have been impermissible.[425] Reacting to the "Citigroup" and other similar notices, one tax expert commented, "I've been doing taxes for almost 40 years, and I've never seen anything like this, where the IRS and Treasury acted unilaterally on so many fronts."[426] A similar IRS notice issued during the recent economic crisis was the Treasury Department's special tax ruling facilitating Wells Fargo's acquisition of the failing Wachovia by allowing Wells Fargo to deduct otherwise impermissible Wachovia NOLs against its own income.[427]

4. Government Loan, Loan Guarantees, Stock Purchases, and Nationalization

a. Federal Loans and Loan Guarantees—Equity Purchases as "Loans"

Direct bailout-type assistance to struggling businesses has often taken the form of federal loans or loan guarantees.[428] As an alternative to direct lending, the government can effectively provide cash "loans" to struggling

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giant General Motors"). *See also* JOINT COMM. ON TAXATION, JCX-18-09, ESTIMATED BUDGET EFFECTS OF THE REVENUE PROVISIONS CONTAINED IN THE "AMERICAN RECOVERY AND REINVESTMENT ACT OF 2009" (Feb. 12, 2009) (estimating cost of GM provision at approximately $3.2 billion revenue foregone from 2009–2019).

425. I.R.S. Notice 2010-2, 2010-2 I.R.B. 251; *see also* CONG. OVERSIGHT PANEL, JANUARY OVERSIGHT REPORT: EXITING TARP AND UNWINDING ITS IMPACT ON THE FINANCIAL MARKETS 20 (2010) (describing notice as "additional subsidy to Citigroup and a loss to the taxpayers").

426. Binyamin Appelbaum, *Tax Deal is Worth Billions to Citigroup; Deal Made to Recover Bailout Firms Exempted from Rule When U.S. Sells its Stake*, WASH. POST, Dec. 16, 2009, at A1 (quoting Robert Willens). More recently, when AIG finally reported a nearly $20 billion quarterly profit after earlier receiving substantial ad hoc and TARP government assistance, see *supra* note 127, former appointees of the TARP Congressional Oversight Panel noted that $17.7 billion of the "profit" came from liberal tax breaks allowing its otherwise impermissible NOLs, and referred to the tax break as a "stealth bailout." Jim Puzzanghera, *Former Bailout Watchdogs Criticize AIG Tax Break*, L.A. TIMES, Mar. 13, 2012, at B5.

427. *See* Amit R. Paley, *A Quiet Windfall for U.S. Banks: With Attention on Bailout Debate, Treasury Made Change to Tax Policy*, WASH. POST, Nov. 10, 2008, at A1 (quoting the Jones Day law firm as saying that the ruling "could be worth about $25 billion for Wells Fargo"). For a more detailed discussion of the Wells Fargo tax break and its implications, *see* Block, *Measuring Bailout Cost*, *supra* note 8, at 218−20.

428. In 2008, for example, the Federal Reserve made an initial $85 billion loan to avoid the imminent collapse of American International Group (AIG). Press Release, Bd. of Governors of the Fed. Reserve Sys. (Sept. 16, 2008), *available at* http://www.federalreserve.gov/newsevents/press /other/20080916a.htm. *See also* WEBEL, *supra* note 286. Earlier instances of emergency government loans include Chrysler, Chrysler Corporation Loan Guarantee Act of 1979, Pub. L. No. 96-185, 93 Stat. 1324 (1980) (codified in various sections of 15 U.S.C.), and Lockheed. Emergency Loan Guarantee Act, Pub. L. No. 92-70, 85 Stat. 178 (1971) (codified at 15 U.S.C.A. §§ 1841−1852).

corporate entities by purchasing an equity interest in the corporation's preferred stock. In such cases, the government does not intend to maintain a long-term equity interest. As a practical matter, the government equity purchase functions as a loan, which is repaid upon the corporation's subsequent redemption of the stock for cash, or when the government otherwise sells the stock.[429] Although the recent TARP "bailout" program originally called for the government to purchase "bad assets" from struggling banks, thereby leaving the banks with only their healthy assets, the Treasury Department ultimately "abandoned its original strategy, . . . deciding instead to invest money directly into [the struggling institutions]."[430] In the end, much of the government's assistance to struggling banks during the Great Recession actually took the form of government preferred stock purchases.[431]

Consistent with its anti-bailout rhetoric, Dodd-Frank not only significantly limited regulators' authority to make emergency loans,[432] but further prohibited the government from taking "an equity interest in or becom[ing] a shareholder of any covered company or any covered subsidiary."[433] Though the Federal Reserve is no longer authorized to make emergency loans to individual institutions, it can still make loans to eligible institutions through the regular discount window. In effect, the Dodd-Frank restrictions have simply made it more difficult for others in similar circumstances to do the same, thus raising the issue on unequal access.

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429. For example, the government was effectively "repaid" some of its General Motors assistance when the Treasury Department sold some of its GM stock in a GM initial public offering (IPO). *See* GEN. ACCOUNTABILITY OFFICE, TROUBLED ASSET RELIEF PROGRAM: AS TREASURY CONTINUES TO EXIT PROGRAM, OPPORTUNITIES TO ENHANCE COMMUNICATION ON COSTS EXIST 8, GAO-12-229 (2012) [hereinafter GAO, TARP EXIT] (describing Treasury Department's unwinding part of its GM assistance by participating in GM initial public offering). *See also* Block, *Measuring Bailout Cost*, *supra* note 8, at 198.

430. Cong. Oversight Panel, February Oversight Report: Valuing Treasury's Acquisitions 4 (2009).

431. One of the largest TARP programs, for example, was the Capital Purchase Program (CPP), through which the Treasury Department purchased senior preferred equity and subordinated debentures. OFFICE OF FIN. STABILITY, U.S. DEP'T OF THE TREASURY, AGENCY FINANCIAL REPORT: FISCAL YEAR 2009, 14–15 (2009).

432. *See supra* notes 265–67, and accompanying text.

433. Dodd-Frank Act § 206(6), 124 Stat. 1459 (codified at 12 U.S.C. § 5386) (prohibiting FDIC use of orderly liquidation authority to take "an equity interest in or become a shareholder of any covered company or any covered subsidiary"). Though this provision is included in the orderly liquidation title, it represents more broadly, I think, hostility to and backlash against the government's acquisition of bank equity interests through its 2008 TARP rescues.

b. Government as Creditor with Effective Control in "Private" Bankruptcy

When the government itself is a creditor of the bankrupt debtor, its role in the bankruptcy proceeding is more than simply administrative.[434] In particular, the auto industry bankruptcies during the recent economic crisis provide an excellent illustration of the extent to which the government's creditor role can alter bankruptcy dynamics and accomplish results more akin to continuing direct government assistance to a private failing firm than to bankruptcy.[435] Prior to the Chrysler and GM bankruptcy filings, the Bush administration Treasury Department had already provided both companies with TARP loans,[436] which were conditioned on a deadline by which Chrysler and GM were required to submit viable restructuring plans.[437] When the required viability plans, which included requests for additional assistance, were ultimately submitted to the Obama administration, President Obama announced that "neither goes far enough to warrant the substantial new investments that these corporations are requesting."[438] At the same time, the President proclaimed that "[w]e cannot, and must not, and we will not let our auto industry simply vanish."[439] Though falling short of a direct declaration of systemic importance, these and other government statements suggest a "too important" or "too-big-to-fail" reasoning behind the auto industry rescue measures. The President gave Chrysler and GM limited additional time to continue work on restructuring, but nonetheless anticipated that such continued efforts might not succeed. Hinting at the resolution response

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434. For purposes of this discussion, references to the government as creditor are limited to its claims other than tax claims against the bankrupt debtor (e.g., debtor obligations on federal loans and other non-tax obligations).

435. For detailed discussion of the 2008 auto industry crisis and development of reorganization plans, see STEPHEN COONEY ET AL., CONG. RESEARCH SERV., R40003, U.S. MOTOR VEHICLE INDUSTRY: FEDERAL FINANCIAL ASSISTANCE AND RESTRUCTURING (2009) [hereinafter CRS, MOTOR VEHICLE INDUSTRY]; CONG. OVERSIGHT PANEL, SEPTEMBER OVERSIGHT REPORT: THE USE OF TARP FUNDS IN THE SUPPORT AND REORGANIZATION OF THE DOMESTIC AUTOMOTIVE INDUSTRY 7–23 (2009) [hereinafter OVERSIGHT PANEL, AUTOMOTIVE INDUSTRY REP.].

436. Chrysler had previously received federal government assistance in the late 1970s. Chrysler Corporation Loan Guarantee Act of 1979, Pub. L. No. 96-185, 1324 Stat. 1324. For an excellent review of this earlier auto industry "bailout," see ROBERT B. REICH & JOHN D. DONAHUE, NEW DEALS: THE CHRYSLER REVIVAL AND THE AMERICAN SYSTEM (1985).

437. *See* CRS, MOTOR VEHICLE INDUSTRY, *supra* note 435, at 8–10, 27–29, 41–48 (description of viability plan, executive compensation, labor renegotiations, and other Chrysler and General Motors TARP loan conditions).

438. Barack Obama, U.S. President, Remarks by the President on the American Automotive Industry, 2009 DAILY COMP. PRES. DOC. 199 (Mar. 30, 2009), *available at* http://www.whitehouse.gov/the_press_office/Remarks-by-the-President-on-the-American-Automotive-Industry-33009. *See also* OVERSIGHT PANEL, AUTOMOTIVE INDUSTRY REP., *supra* note 435, at 10–13 (describing President Obama's interagency Task Force on the Auto Industry findings on submitted viability plans).

439. Obama, *supra* note 438.

ultimately used to rescue the two failing auto companies,[440] he noted that both

> need a fresh start to implement the restructuring plan they develop. That may mean *using our bankruptcy code as a mechanism* to help them restructure quickly and emerge stronger. . . . . What I'm talking about is *using our existing legal structure as a tool that, with the backing of the U.S. Government, can make it easier for General Motors and Chrysler to quickly clear away old debts that are weighing them down so that they can get back on their feet and onto a path to success. . .*[441]

Exactly as anticipated by these remarks, the government in the end *used the existing private bankruptcy legal regime* to structure Chrysler and GM reorganizations that bore little or no resemblance to ordinary Chapter 11 bankruptcies. As a practical matter, these bankruptcies were "functionally equivalent" to similar government assistance provided to other private failing firms through ad hoc interventions, or as part of the overall so-called TARP "bailout" program.[442]

In anticipation of Chrysler's Chapter 11 bankruptcy filing, U.S. officials led negotiations with Italian auto manufacturer, Fiat, the United Auto Workers Union (UAW), and the Canadian government to arrange a pre-packaged § 363 bankruptcy sale of "old" Chrysler's assets to "New Chrysler," a "shell" entity created solely for purposes of the bankruptcy sale.[443] On the same day that Chrysler filed its bankruptcy petition,[444] the White House announced that "as a result of the sacrifices by key stakeholders and *a substantial commitment of U.S. government resources*," the government had reached agreement with Chrysler, Fiat, and key stakeholders regarding the terms of a Chrysler § 363 bankruptcy sale.[445] Remarkably, the sale closed only forty-two days later.[446] In exchange for working capital and other financing, the U.S. government took an eight percent equity interest in "New Chrysler" and the right to select four

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440. *See* OVERSIGHT PANEL, AUTOMOTIVE INDUSTRY REP., *supra* note 435, at 35 (explaining decisions of both companies to file for bankruptcy was prompted by government response to viability plans).

441. *Id.* (emphasis added).

442. *See supra* notes 117–24.

443. *See supra* notes 343–46 and accompanying text (discussion of § 363 sales in private bankruptcy). For a short description of the auto industry bankruptcy details, and the difference between § 363 sales and traditional Chapter 11 bankruptcy, see Stephen B. Selbst, *General Motors and Chrysler: The Changing Face of Chapter 11*, COMMERCIAL LENDING REV. 3 (Nov.-Dec. 2009) [hereinafter Selbst].

444. Voluntary Petition at 1, *In re* Chrysler LLC, 405 B.R. 84 (Bankr. S.D.N.Y. 2009) (No. 09 B 50002(AJG)).

445. Press Release, The White House, Office of the Press Sec'y, Obama Administration Auto Restructuring Initiative Chrysler-Fiat Alliance (Apr. 30, 2009)(emphasis added) *available at* http://www.whitehouse.gov.the_press_office/Obama-Administration-Auto-Restructuring-Initiative/.

446. OVERSIGHT PANEL, AUTOMOTIVE INDUSTRY REP., *supra* note 435, at 13.

independent directors.[447] Other important components of the Chrysler bankruptcy and § 363 sale included: (1) forfeitures by "Old Chrysler" shareholders of their equity interests; (2) substantial waivers by second-lien debt holders; (3) funding of retiree and medical benefits trusts with an unsecured note and a fifty-five percent equity interest in New Chrysler; and (4) a twenty percent New Chrysler equity interest to Fiat in exchange for technical know-how, with Fiat rights to acquire an additional fifteen percent upon meeting specified performance standards.[448]

General Motors filed for bankruptcy shortly after Chrysler.[449] Prior to filing, GM had already borrowed substantial amounts from the Treasury Department through the TARP program.[450] In exchange for this prior financial assistance, the Treasury Department had received various claims, including warrants to acquire GM common stock. Immediately after GM's bankruptcy filing, the government also extended new "debtor-in-possession" priority loans to "old GM." Shortly thereafter, "old GM" transferred substantially all of its assets in a pre-packaged § 363 bankruptcy sale, with substantial financing from the U.S. and Canadian governments. As part of the transaction, the U.S. government assigned its debtor claims and warrants to acquire GM common stock in exchange for cumulative preferred GM shares and an over *sixty percent* interest in GM common stock.[451] Remarkably, the Treasury Department reported in recent financial statements that it considers the GM stock received in exchange for these assignments of claims and warrants in the bankruptcy sale as "recoveries of the original loans for subsidy cost estimation purposes."[452] In other words, because the § 363 exchange effectively extinguished the government's claims for repayment of prior "bailout-type" loans, the government considers those loans "repaid." This description is technically accurate to the extent that the government relinquished its formal "creditor" status. At the same time, however, the § 363 sale effectively converted the government from creditor to majority equity owner. More simply put, GM had become a government-owned company.[453] Any claim under these

447. *Id.* at 14. The Canadian and Ontario governments also made contributions in exchange for a two percent interest. *Id.* Its pre-bankruptcy TARP loans made the U.S. government a regular Chapter 11 creditor. More important, the government's substantial *post*-petition financing made it a "debtor-in-possession" (DIP) with special bankruptcy code priority. 11 U.S.C. § 364.

448. OVERSIGHT PANEL, AUTOMOTIVE INDUSTRY REP., *supra* note 435, at 14.

449. Voluntary Petition at 1, *In re* General Motors Corp., 409 B.R. 24 (Bankr. S.D.N.Y. 2009) (No. 09–50026 (REG)).

450. *See supra* note 124.

451. The remainder of new GM's common stock was distributed to a UAW trust and to old GM unsecured creditors. *See* OVERSIGHT PANEL, AUTOMOTIVE INDUSTRY REP., *supra* note 434, at 19–20 (describing GM § 363 sale). The government also was entitled to appoint new GM directors.

452. U.S. Dep't of Treasury, 2011 Financial Report of the United States Government 72 (2011).

453. The U.S. government no longer holds a majority equity stake in GM. As a participant in GM's November, 2010 initial public offering (IPO), the Treasury Department sold enough of its

circumstances that GM had repaid its obligations to the government is misleading and even disingenuous.

Although not explicitly part of the § 363 bankruptcy sale or the government's prior assistance to GM, a series of related transactions with GMAC should be considered part of the overall GM rescue plan.[454] Originally an in-house GM financial services arm established to provide financing to customers and dealers, GMAC was later spun off as an independent entity.[455] Over time, GMAC expanded into other financial markets, to become the nation's fourteenth largest bank holding company.[456] When GMAC faced imminent bankruptcy during the 2008 economic crisis, the Treasury Department provided an initial $5 billion capital contribution through the TARP program in exchange for GMAC preferred stock.[457] As a result of several complex transactions involving additional substantial capital infusions,[458] and conversions of various government-held GMAC interests into common stock,[459] the Treasury Department ultimately came to own seventy-four percent of GMAC's common stock, making GMAC a government-owned company.[460]

GM stock at $33 per share to reduce the government's equity interest in GM from 61 percent to 26 percent. *See* Michael J. de la Merced & Bill Vlasic, *U.S. Recovers Billions in Sale of G.M. Stock*, N.Y. TIMES, Nov. 18, 2010, at A1. As a result of these IPO stock sales, the government recouped some of its GM "bailout costs." However, the government reportedly will need to sell its remaining GM stock at an average price of $53 per share to "break even" on its investment in GM. *Id.*

454. In fact, the Treasury Department defended its assistance to GMAC "as crucial to supporting its extensive investments in GM and Chrysler . . . ." OVERSIGHT PANEL, GMAC REP., *supra* note 403, at 66.

455. OVERSIGHT PANEL, GMAC Rep., *supra* note 403, at 1.

456. *Id.* As a non-depository institution, GMAC did not initially meet the statutory definition of a BHC. *See supra* notes 443–444 and accompanying text (regarding GMAC's conversion to BHC status).

457. Press Release, U.S. Department of the Treasury, Treasury Announces TARP Investment in GMAC (Dec. 29, 2008), *available at* http://www.treasury.gov/press-center/press-releases/Pages /hp1335.aspx.

458. Press Release, U.S. Department of the Treasury, Treasury Announces Additional Investment in GMAC LLC (May 21, 2009) (announcing $7.5 billion Treasury Department investment) *available at* http://www.treasury.gov/press-center/press-releases/Pages/tg154.aspx. Press Release, U.S. Department of the Treasury, Treasury Announces Restructuring of Commitment to GMAC (Dec. 30, 2009) (announcing $3.8 billion contribution of new capital), *available at* http://www.treasury.gov/press-center/press-releases/pages/tg501.aspx.

459. For a detailed description and analysis of Treasury Department GMAC capital contributions and conversions of government-held GMAC interests into common stock, see OVERSIGHT PANEL, GMAC REP., *supra* note 403, at 36–46. GMAC "rebranded its corporate entity" and changed its name to Ally Financial, Inc., effective May 10, 2010. *See* Aparajita Saha-Bubna & Nathan Becker, *GMAC Posts Profit; Renaming Itself Ally*, WALL. ST. J., May 4, 2010, at C4.

460. At the time of the Congressional Oversight Panel's GMAC report, the Treasury Department's stake in GMAC common stock was 56.3 percent. OVERSIGHT PANEL, GMAC REP., *supra* note 403, at 411. The government's common stock interest in GMAC increased to 74 percent when it later converted additional preferred shares into common stock. *See* Press Release, U.S. Department of the Treasury, Treasury Converts Nearly Half of its Ally Preferred Shares to

Both of the recent auto industry § 363 bankruptcy sales generated significant controversy. The Chrysler sale in particular contained several unusual features that many found troubling, including Fiat's receipt of a substantial managerial and equity interest without any cash contribution, first-lien holder repayments of only thirty cents on the dollar, and unsecured supplier creditor repayments in full, leaving other unsecured claim holders with little likelihood of payment.[461] Stated more generally, the complaint was that the "federal government used the value of its prepetition emergency loans and its DIP [debtor-in-possession] loan and political power to buy Chrysler and distribute its value as it saw fit among the creditor constituencies."[462] Several Indiana state employee pension funds, which held Chrysler first-lien secured debt, objected to Chrysler's § 363 sale on the grounds that it violated statutory creditor protections by paying junior claim holders and unsecured trade creditors without paying secured creditors in full.[463] In a decision subsequently upheld by the Second Circuit and the Supreme Court, the Bankruptcy Court rejected the pension funds' argument that the § 363 sale was really a de facto or *sub rosa* plan of reorganization, which should not be permitted to by-pass creditor protection and court confirmation requirements otherwise applicable to reorganization plans.[464]

Controversy over whether the GM and Chrysler § 363 sales should have been treated as de facto reorganization plans,[465] and debate over what these precedents auger for the future of Chapter 11 bankruptcy undoubtedly

Common Stock (Dec. 30, 2010) (announcing conversion of $5.5 billion preferred into common), *available at* http://www.treasury.gov/press-center/press-releases/pages/tg1014.aspx.

461. *See, e.g.*, Selbst, *supra* note 443, at 4.

462. *Id.* (footnote omitted).

463. *In re* Chrysler LLC, 405 B.R. 84, 93 (Bank. S.D.N.Y. 2009), *aff'd*, 576 F.3d 108 (2d Cir. 2009), *aff'd per curiam sub nom,* Indiana State Police Pension Trust v. Chrysler LLC, 556 U.S. 960 (2009) *vacated*, 130 S. Ct. 1015 (2009), *remanded sub nom. In re* Chrysler LLC, 592 F.3d 370 (2d Cir. 2010).

464. 576 F.3d 108, *supra* note 466, at 118. In a series of unusual rulings, the Supreme Court allowed the Chrysler sale to go through, but vacated the Second Circuit's opinion. *See* Fred N. David, *Interpreting the Supreme Court's Treatment of the Chrysler Bankruptcy and its Impact on Future Business Reorganizations*, 27 EMORY BANK. J. 25 (2010) (interpretation of the Supreme Court's temporary stay, vacating the stay, and subsequently vacating and remanding to the Second Circuit).

465. Barry E. Adler, *A Reassessment of Bankruptcy Reorganization After Chrysler and General Motors*, 18 AM. BANKR. INST. L. REV. 305, 308 (2010) ("[v]iewed another way, the approved transaction was not a sale at all, but a disguised reorganization plan . . . ."); Mark K. Roe & David Skeel, *Assessing the Chrysler Bankruptcy*, 108 MICH. L. REV. 727, 759–60 (2010) [hereinafter, Roe & Skeel] (sale "determined so many plan terms that are typically governed by § 1129 that it was a sub rosa plan of reorganization . . . ."). *But see* Stephen J. Lubben, *No Big Deal: The GM and Chrysler Cases in Context*, 83 AM. BANKR. L.J. 531, 532 (2009) (arguing that GM and Chrysler § 363 sales were "entirely within the mainstream of chapter 11 practice for the last decade"). For earlier discussion of § 363 sales as potential *sub rosa* plans, see *supra* 345–47 and accompanying text.

will continue.[466] In the meantime, the important point for purposes of this Article is that the 2009 auto industry bankruptcies were arguably functionally equivalent to other government "bailout-type" assistance during the same period through TARP loans and other ad hoc rescue measures.[467] This functional equivalence is especially striking in connection with the overall auto industry rescue itself, in which the government took a 61 percent equity interest in GM after a forced, prearranged § 363 bankruptcy sale, and a 74 percent equity stake in GMAC in exchange for more direct government loans. Though it took no position on whether the government should have provided rescue assistance to GMAC, the Congressional Oversight Panel established to review and report on TARP loans and related activities,[468] noted the different approaches taken to assist auto companies GM and Chrysler as opposed to GMAC. With regard to GMAC, for example, the Panel found that

> Treasury missed opportunities to increase accountability and better protect taxpayers' money. Treasury did not, for example, condition access to TARP money on the same sweeping changes that it required from GM and Chrysler; it did not wipe out GMAC's equity holders; nor did it require GMAC to create a viable plan for returning to profitability . . . .
>
> Moreover, the Panel remains unconvinced that bankruptcy was not a viable option [for GMAC] in 2008.[469]

In assessing government assistance policies adopted during the most recent economic crisis, it is important to acknowledge that the end result in these bankruptcies was not substantially different from other government-facilitated economic rescues. This is one example of what I refer to as "functional equivalence." When the same substantive end result can be achieved through multiple avenues, it is important to examine any inconsistencies in the process, and determine why one was chosen over the other. This is especially important in the interest of horizontal equity—the idea that those similarly situated should be treated alike.

5. Government-Controlled Corporations

Nationalization, of course, constitutes the extreme public end of the private-public risk allocation continuum. Many countries have adopted this

466. *See* Roe & Skeel, *supra* note 465.

467. Several commentators have referred to the 2009 auto industry Chapter 11 bankruptcies as "bailouts." *See, e.g.*, *id.* at 728 (noting about the auto industry collapse: "Never before had the government used bankruptcy to bail out a major industrial corporation."); Levitin, *supra* note 8, at 487 ("The way the Treasury handled GM and Chrysler provoked significant protest because the Bankruptcy Code was used to facilitate what was properly perceived as a bailout.").

468. EESA §125(b)(1), 122 Stat. 3791 (codified at 12 U.S.C. § 5233).

469. OVERSIGHT PANEL, GMAC REP., *supra* note 403, at 4. *See also id.* at 83–88 (assessing Treasury Department explanations for not using Chapter 11 bankruptcy and § 363 sales similar to those used for Chrysler and GM in connection with GMAC).

approach to imminent major bank collapses by temporarily nationalizing failing banks.[470] In the U.S., the most overt nationalization response to the recent economic crisis was the placement of mortgage giants, Fannie Mae and Freddie Mac, in conservatorship.[471] Though privately owned and operated, Fannie Mae and Freddie Mac are government-sponsored enterprises (GSEs)—federally chartered entities that are "limited [in] their activities to certain economic sectors deemed worthy of public support, and [given] certain advantages to help accomplish their public purposes."[472] Fannie Mae and Freddie Mac in particular were "created to provide liquidity and stability in the home mortgage market, thereby increasing the flow of funds available to mortgage borrowers."[473]

Given that GSEs are federally chartered, their nationalization in times of significant economic distress may not be surprising. On the other hand, government takeovers of other types of private business would likely strike most observers as extraordinary. Although officials did not refer to them as such, several government interventions during the Great Recession certainly had the flavor of nationalization. For example, GM's 2009 bankruptcy was structured to provide the U.S. government with a controlling equity interest in the recapitalized GM.[474] While the Treasury Department no longer owns a controlling interest, it retains a substantial proportion of GM stock, and

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470. *See, e.g.*, David Jolly, *Austria Takes Over Bank as it Teeters on the Brink*, N.Y. TIMES, Dec. 15, 2009, at B9; Carter Dougherty, *Sweden's Fix for Banks: Nationalize*, N.Y. TIMES, JAN. 23, 2009, at B1; Sarah Lyall, *Iceland, Bankrupt and Looking for Help*, N.Y. TIMES, Nov. 2, 2008, Nov. 2, 2008, at A6 (referring to Iceland's takeover of two the the country's three largest banks). See also Randall D. Guynn, *The Global Financial Crisis and Proposed Regulatory Reform*, 2010 B.Y.U. L. Rev. 421, 45 (2010) 459-60 (discussing EU countries passing or considering special resolution regimes to take over failing banks during recent economic crisis).

471. *See* Housing and Economic Recovery Act of 2008, Pub. L. No. 110-289, § 1117, 122 Stat. 2654, 2683–88 (creating new Federal Housing Finance Agency (FHFA) within the Treasury Department as independent regulator with authority to take control of the housing-related GSEs); Press Release, U.S. Dep't of the Treas., Statement by Secretary Henry M. Paulson, Jr. on Treasury and Federal Housing Finance Agency Action to Protect Financial Markets and Taxpayers (Sept. 7, 2008), *available at* http://www.treasury.gov/press-center/press-releases/Pages/hp1129.aspx (announcing FHFA conservatorship over Fannie Mae and Freddie Mac, thus transferring complete control from the shareholders to the government). For general discussion of the implicit GSE guarantee, *see* Carol J. Perry, *Rethinking Fannie and Freddie's New Insolvency Regime*, 109 COLUM. L. REV. 1752, 1760–61 (2009).

472. U.S. Gen. Accounting Office, GSEs: Recent Trends and Policy, GAO/T-OCE/GGD-97-76, at 1 (July 1997). Special advantages available to GSEs include tax exemptions, SEC registration requirement exemptions, special access to Treasury Department lines of credit, and investor perceptions of implicit government guarantees. *Growing Role of GSEs in the Nation's Credit Markets: Hearings Before the House Subcomm. on Capital Markets, Securities, and Gov't. Sponsored Enterprises, Comm. on Banking and Financial Services*, 106th Cong. 7-30 (1997) (statement of James L. Bothwell, GAO, Chief Economist).

473. CONG. BUDGET OFFICE, U.S. CONG., FEDERAL SUBSIDIES AND THE HOUSING GSES 10 (May 2001).

474. *See supra* notes 449–50, and accompanying text.

still holds a controlling interest in GMAC, now renamed Ally Bank.[475] In addition, some have argued that financial instruments and stock received by the government in exchange for its financial assistance to Citigroup and Bank of America during the recent crisis at least temporarily gave the government controlling stakes in the banks, thus functioning as a "weird, shadow nationalization."[476]

I contend that is important to recognize transactions that have the practical effect of nationalizing or otherwise providing the government with a substantial equity stake in a private business for what they are. In other words, they should be regarded as government interventions located on the far public end of the private-public risk continuum. I do not mean here to make any judgments about whether such transactions are good or bad under any particular circumstances of financial distress. I argue that we should treat functionally equivalent types of government intervention or assistance alike so as to provide similar access—as well as comparable substantive and procedural rights and protections—to all relevant parties, including general taxpayers. Different intervention categories along the private-public continuum can raise different sets of policy issues. With regard to nationalization in particular, the U.S. government has little past experience addressing the host of issues regarding the scope of the government's corporate management role when it owns a substantial equity stake in an otherwise private business. One lesson from the recent economic crisis is that we should at least anticipate the possibility of such government interventions in extreme cases and begin to address potential policy questions when policy makers are not operating in crisis mode.

CONCLUSION

According to some reports, public anger over 2008 bipartisan bailout legislation was so intense that "lawmakers from both parties who backed it remain[ed] haunted by the vote."[477] This anti-bailout political climate so

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475. *See supra* note 414, and accompanying text.

476. Edmund L. Andrews, *Nationalization Hinted in Rescues*, N.Y. TIMES, Jan. 16, 2009, at B1 (quoting Karen Shaw Petrou, consulting firm Federal Financial Analytics managing partner); Marvel Kahan & Edward B. Rock, *When the Government in the Controlling Shareholder*, 89 TEX. L. REV. 1293 (2011). *See also* U.S. GEN. ACCOUNTING OFFICE, FINANCIAL ASSISTANCE: ONGOING CHALLENGES, AND GUIDING PRINCIPLES RELATED TO GOVERNMENT ASSISTANCE TO PRIVATE SECTOR COMPANIES, GAO-10-719 20-35 (2010) (describing different levels of government officials' involvement in private corporate management depending upon type and amount of the government's debt or equity interest received in exchange for financial assistance).

477. Carl Hulse & David M. Herszenhorn, *Bank Bailout is Potent Issue for Fall Races*, N.Y. TIMES, July 11, 2010, at A1. In fact, such "deep-seated resentment . . . factored into the anti-Washington, anti-incumbent sentiment so prominent in [the 2010] midterm elections, in which a yes vote on TARP has proven to be its own toxic asset." Brady Dennis, *TARP at Two: Officials Assess Bailouts*, WASH. POST, Oct. 1, 2010, at A16 (referring to the Troubled Asset Relief Program (TARP) enacted as part of the 2008 so-called "bailout" legislation, Emergency

dominated congressional consideration of financial reforms that post-Dodd-Frank *resolution* authority—at least on the theoretical surface—now offers regulators little leeway to take any action other than overseeing liquidation of systemically important financial institutions. In other words, government "rescue" assistance to individual large banks or systemically important financial institutions in danger of default is no longer sanctioned.

In contrast, the post-Dodd-Frank financial regime places considerably more faith in *regulatory* responses to systemic risk.[478] In principle, prudential financial regulations are designed to increase in stringency along a risk-based continuum. These principles have a long history for depository institutions and commercial banks. Dodd-Frank's expanded prudential regulatory authority over large BHCs and systemically important nonbank financial companies also theoretically incorporates prudential regulation requirements that increase with risk. On the other hand, the statutory provisions themselves include some unusual and unfortunate cliff effects, which interrupt the flow of the risk-based continuum.

Regulators may be reasonably diligent in regulating small to medium-sized financial institutions by increasing monitoring and enforcement as bank health deteriorates. On the other hand, regulators face various incentives to resist early intervention as problems become apparent at large, interconnected financial institutions.[479] Regulators' inclinations to lax enforcement, delayed intervention, or even loans through the Federal Reserve's discount window for large, troubled, and interconnected banks facilitate continued operation of such struggling financial institutions. In the event that the troubled institution reaches the point of imminent collapse, regulators face a binary choice: allow the bank to fail and suffer whatever systemic harms might result, or go through the complex systemic risk determination procedure, thus placing the bank in receivership and foreclosing any further efforts to preserve the entity. In fact, the procedural

Stabilization Act of 2008, Pub. L. No. 110-343, tit. I, §§ 101136, 122 Stat. 3765 (codified at 12 U.S.C. §§ 5211–5241)). Ultimate costs for the 2008 legislation are estimated to be much less than the originally allocated $700 billion. In March 2011, the Congressional Budget Office's ("CBO") lifetime TARP costs estimate was $19 billion, which was $6 billion less than its November 2010 estimate. CONG. BUDGET OFFICE, REPORT ON THE TROUBLED ASSET RELIEF PROGRAM – MARCH 2011 1 (2011). Several individual government "rescue" programs even generated government profits. As of March 2011, for example, CBO estimated a $16 billion net government profit from TARP's Capital Purchase Program ("CPP"). *Id.* at 4.

478. For similar observations about the emphasis on regulation rather than resolution, *see* Coffee, *supra* note 13, at 797 (describing Dodd-Frank as "invest[ing] heavily in preventive regulation and supervision to prevent a future crisis," while placing restrictions on resolution authority and attributing this imbalanced focus to public anger over bailouts); *see also id.* at 802 (arguing that, "[a]lthough greater regulatory oversight [as provided in Dodd-Frank] is certainly desirable, . . . exclusive reliance upon it is unrealistic.").

479. Even "mandatory" prompt correction action (PCA) measures have not been very effective at stimulating early intervention actions for struggling banks. *See supra* text accompanying notes 107–16 .

obstacles to making a systemic risk determination may make delayed enforcement intervention even more likely for large financial companies.

Congress has unfortunately tied regulators' hands by enhancing prudential regulatory risk-based measures designed to prevent or mitigate system wide economic crises, but simultaneously limiting resolution authority. My concern on the resolution side is that efforts to limit resolution authority may backfire as a practical matter. Faced with severe economic crisis, but restricted in their resolution authority, regulators may simply go "underground," less transparently providing types of assistance to struggling banks that they might provide more openly if Congress had not narrow-mindedly imposed limits. Moreover, Congress is either ignoring or failing to see the many ways in which government is already involved in allocation of risk and resolution of business difficulties.

Finally, when the next really big crisis arises, Congress is unlikely to stick to its "no bailout" pledge in any event. As I argued before,

> political 'no more bailout' assertions—even those ultimately included in statutory text—simply are not credible as pre-commitment devices. Statutory declarations can always be amended. As much as Congress would like to eliminate any "too-big-to-fail" policy, the reality is that there may—and probably will—come a time when the failure of a particular firm or industry would be so economically devastating that Congress would step in to save it, despite earlier protestations to the contrary.[480]

On the other hand, my concern on the regulation side is that enhanced prudential regulation, laudable though it is, may not be the hoped for panacea in preventing or mitigating systemic risk. If the past is any indication, regulators are unlikely to be aggressive in exercising their new powers to heighten supervision and enforcement as risk increases along a risk continuum. Moreover, the new enhanced prudential regulations result in arbitrary cliff effects inconsistent with a risk continuum principle. Though I favor new and enhanced prudential regulation, the real challenge to financial regulation and resolution reform is providing incentives for regulators to *use* their existing and enhanced prudential regulatory powers rather than restricting their resolution authority. This Article has exposed the ironic contrast between prudential regulation and resolution authority. The former is theoretically based on a risk continuum, but in reality implemented in a far more binary fashion. On the other hand, resolution authority is theoretically limited to largely binary options but in reality can be plotted along a private-public risk allocation continuum. I contend that it is important to acknowledge and preserve a continuum approach on both sides of the equation. Despite improvements, the financial regulatory regime remains fragmented and unprepared to respond rapidly and coherently to the next economic crisis. This fragmentation can result in

480. Block, *Measuring Bailout Cost*, *supra* note 8, at 154.

inconsistencies and inequities in resolving the potential failure of different businesses or industries. Properly calibrating an appropriate solution to different types of economic risk requires a more nuanced account of the various levels of risk on the road to "systemic" in order to better identify danger points and provide mechanisms to ensure that banking regulators are unified in their approach.[481] Financial regulation reforms should also focus on altering the current regulatory dynamic and structure to eliminate regulator incentives to forbear enforcement at early signs of trouble at large financial institutions. Such reforms should include lobbying restrictions to reduce large financial firm opportunities for regulatory capture, which often results in special "white glove" treatment for large banks.

With regard to resolution authority reforms, I believe that it is important for legislators to be more honest with themselves about the extent to which government is already involved. Rather than impose rigid restrictions on regulators' resolution authority, the better approach would be to acknowledge the different possibilities along the private-public continuum and carefully assess elements that should be relevant in deciding which of the various resolution methods is best under particular circumstances. In the end, the most important objective is a prudential regulatory and resolution approach to systemic risk that is transparent and equitable for both failing firm stakeholders and the general public.

481. Though I believe that it would be sensible to consolidate the various bank regulation agencies into a sole agency, such discussion is beyond the scope of this Article.