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Are Certain Creditors Too Big (or Important) to Fail?

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ARE CERTAIN CREDITORS TOO BIG (OR IMPORTANT) TO FAIL?

INTRODUCTION

The most recent financial crisis, which produced the worst recession since the Great Depression, affected financial markets both in the United States and abroad.[1] The financial crisis has been attributed to many causes—chief among them, the deregulation of the financial markets, subprime mortgage lending, and securitization of complex and opaque financial products.[2] One of the most notable and widely criticized responses to the financial crisis was the government-sponsored bailout[3] of financial institutions.[4] In the years preceding the crisis, many financial institutions, such as Bear Sterns[5] and Lehman Brothers,[6] had grown so large and interconnected that their collapse would have had a catastrophic effect on the U.S. financial markets, thereby coining the phrase "too big to fail" (TBTF).[7] The federal government viewed current insolvency regimes as an

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1. *See* DICK K. NANTO, CONG. RESEARCH SERV., RL34742, THE GLOBAL FINANCIAL CRISIS: ANALYSIS AND POLICY IMPLICATIONS 2 (2009), *available at* http://www.fas.org/sgp/crs /misc/RL34742.pdf; Martin Neil Baily & Douglas J. Elliott, *The US Financial and Economic Crisis: Where Does It Stand and Where Do We Go From Here?*, BROOKINGS (June 2009), http://www.brookings.edu/~/media/Files/rc/papers/2009/0615_economic_crisis_baily_elliott/0615 _economic_crisis_baily_elliott.pdf.

2. Ben S. Bernanke, Chairman, Bd. of Governors of the Fed. Reserve Sys., Statement before the Fin. Crisis Inquiry Comm'n: Causes of the Recent Financial and Economic Crisis (Sept. 2, 2010), *available at* http://www.federalreserve.gov/newsevents/testimony/bernanke20100902a.pdf [hereinafter Causes of the Recent Financial and Economic Crisis].

3. A bailout is a rescue from financial distress. During the recent financial crisis, the Federal Reserve implemented a bailout program by using its emergency lending authority under § 13(3) of the Federal Reserve Act. AIG is an example of such a bailout program. *See* Scott G. Alvarez, General Counsel, Bd. of Governors of the Fed. Reserve Sys., Testimony before the Cong. Oversight Panel: Government Assistance to AIG (May 26, 2010), *available at* http://federalreserve.gov/newsevents/testimony/alvarez20100526a.pdf; WEBSTER'S NEW UNIVERSAL UNABRIDGED DICTIONARY 140 (2d ed. 1983).

4. John C. Coffee, Jr., *Systemic Risk After Dodd-Frank: Contingent Capital and the Need for Regulatory Strategies Beyond Oversight*, 111 COLUM. L. REV. 795, 797 (2011).

5. Bear Sterns was an investment bank, and a securities and trading brokerage company. The company collapsed in 2008 and was subsequently sold in a "fire sale" to JPMorgan in a deal facilitated by the Federal Reserve. Andrew Ross Sorkin & Landon Thomas Jr., *JPMorgan Acts to Buy Ailing Bear Stearns at Huge Discount*, N.Y. TIMES, Mar. 16, 2008, http://www.nytimes.com /2008/03/16/business/16cnd-bear.html?scp=2&sq=bear%20stearns&st=Search.

6. Lehman Brothers Holdings Inc. was the fourth-largest investment bank in the United States before it filed for Chapter 11 protection under the Bankruptcy Code on September 15, 2008. The Lehman Brothers' bankruptcy is the largest bankruptcy in the history of the United States, involving over 100,000 unsecured creditors and $613 billion in debt. *See* Sam Mamudi, *Lehman Folds with Record $613 Billion Debt*, MARKETWATCH (Sept. 15, 2008, 10:11 AM) http://www .marketwatch.com/story/lehman-folds-with-record-613-billion-debt?siteid=rss; *Barclays Buys Core Lehman Assets*, BBC NEWS, Sept. 17, 2008, http://news.bbc.co.uk/2/hi/business /7620306.stm.

7. "A too-big-to-fail firm is one whose size, complexity and interconnectedness, and critical functions are such that, should the firm go unexpectedly into liquidation, the rest of the financial system and the economy would face severe adverse consequences." Causes of the Recent

inadequate response to address the failure of a TBTF financial institution.[8] Consequently, "financial support for [these] compan[ies] sometimes was the only viable option . . . to avoid or mitigate serious adverse effects on economic conditions and financial stability . . . ."[9] In furtherance of this solution, Congress established the Troubled Asset Relief Program (TARP),[10] which allowed the Department of the Treasury (the Treasury Department) to inject capital into failing institutions and purchase their distressed assets.[11]

In 2010, in response to the crisis, Congress passed the most sweeping financial reform regulation of the past seventy years—the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank).[12] Dodd-Frank was implemented to address the regulatory gaps that exacerbated the financial crisis by: imposing stricter regulations on financial institutions, regulating particular financial products that were previously unregulated,[13] and creating an adequate system for liquidating TBTF institutions.[14] These laws were structured in an effort to eliminate systemic risk[15] and minimize

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Financial and Economic Crisis, *supra* note 2, at 20–23; *see also* Reza Dibadj, *Four Key Elements To Successful Financial Regulatory Reform*, 6 HASTINGS BUS. L.J. 377, 389–90 (2010).

8. Notice of Proposed Rulemaking Implementing Certain Orderly Liquidation Authority Provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act, 75 Fed. Reg. 64,173, 64,174 (proposed Oct. 19, 2010) (to be codified at 12 C.F.R. pt. 380) [hereinafter Notice of Proposed Rulemaking].

9. *Id*.

10. Emergency Economic Stabilization Act of 2008 (EESA), Pub. L. N. 110-343, 122 Stat. 3765 (codified in scattered sections of the U.S.C.).

11. At the request of the Treasury Department, Congress enacted the EESA to effectively bail out TBTF institutions. *Id.* § 5201 et seq.; Greg Hitt, Damian Paletta & Deborah Solomon, *Lawmakers Battle Over Rescue Plan*, WALL ST. J., Sept. 22, 2008, http://online.wsj.com/article/SB122200573768460503.html. The EESA allowed the Treasury Department to use up to $700 billion to inject capital into failing institutions and purchase their distressed assets through TARP. EESA, 12 U.S.C. §§ 5211–5241.

12. 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.).

13. Dodd-Frank will now regulate over-the-counter derivatives (once a primarily unregulated financial market), which will be enforced by the Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission. Regulatory Practice Letter, KPMG, Dodd-Frank Act: Regulation of Over-the-Counter Derivatives (Title VII) (Aug. 10, 2010), *available at* http://www.us.kpmg.com/microsite/RegulatoryPractice/2010/rpl-1013-otc-derivatives.pdf.

14. *See* Dodd-Frank Act § 206, 124 Stat. 1459 (codified at 12 U.S.C. § 5386); U.S. S. COMM. ON BANKING, HOUS. & URBAN AFFAIRS, BRIEF SUMMARY OF THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT (2010), *available at* http://banking.senate.gov/public/_files/070110_Dodd_Frank_Wall_Street_Reform_comprehensive_summary_Final.pdf.

15. Although there is no single definition for systemic risk, Steven L. Schwarcz states,

> A common factor in the various definitions of systemic risk is that a trigger event, such as an economic shock or institutional failure, causes a chain of bad economic consequences—sometimes referred to as a domino effect. . . .
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> . . . .

moral hazard[16] in an orderly and transparent manner.[17] Dodd-Frank, specifically Title II, created the Orderly Liquidation Authority (OLA),[18] which grants the Federal Deposit Insurance Corporation (FDIC)[19] the authority to act as receiver[20] and wind down bank holding companies[21] and nonbank financial companies,[22] which pose a significant risk.[23] This is to ensure that creditors and shareholders, and not the U.S. taxpayers, will sustain the loss of the financial company.[24] To address the widespread public contempt over the bailouts, Title II also prohibits the FDIC from taking an equity interest in or becoming a shareholder of a failing financial company.[25]

The OLA is a hybrid model[26] of two existing insolvency regimes—the Federal Deposit Insurance Act (FDIA)[27] and the Bankruptcy Code (the

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> The classic example of systemic risk in this context is a "bank run," in which the inability of a bank to satisfy withdrawal-demands causes its failure, in turn causing other banks or their creditors to fail.

Steven L. Schwarcz, *Systemic Risk*, 97 GEO. L.J. 193, 196, 198–99 (2008). As such, the federal government anticipated that if complex financial institutions failed, U.S. financial markets could experience catastrophic harm. Notice of Proposed Rulemaking, 75 Fed. Reg. 64,173, 64,174 (proposed Oct. 19, 2010) (to be codified at 12 C.F.R. pt. 380).

16. Moral hazard results when a party who is protected from risk (i.e., a bailout recipient) fails to take the same precautions as a party who is not protected under the bailout regime. Kenneth Ayotte & David A. Skeel, Jr., *Bankruptcy or Bailouts?*, 35 J. CORP. L. 469, 485 (2010).

17. *See* Dodd-Frank Act § 204, 124 Stat. 1454 (codified at 12 U.S.C. § 5384); U.S. S. COMM. ON BANKING, HOUS. & URBAN AFFAIRS, BRIEF SUMMARY OF THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT (2010), *available at* http://banking.senate.gov/public/_files/070110_Dodd_Frank_Wall_Street_Reform_comprehensive_summary_Final.pdf.

18. Dodd-Frank Act § 204(a), 124 Stat. 1454 (codified at 12 U.S.C. § 5384).

19. The FDIC is an independent federal agency that monitors and provides insurance for bank and thrift institutions' deposits to limit the adverse impact that institutional failure would have on the U.S. economy. FDIC, Who is the FDIC? (Aug. 11, 2010), http://www.fdic.gov/about/learn/symbol/.

20. The FDIC, as receiver, has the power to liquidate a financial company's assets in a manner it deems appropriate. Dodd-Frank Act § 210(a), 124 Stat. 1460 (codified at 12 U.S.C. § 5390).

21. A bank holding company includes a company which has control over a bank, or a company that has control over another company that is or may become a bank holding company. 12 U.S.C. § 1841(a)(1) (2006); Dodd-Frank Act § 102(a)(1), 124 Stat. 1391 (codified at 12 U.S.C. § 5311).

22. A nonbank financial company has been defined as a U.S. or foreign nonbank financial company that is "predominantly engaged in financial activities." Dodd-Frank Act § 102(a)(4), 124 Stat. 1391 (codified at 12 U.S.C. § 5311). This includes companies in which 85 percent of its annual gross revenues or consolidated assets are derived from financial activities. *Id.* § 102(a)(6).

23. Significant risk institutions are nonbank financial companies that the Board of Governors determines will pose a systemic risk to the financial markets. *Id.* §§ 102(a)(7), 113(a).

24. *Id.* § 204(a).

25. *Id.* § 206(6). *See also* Sheila C. Bair, Chairman, Fed. Deposit Ins. Corp., Statement before the Fin. Crisis Inquiry Comm'n: Systemically Important Institutions and the Issue of "Too Big to Fail" (Sept. 2, 2010) [hereinafter Systemically Important Institutions].

26. Jenna Greene, *FDIC's New Power to Dissolve Companies Raises Concerns*, NAT'L L.J. (ONLINE) (Sept. 7, 2010), http://www.law.com/jsp/article.jsp?id=1202471686189 [hereinafter *FDIC's New Power*].

27. *See* 12 U.S.C. § 1811 et seq. (2006).

Code).[28] Under the FDIA, the FDIC has similar authority as receiver to wind down failing depository institutions.[29] Analogous provisions of the Code, such as preferential transfers and fraudulent conveyances, were also included in order to supplement and clarify the authority of the FDIC.[30]

Under the OLA, the FDIC is granted wide discretion as receiver to carry out Title II's objectives—the most important being, mitigating systemic risk and moral hazard. This discretion includes the ability to pay certain unsecured creditors before others that are similarly situated, which has raised substantial concern.[31] Although concern may be warranted, the ability to treat similarly situated creditors differently is not a novel idea.[32] In fact, it is a controversial principle, known as the doctrine of necessity.[33]

The doctrine of necessity is a common law rule that allows a debtor to pay certain pre-petition unsecured claims before others that would normally be subject to a distribution pursuant to § 507 of the Code,[34] or a confirmation plan in a Chapter 11 reorganization case.[35] In some instances, the payments of certain unsecured claims are allowed if the creditor is deemed to be a "critical vendor."[36] The rationale for payment has been that paying certain critical vendors will allow the business to continue, thereby benefitting all creditors by maximizing the value of assets.[37] Courts are split as to the application and use of the doctrine because of the potential for abuse of judicial discretion and the possibility that select creditors' distributions will be altered arbitrarily.[38]

In order to avoid controversial critical vendor issues and to create a more transparent system, the FDIC promulgated a rule, which clarified how it intends to exercise its authority regarding additional payments (the Final

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28. *See* 11 U.S.C. § 101 et seq. (2006); Notice of Proposed Rulemaking, 75 Fed. Reg. 64,173, 64,174–75 (proposed Oct. 19, 2010) (to be codified at 12 C.F.R. pt. 380).

29. 12 U.S.C. § 1822.

30. Notice of Proposed Rulemaking, 75 Fed. Reg. at 64,175 (to be codified at 12 C.F.R. pt. 380).

31. *See id.*; *FDIC's New Power*, *supra* note 26; Dodd-Frank Act, Pub. L. No. 111-203, § 210(b)(4), 124 Stat. 1376, 1476 (2010) (codified at 12 U.S.C. § 5390 (2010)).

32. *In re* Ionosphere Clubs, Inc., 98 B.R. 174, 175–176 (Bankr. S.D.N.Y. 1989) (citing Miltenberger v. Logansport, C. & S.W. R. Co., 106 U.S. 286 (1882)).

33. *See id.*; *Miltenberger*, 106 U.S. 286; Alan N. Resnick, *The Future of the Doctrine of Necessity and Critical-Vendor Payments in Chapter 11 Cases*, 47 B.C. L. REV. 183, 187–88 (2005).

34. 11 U.S.C. § 507 (2006).

35. Resnick, *supra* note 33, at 183.

36. Critical vendors offer a "unique product or special relationship with the debtor" that makes them indispensible in order to maximize the value of the assets. Therefore, pre-petition payments are permitted to maintain the business relationship between vendor and debtor, notwithstanding the adequate stay of § 362. Lynn P. Harrison, III & James V. Drew, *First Day Orders: A Survey of Critical Vendor Motions and Recent Developments*, *in* BANKRUPTCY & REORGANIZATIONS: CURRENT DEVELOPMENTS 2011, at 341 (PLI On Demand Web Program Ser. No. 28454) (2009).

37. *See* Resnick, *supra* note 33, at 185–86.

38. *See* Russell A. Eisenberg & Frances F. Gecker, *The Doctrine of Necessity and Its Parameters*, 73 MARQ. L. REV. 1, 27–37 (1989); Resnick, *supra* note 33, at 189–203.

Rule).[39] Although the Final Rule elucidated the FDIC's treatment toward unsecured creditors, it was primarily directed at long-term creditors and failed to address short-term creditors. The FDIC's decision to omit short-term creditors from the Final Rule indicates that certain creditors may be too big or important to fail. This note does not dispute the fact that under certain circumstances, when time is of the essence, it may be necessary to treat certain creditors more favorably than others in order to limit systemic risk to the financial markets. The reduction of systemic risk, however, can still be achieved while incorporating other important goals of Title II as well. Thus, the purpose of this note is to offer a standard by which the FDIC should determine whether a short-term creditor is necessary to the failing financial company. This standard would have the effect of promoting transparency within a newly created liquidation regime, minimizing moral hazard among short-term creditors, maximizing the assets of the failing financial company, harmonizing the OLA with existing insolvency regimes, and maintaining FDIC flexibility.

Part I will describe the FDIC's Final Rule and the aspects of Title II that it sought to clarify. Part II will explain the origins of the doctrine of necessity and analyze the various approaches taken by courts today. Part III will explain the rationale behind the creation of the OLA compared to other alternatives, and its mandated and overarching objectives. Part IV will critique the FDIC's decision to omit short-term creditors from the Final Rule. Finally, Part V will recommend that the FDIC adopt a clear standard by which it could determine a critical short-term creditor, which would create a more transparent and efficient insolvency regime.

I. SECTION 210 AND THE FDIC'S FINAL RULE

Dodd-Frank, although over 800 pages in length, operates more as a skeletal framework than a definitive set of rules.[40] A majority of the legislation grants authority to the various governmental agencies to create rules and regulations as each agency sees fit.[41] Specifically, § 209 of Title II authorizes the FDIC, in consultation with the Financial Stability Oversight

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39. The Final Rule was adopted after the Notice of Proposed Rulemaking and an Interim Rule. Both solicited comments and suggestions from various business organizations and private parties. Certain Orderly Liquidation Authority Provisions under Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act, 76 Fed. Reg. 41,626 (July 15, 2011) (codified at 12 C.F.R. pt. 380.27) [hereinafter Final Rule]. *See also* Orderly Liquidation Authority Provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act, 76 Fed. Reg. 4,207 (proposed Jan. 25, 2011) (to be codified at 12 C.F.R. pt. 380) [hereinafter Interim Rule]; Notice of Proposed Rulemaking, 75 Fed. Reg. 64,173 (proposed Oct. 19, 2010) (to be codified at 12 C.F.R. pt. 380).

40. David S. Huntington, *Corporate Governance, Executive Compensation and Dodd-Frank*, BLOOMBERG LAW SEMINAR (Nov. 10, 2010).

41. *See* Ronald D. Orol, *Fed: No Controversy on Dodd-Frank Rules*, MARKETWATCH (Sept. 30, 2010, 1:01 PM), http://www.marketwatch.com/story/oversight-panel-to-eye-risky-financial-firms-2010-09-30 (noting that the Federal Reserve must write more than fifty rules on Dodd-Frank, while the SEC must write more than 100).

Council (FSOC),[42] to promulgate rules that both agencies determine are necessary or appropriate for an efficient liquidation.[43] In addition, these rules seek to complement current insolvency regimes that would otherwise apply absent the OLA.[44] The objective of this delegation is to "provide guidance on certain key issues in order to provide clarity and certainty to the financial industry" as well as comply with Title II's "mandate of transparency" during the receivership process.[45] Following these guidelines, the FDIC issued the Final Rule in July 2011, which clarified how the FDIC would exercise its discretionary authority regarding additional payments to unsecured creditors.[46]

The authority to make additional payments and treat creditors of the same class differently was delegated to the FDIC under § 210(b)(4) of Dodd-Frank. This authority, if exercised, would have the effect of altering the priority structure,[47] which mandates the payment distributions of unsecured claims.[48] Many commentators have criticized the implementation of this authority because it grants the FDIC too much discretion, and as a consequence, market participants will have no way to predict how the FDIC will act.[49] Thus, the FDIC has clarified how it intends to implement its discretion. The Final Rule excludes certain creditors that the FDIC has determined should not receive additional payment because they are not necessary to maximize the value of the failing company's assets.[50] The four categories of creditors that have been excluded are: "[h]olders of long-term senior debt who have a claim entitled to priority of payment at the level"[51]

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42. FSOC was created under Dodd-Frank, and is responsible for detecting and responding to systemic threats to the U.S. financial system, while promoting market discipline. *Financial Stability Oversight Council*, U.S. DEPT. OF TREAS., http://www.treas.gov/FSOC (last visited Oct. 6, 2011).

43. Dodd-Frank Act, Pub. L. No. 111-203, § 209, 124 Stat. 1376, 1460 (2010) (codified at 12 U.S.C. § 5389 (2010)).

44. *Id*.

45. Notice of Proposed Rulemaking, 75 Fed. Reg. 64,173, 64,173, 64,177 (proposed Oct. 19, 2010) (to be codified at 12 C.F.R. pt. 380).

46. *Id*. at 64,181; Final Rule, 76 Fed. Reg. 41,626 (July 15, 2011) (codified at 12 C.F.R. pt. 380.27).

47. Dodd-Frank Act § 210(b)(1), 124 Stat. 1475 (codified at 12 U.S.C. § 5390).

48. The priorities set forth under § 210(b)(1) of Dodd-Frank define the order in which unsecured claims are paid to each creditor class. The ability to authorize payment of certain unsecured claims over others would alter mandated priorities and act as an exception to the rule. *Id*. § 210(b)(1), (4).

49. *See, e.g*., Letter from Comm. on Capital Mkts. Reg. to Robert E. Feldman, Exec. Sec'y (Nov. 15, 2010), *available at* http://www.capmktsreg.org/pdfs/2010.11.15_FDIC_letter.pdf.

50. Notice of Proposed Rulemaking, 75 Fed. Reg. at 64,177 (to be codified at 12 C.F.R. pt. 380).

51. Long-term senior debt has been defined as

> debt issued by the covered financial company to bondholders or other creditors that has a term of more than 360 days. It does not include partially funded, revolving or other open lines of credit that are necessary to continuing operations essential to the

of general or senior liability; "[h]olders of subordinated debt" to general creditors;[52] "[s]hareholders, members, general partners, limited partners, or other persons";[53] and "[o]ther holders of claims" of general or senior liability.[54] The Final Rule was adopted to put these creditors on notice that they "will not receive additional payments compared to other general creditors . . . ."[55] These categories can be subject to change, however, if by a vote of its Board of Directors, the FDIC determines that additional payments are needed.[56]

Although the Final Rule aimed to clarify the exercise of the FDIC's discretion regarding additional payments, it omitted an important class of creditors. The Final Rule failed to include any standard or framework in which the FDIC will determine how the creditors that are not per se excluded (i.e., short-term creditors) will be deemed necessary to the liquidation. As a result, this gap poses the same question that has troubled courts when considering whether to apply the doctrine of necessity: how does one determine a creditor's necessity?[57]

II. OVERVIEW OF THE DOCTRINE OF NECESSITY

Granting the FDIC authority to make additional payments and circumvent the priority scheme is not a novel concept. In bankruptcy, it is known as the doctrine of necessity. The doctrine of necessity recognizes that judicial authority exists to allow a debtor to pay certain pre-petition unsecured creditors because payment is essential to the debtor's continued operation.[58] These creditors are also known as "critical vendors" because they generally have an unparalleled relationship with the debtor that makes them indispensible in order to maximize the value of the assets.[59] The doctrine is quite controversial and is exercised differently depending on the jurisdiction.[60] In order to understand the implications of the FDIC's favorable treatment of certain creditors, it is necessary to briefly review the

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> receivership or any bridge financial company, nor to any contracts to extend credit enforced by the receiver under 12 U.S.C. § 5390(c)(13)(D).

Id. at 64,181; Final Rule, 76 Fed. Reg. at 41,644 (codified at 12 C.F.R. pt. 380.27).

52. Notice of Proposed Rulemaking, 75 Fed. Reg. at 64,181 (to be codified at 12 C.F.R. pt. 380); Final Rule, 76 Fed. Reg. at 41,644 (codified at 12 C.F.R. pt. 380.27).

53. Notice of Proposed Rulemaking, 75 Fed. Reg. at 64,181 (to be codified at 12 C.F.R. pt. 380); Final Rule, 76 Fed. Reg. at 41,644 (codified at 12 C.F.R. pt. 380.27).

54. Notice of Proposed Rulemaking, 75 Fed. Reg. at 64,181 (to be codified at 12 C.F.R. pt. 380); Final Rule, 76 Fed. Reg. at 41,644 (codified at 12 C.F.R. pt. 380.27).

55. Notice of Proposed Rulemaking, 75 Fed. Reg. at 64,177 (to be codified at 12 C.F.R. pt. 380).

56. *Id*. at 64,181; Final Rule, 76 Fed. Reg. at 41,644 (codified at 12 C.F.R. pt. 380.27).

57. *See* Joseph Gilday, *"Critical" Error: Why Essential Vendor Payments Violate the Bankruptcy Code*, 11 AM. BANKR. INST. L. REV. 411, 419 (2003).

58. *See* Resnick, *supra* note 33, at 183–84.

59. *See* Harrison & Drew, *supra* note 36, at 341.

60. *See* Eisenberg & Gecker, *supra* note 38, at 27–37; Resnick, *supra* note 33, at 189–203.

common law origins of the doctrine of necessity and its disparate application by courts today.

A. RAILROADS AND BEYOND: COMMON LAW ORIGINS OF THE DOCTRINE OF NECESSITY

The doctrine of necessity was originally set forth in *Miltenberger v. Logansport Railway* in 1882. In *Miltenberger*, the Supreme Court allowed the payment of certain pre-receivership claims against the debtor-railroad in order to avert threatened supply and exchange stoppages.[61] The Supreme Court held "that a court has the authority to grant an equity receiver discretion to pay preexisting debts 'necessary and indispensible' to the continued operation of the business as part of the receiver's general duty to protect and preserve property under their charge."[62] The "Necessity of Payment Rule," as it became known, quickly cemented itself in the railroad context and was routinely applied.[63]

The first extension beyond the railroad context where a court allowed the debtor to pay pre-petition debts was in *Dudley v. Mealey*.[64] In *Dudley*, however, the Second Circuit Court of Appeals did not justify its decision on the Necessity of Payment Rule or *Miltenberger*, but rather on the "Six Months Rule."[65] The court allowed a debtor-hotel to pay certain pre-receivership suppliers, whose debts arose six months before the petition date, and justified the payment by the benefit to all creditors.[66] The Second Circuit articulated that in order to protect the secured creditors, it might be necessary to pay unsecured creditors in order to continue the relationship.[67] Although the doctrine of necessity (or its predecessor, the Necessity of Payment Rule) was never mentioned in *Dudley*, courts still use the decision as justification to permit payment of pre-petition claims in order to protect creditors' interests and better facilitate reorganization outside the railroad context.[68]

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61. Miltenberger v. Logansport, C. & S.W. R. Co., 106 U.S. 286, 311–12 (1882).

62. Jeffrey N. Pomerantz, *The Bare Necessities of Critical Vendor Motions-It's a Jungle Out There*, 13 J. BANKR. L. & PRAC. 73 (2004) (citing *Miltenberger*, 106 U.S. 286).

63. *See* Eisenberg & Gecker, *supra* note 38, at 3.

64. Dudley v. Mealey, 147 F.2d 268 (2d Cir. 1945); *see generally* Pomerantz, *supra* note 62; Resnick, *supra* note 33, at 188.

65. The Six Months Rule granted administrative priority status to certain expenses within six months of receiver appointment. The rule was later codified in § 77(b) of the Bankruptcy Act and later in § 1171(b) of the Bankruptcy Code. *See* Gilday, *supra* note 57, at 426–27; Pomerantz, *supra* note 62; 11 U.S.C. § 1171(b) (2006).

66. *Dudley*, 147 F.2d at 271.

67. *Id.*

68. *See, e.g.*, *In re* Ionosphere Clubs, Inc., 98 B.R. 174 (Bankr. S.D.N.Y. 1989); *In re* Eagle-Picher Indus., Inc., 124 B.R. 1021, 1023 (Bankr. S.D. Ohio 1991); Resnick, *supra* note 33, at 188.

B. HOW THE DOCTRINE IS APPLIED TODAY: THREE APPROACHES

1. Liberal Application

The tendency of courts to utilize the doctrine of necessity varies drastically by jurisdiction.[69] Courts that have been more inclined to grant critical vendor motions for the payment of pre-petition claims have been referred to as "debtor friendly."[70] Debtor-friendly courts include the Second and Third Circuits, which notably encompass the Southern District of New York and the District of Delaware.[71] Despite the presence of the word "necessity" in the name of the doctrine, debtor-friendly courts grant critical vendor motions quite frequently.[72] The grant of critical vendor pre-petition claims[73] is justified by its tendency to maximize the value of the business, which increases the total assets and income that will be distributed to all creditors.

Some courts have derived their authority from the equitable power of § 105(a), which states "the court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title[]" in conjunction with the doctrine of necessity.[74] These courts have interpreted § 105(a) very broadly. They reason that payment of pre-petition claims is warranted because it is necessary and consistent with the general policy

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69. *See* Eisenberg & Gecker, *supra* note 38, at 27–37; Resnick, *supra* note 33, at 189–203.

70. *See, e.g.*, *In re* Just For Feet, Inc., 242 B.R. 821 (D. Del. 1999); Mich. Bureau of Workers Disability Comp. v. Chateaugay Corp. (*In re* Chateaugay Corp.), 80 B.R. 279 (S.D.N.Y. 1987); *In re* Wehrenberg, Inc., 260 B.R. 468 (Bankr. E.D. Mo. 2001); *see also* Bruce H. White, William L. Medfort & Patton Boggs, *The Doctrine of Necessity and Critical Trade Vendors: The Impracticality of Maintaining Post-Petition Business Relations in Mega-Cases*, 21 AM. BANKR. INST. J. 24, 24 (2002).

71. *See, e.g.*, *In re Ionosphere*, 98 B.R. at 179 (approving the debtor's payment of pre-petition salaries and benefits to active employees); *In re* Lehigh & New Eng. Ry. Co., 657 F.2d 570, 581 (3d Cir. 1981) (stating that payment of a claim arising before reorganization is authorized if it is "essential to the continued operation of the [debtor]"); *In re* Columbia Gas Sys., Inc., 171 B.R. 189, 192 (Bankr. D. Del. 1994) (noting that in the Third Circuit, a debtor may pay pre-petition creditors "in advance of a confirmed plan," where such payments are "essential to the continued operation of the [debtor's] business"); *In re* Fin. News Network, Inc., 134 B.R. 732, 735–36 (Bankr. S.D.N.Y. 1991) (observing that "[t]he 'doctrine of necessity' stands for the principle that a bankruptcy court may allow pre-plan payments of prepetition obligations where such payments are critical to the debtor's reorganization"). *See also In re* Payless Cashways, Inc., 268 B.R. 543, 544 (Bankr. W.D. Mo. 2001); *In re Just For Feet, Inc.*, 242 B.R. at 821; *In re Chateaugay Corp*., 80 B.R. at 279; *In re* United Am., Inc., 327 B.R. 776, 781 (Bankr. E.D. Va. 2005); *In re* NVR L.P., 147 B.R. 126, 127 (Bankr. E.D. Va. 1992).

72. *See* White, Medfort & Boggs, *supra* note 70, at 24; Harrison & Drew, *supra* note 36, at 348.

73. Critical vendor motions are usually made with the other first day motions, in which a debtor will petition the bankruptcy court to allow certain pre-petition claims to be paid. JEFFREY T. FERRIELL & EDWARD J. JANGER, UNDERSTANDING BANKRUPTCY 725–26 (2d ed. 2007).

74. *See* 11 U.S.C. § 105(a) (2006); White, Medfort & Boggs, *supra* note 70, at 24. *See generally In re Just for Feet, Inc.*, 242 B.R. 821; *In re Wehrenberg*, 260 B.R. 468.

goals of bankruptcy, such as debtor rehabilitation,[75] preservation of the going-concern value,[76] and maximization of value of the debtor.[77]

Other courts have held that applying the doctrine under § 105(a) alone is not sufficient to support critical vendor motions, and consequently, have derived their powers from other provisions of the Code. The bankruptcy court in *In re Payless Cashways* found support for pre-petition payments under both §§ 364(b) and 549 of the Code.[78] The court granted the debtor the authority to pay pre-petition claims of its lumber suppliers on the basis that they were "critical to the continued operation of the debtor . . . ."[79] The court affirmed that § 364(b) "grants the Court broad authority, at the outset of a case, to approve borrowing arrangements that are found to be in the best interests of the debtor, its estate, and its creditors."[80] The *Payless* court went on to recognize that it should follow the priorities established in § 507 of the Code; however, the Code permits the court "some limited power to authorize preferential treatment to certain creditors."[81] Since the debtor failed to secure post-petition financing, the court found that the granting of preferential treatment was the only way vendors who were critical to the debtor's restructuring would continue to supply goods.[82]

In addition, other courts have suggested that pre-petition payments may be justified under § 363(b) of the Code, which allows the trustee to "use, sell, or lease, other than in the ordinary course of business, property of the estate" of the debtor.[83] Section 363(b) gives the court the authority and flexibility to craft solutions in various situations, including the payment for certain pre-petition claims.[84]

Liberally granting critical vendor motions is not without its drawbacks. Payment of pre-petition claims invariably will reduce the cash reserves of the debtor. Therefore, if a company cannot adequately reorganize and is

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75. *In re Wehrenberg*, 260 B.R. at 469.

76. The going-concern value means that a business will continue to operate for the foreseeable future and will be able to realize assets and discharge liabilities in the normal course of operations. This concept occurs under the Code when the value of the business's assets exceeds the value the business would receive in a Chapter 7 liquidation. The ultimate goal is that business will continue to operate in order to preserve the going concern. *See* Harvey R. Miller & Shai Y. Waisman, *Does Chapter 11 Reorganization Remain a Viable Option for Distressed Businesses for the Twenty-First Century?*, 78 AM. BANKR. L.J. 153, 164–66 (2004).

77. *In re Wehrenberg*, 260 B.R. at 469.

78. *In re* Payless Cashways, Inc., 268 B.R. 543, 546–47 (Bankr. W.D. Mo. 2001).

79. *Id.* at 544.

80. *Id.*

81. *Id.* at 546. Under the Code, a trustee may avoid the transfer of property of the estate that occurs post-petition. 11 U.S.C. § 549 (2006).

82. *In re Payless*, 268 B.R. at 547.

83. 11 U.S.C. § 363(b). *See also In re* Ionosphere Clubs, Inc., 98 B.R. 175, 175 (Bankr. S.D.N.Y. 1989); *In re* Lionel Corp., 722 F.2d 1063, 1069 (2d Cir. 1983); *In re* Kmart Corp., 359 F.3d 866, 872 (7th Cir. 2004) (leaving open the possibility that pre-petition payments may be allowed under § 363(b)(1), which does the least damage to the Code's priorities).

84. *In re Lionel*, 722 F.2d at 1069; *In re Ionosphere*, 98 B.R. at 175.

forced to liquidate, less cash, if any, will be available for distribution to the secured and unsecured creditors. Furthermore, it is typically the debtor that petitions the court to grant their critical vendor motions, which has elicited criticism in that the debtor will select certain creditors based on favoritism, and not necessity. If creditors believe that they will be paid so long as the debtor petitions the court, creditors will be less inclined to take adequate precautions. Thus, the consequential lack of monitoring risk exposure will increase moral hazard among creditors.

2. Prohibition of the Doctrine

In contrast to the liberal application, some courts reject or drastically limit the use of the doctrine of necessity.[85] These courts find that the doctrine contradicts the overarching bankruptcy principle that creditors of the same class are not to be treated dissimilarly.[86] Under the Code, unsecured claims are paid in accordance with their respective priority position under § 507, and claims that are at the same priority level are entitled to the same treatment.[87] Thus, the doctrine of necessity operates as an exception to the general claims priority rule.[88] Critics of the doctrine's use argue that the Code is clear on the types of claims that are entitled to a certain status in the priority scheme. They also argue that judges do not have "free-floating discretion to redistribute rights in accordance with [their] personal views of justice and fairness . . . ."[89] The importance of strictly adhering to § 507 is to create a transparent and predictable system for creditors that decide to engage in or continue business with the debtor.[90]

Some courts also refuse to apply the doctrine because it is difficult for judges to determine which creditors are necessary.[91] Critical vendor motions typically accompany all other emergency requests for payment on the first day the petition is filed.[92] These courts argue that the "doomsday scenario"[93] described by debtors in these motions and the expedited first day procedure prompt debtor-friendly courts[94] to grant motions without an

85. *See* Official Comm. of Equity Sec. Holders v. Mabey, 832 F.2d 299, 302 (4th Cir. 1987); *In re* Chi., Milwaukee, St. Paul & Pac. R.R. Co., 791 F.2d 524, 528 (7th Cir. 1986).

86. *See In re Chi.*, 791 F.2d at 528.

87. 11 U.S.C. § 507. *See also* Jo Ann J. Brighton, *The Doctrine of Necessity: Is it Really Necessary?*, 10 J. BANKR. L. & PRAC. 107, 108 (2000); Bruce S. Nathan, *Critical Vendors: Elevating the Low-Priority Unsecured Claims of Pre-Petition Trade Creditors*, 21 AM. BANKR. INST. J. 14, 14 (2002).

88. Nathan, *supra* note 87, at 14.

89. *See In re Chi.*, 791 F.2d at 528.

90. *See* Resnick, *supra* note 33, at 184.

91. *See* Harrison & Drew, *supra* note 36, at 344–46.

92. FERRIELL & JANGER, *supra* note 73, at 725–26.

93. *See* Gilday, *supra* note 57, at 416.

94. *See, e.g.*, *In re* Just For Feet, Inc., 242 B.R. 821 (D. Del. 1999); Mich. Bureau of Workers Disability Comp. v. Chateaugay Corp. (*In re* Chateaugay Corp.), 80 B.R. 279 (S.D.N.Y. 1987); *In*

in-depth analysis of whether the creditors are in fact essential to the health of the debtor.[95]

Furthermore, granting critical vendor motions may not give adequate notice of pre-petition payment to the debtor's other creditors.[96] Generally, all interested parties in a bankruptcy proceeding will receive notice, which affords them an opportunity to object.[97] Yet granting certain vendor motions on the first day, before a hearing, may violate a creditor's right to due process.[98]

Although a bright-line rule rejecting the doctrine provides clarity to the bankruptcy proceedings, the outright denial of pre-petition payments is not without its disadvantages. Prohibiting pre-petition payments could prevent the company from continuing its operations, thereby reducing the total value of the assets or forcing a "fire sale" of the assets. Furthermore, the prohibition of payment could have systemic consequences. For example, certain creditors, most likely trade creditors, will face financial difficulties and possibly fail if pre-petition payment is not made.[99] One reason for failure is that the debtor could be the largest account for the trade vendor and thus, if the vendor is not paid, a majority of its revenue will be lost.[100]

In addition, certain debtors not only require pre-petition payments to sustain their business, but also post-petition financing or debtor-in-possession (DIP) financing.[101] Typically, if a debtor files for a Chapter 11 reorganization, it secures DIP financing in order to make post-petition payments and continues running the business. A majority of the time, the creditors that extend DIP financing are the same unsecured creditors that are seeking pre-petition payment. Eliminating the doctrine could prevent unsecured creditors from financing the post-petition debt altogether, forcing the debtor into a liquidation proceeding. This in turn may inhibit the realization of full asset value. The prohibition of the doctrine by these courts is an overly conservative restriction to the exercise of judicial discretion, which may create unnecessary and deleterious consequences to all creditors.

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re CoServ, L.L.C., 273 B.R. 487 (Bankr. N.D. Tex. 2002); *In re* Wehrenberg, Inc., 260 B.R. 468 (Bankr. E.D. Mo. 2001); *see also* White, Medfort & Boggs, *supra* note 70, at 24.

95. *See* Gilday, *supra* note 57, at 419.

96. *See* Brighton, *supra* note 87, at 115.

97. *See id.*

98. *See id.*; Harrison & Drew, *supra* note 36, at 337.

99. *See* Gilday, *supra* note 57, at 420.

100. *See id.*; *In re* CoServ, L.L.C., 273 B.R. 487, 499–500 (Bankr. N.D. Tex. 2002).

101. DIP financing under Chapter 11 of the Code allows debtors of a failing company access to secure proceeds, enabling the continuation of the business. To entice creditors to lend to a distressed company, DIP financing lenders receive super-priority status over all other debt, and equity claims. 11 U.S.C. § 364 (2006).

3. Striking the Correct Balance

Contrary to the all-or-nothing approaches used by some courts, other courts have attempted to strike a balance by implementing tests for determining such critical vendors.[102] These courts have recognized the need for certain pre-petition payments, but have also exercised caution in determining which claims should receive critical vendor status.

One of the most prominent cases where the court correctly balanced critical vendor motions was *In re Kmart Corp*.[103] In *Kmart*, the Seventh Circuit affirmed the district court's denial of orders that allowed the debtor, Kmart, to pay pre-petition claims of certain alleged critical vendors and suppliers before confirmation of the debtor's Chapter 11 plan of reorganization.[104] It did not, however, affirm the district court's reasoning or the per se prohibition of critical vendor motions in general.[105]

In the initial bankruptcy proceeding, the bankruptcy court had granted pre-petition payments, which totaled approximately $300 million to 2,330 critical vendors, while approximately 2,000 other vendors were deemed not critical, and over 43,000 additional unsecured creditors were denied any pre-petition payment.[106] The district court reversed the bankruptcy court's order authorizing payment, "conclud[ing] that neither § 105(a) nor a 'doctrine of necessity' supports the orders."[107] On appeal, the Seventh Circuit articulated that the bankruptcy court failed to explain or justify any basis for granting the critical vendor motions.[108] In order to prove the vendor was necessary, the bankruptcy court should have shown that disfavored creditors would have received more in a reorganization than in a liquidation, and "that the supposedly critical vendors would have ceased deliveries if old debts were left unpaid . . . ."[109] The Seventh Circuit alluded to alternative options that were available to Kmart, which the bankruptcy court failed to address.[110] For instance, the bankruptcy court neglected the option of using a letter of credit to assure payment, failed to find that vendors would discontinue business with Kmart absent payment, failed to determine that dissimilar treatment of unsecured creditors was necessary for reorganization, and failed to show that disfavored creditors were in at least the same position but for the orders.[111] In addition, the Seventh Circuit noted that some creditors should have been excluded from pre-petition payment because

102. *See, e.g.*, *In re CoServ*, 273 B.R. 487; *In re* Kmart Corp., 359 F.3d 866 (7th Cir. 2004).
103. *See In re Kmart Corp*., 359 F.3d 866.
104. *See id.* at 867.
105. The court left open the possibility of a critical vendor motion under § 363(b)(1) by refusing to address the issue since this particular order was unsound for its application. *See id.* at 872.
106. *See id.* at 869.
107. *Id.*
108. *See id.* at 867.
109. *Id.* at 873.
110. *Id.* at 873–74.
111. *Id.*

they were already contractually obligated[112] to continue doing business with the debtor company; thus, pre-petition payment was unnecessary.[113]

Although the Seventh Circuit called the doctrine of necessity "just a fancy name for a power to depart from the Code[,]" it did not reject the principle of pre-petition payment of critical vendors entirely.[114] The court left open the possibility of a pre-petition payment to a critical vendor under § 363(b)(1) of the Code.[115] It considered § 363(b)(1) to be the most promising justification for granting critical vendor orders, reasoning that the payment of pre-petition debt was warranted "in order to keep 'critical' supplies flowing" and "is a use of property other than in the ordinary course of [business] . . . ."[116]

The Seventh Circuit articulated a balance between a "*per se* prohibition" and a frequently exercised grant of pre-petition payments made to critical vendors.[117] The *Kmart* standard requires that unsecured creditor claims not be paid unless it is clear that the creditor will otherwise discontinue its business relations with the debtor, which would in turn have a detrimental effect on all creditors. In addition, all other alternatives should be carefully analyzed before granting the motion. The unfortunate consequence of this approach is that it will reward those who refuse to cooperate by paying them first. It appears that under *Kmart*, noncooperative creditors are rewarded at the expense of cooperative creditors.

Another court has applied similar reasoning and a strict analysis regarding critical vendors as the Seventh Circuit in *Kmart*.[118] The bankruptcy court in *In re CoServ, L.L.C.* denied the debtor's motion with respect to five critical vendors and granted only two.[119] The court found that, in most cases, the alleged critical vendors could be replaced with little or no harm to the debtor's going concern. The court held that, in order to make critical vendor payments, the debtor must show by a preponderance of evidence that: (1) "it must be critical that the debtor deal with the claimant";[120] (2) "unless it deals with the claimant, the debtor risks the possibility of harm, or, alternatively, loss of economic advantage to the estate or the debtor's going-concern value, which is disproportionate to the

112. The automatic stay provision under the Code prohibits vendors with contract obligations from breaching by nonperformance due to the debtor's failure to pay pre-petition debts. An automatic stay is an operation of law in that it automatically prevents all creditors from receiving payment from the debtor until a reorganization plan has been confirmed. 11 U.S.C. § 362 (2006); *In re Kmart Corp*., 359 F.3d at 873.

113. *In re Kmart Corp*., 359 F.3d at 873.

114. *Id.* at 871.

115. *Id*. at 872.

116. *Id.*

117. *See* Harrison & Drew, *supra* note 36, at 348.

118. *See, e.g.*, *In re* CoServ, L.L.C., 273 B.R. 487 (Bankr. N.D. Tex. 2002).

119. *Id.* at 499–501.

120. *Id*. at 498.

amount of the claimant's prepetition claim";[121] and (3) "there is no practical or legal alternative by which the debtor can deal with the claimant other than by payment of the claim."[122] The *CoServ* court further recognized that there may be legal remedies available to the debtor that do not require pre-petition payment, but nonetheless alleviate creditors' concerns.[123]

Both the *CoServ* and *Kmart* courts have established clear factors that should be addressed when establishing critical vendor status, which will strike a correct balance between actual necessity and liberal discretion in granting critical vendor motions. This approach allows for some flexibility of the courts discretionary authority, but is not an invitation for abuse by debtors and creditors.

III. DODD-FRANK'S ORDERLY LIQUIDATION AUTHORITY

Under Title II of Dodd-Frank, the FDIC was granted authority to treat similarly situated creditors differently, so long as it was in furtherance of the OLA's objectives. Some of these objectives are specifically mandated by Title II, and generally by Dodd-Frank. In order to adhere to these objectives, the FDIC clarified how it intended to treat certain creditors as expressed in the Final Rule.[124] Nevertheless, the FDIC's failure to set a standard, for other creditors that were not per se excluded, does not adequately adhere to the OLA's mandated objectives as effectively as it could. Thus, this note proposes a clear standard to address other categories of creditors not encompassed by the Final Rule, which will accomplish OLA's objectives more effectively. To fully understand this note's proposal, a brief discussion of the creation of the OLA and its objectives is necessary.

A. RATIONALE FOR THE ORDERLY LIQUIDATION AUTHORITY

The rationale behind the creation of the OLA was to put in place the legal mechanisms that were not available before the crisis occurred—namely, the ability of the federal government to wind down bank holding companies and nonbank financial companies.[125] Before the creation of the OLA under Dodd-Frank, when a bank holding company or nonbank financial company became insolvent, the only available option was to file for protection under the Code as either a liquidation proceeding under

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121. *Id.*
122. *Id.*
123. *Id.* at 499.
124. Dodd-Frank Act, Pub. L. No. 111-203, § 206, 124 Stat. 1376, 1459 (2010) (codified at 12 U.S.C. § 5386 (2010)); Final Rule, 76 Fed. Reg. 41,626 (July 15, 2011) (codified at 12 C.F.R. pt. 380.27).
125. Notice of Proposed Rulemaking, 75 Fed. Reg. 64,173, 64,174 (proposed Oct. 19, 2010) (to be codified at 12 C.F.R. pt. 380).

Chapter 7,[126] or a reorganization under Chapter 11.[127] Opponents of the Code, including the Treasury Department, however, argued that the bankruptcy system could not adequately liquidate these large financial companies.[128]

The federal government and other commentators have suggested that the bankruptcy process: is not quick enough, which results in loss of asset value; lacks competent bankruptcy judges that can handle liquidating a complex financial company; could potentially cause "rapid runs on short-term financial instruments" leading to "'fire sales' of assets" when the petition is filed; and most importantly, "has neither the goals nor the mechanisms to take externalities such as effects on outside parties or the financial system into account."[129] In support of the position that the Code was an inefficient way to handle the liquidation of these large financial companies, critics point to deleterious effects that occurred subsequent to the bankruptcy filing of Lehman Brothers.[130]

Contrary to previous measures taken by the federal government to prevent failure, such as injecting capital, as they did with Bear Sterns, the federal government let Lehman Brothers fail.[131] Lehman Brothers filed for Chapter 11 protection on September 15, 2008, creating the largest bankruptcy in U.S. history.[132] The events that took place after the collapse of Lehman Brothers were nothing short of earth-shattering.[133] The credit market froze in the United States, banks halted lending, consumer and car loans were impossible to obtain, and businesses could not obtain credit to meet employee payrolls.[134] As a consequence, there was a 6 percent decline

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126. 11 U.S.C. § 701 et seq. (2006).

127. 11 U.S.C. § 1101 et seq.; *see also* Notice of Proposed Rulemaking, 75 Fed. Reg. at 64,174 (to be codified at 12 C.F.R. pt. 380); *see generally* Systemically Important Institutions, *supra* note 25.

128. Ben S. Bernanke, Chairman, Bd. of Governors of the Fed. Reserve Sys., Testimony before the Comm. Fin. Servs.: Lessons from the Failure of Lehman Brothers (Apr. 20, 2010), *available at* http://www.federalreserve.gov/newsevents/testimony/bernanke20100420a.htm.

129. BD. OF GOVERNORS OF THE FED. RESERVE SYS., STUDY ON THE RESOLUTION OF FINANCIAL COMPANIES UNDER THE BANKRUPTCY CODE 7 (2011) (footnote omitted) [hereinafter STUDY UNDER BANKRUPTCY CODE].

130. *Id.*

131. Sorkin & Thomas, *supra* note 5.

132. *See The Orderly Liquidation of Lehman Brothers Holdings Inc. Under the Dodd-Frank Act*, 5 FDIC QUARTERLY 1, 1 (2011) [hereinafter *Orderly Liquidation of Lehman Brothers*].

133. The Lehman Brothers' bankruptcy filing has been noted as "one of the signal events of the financial crisis." In addition, the Dow Jones declined over 500 points, which was the largest single-day drop since the terrorist attacks on September 11th, and credit markets showed distress. *See id.*; Alex Berenson, *Wall St.'s Turmoil Sends Stocks Reeling*, N.Y. TIMES, Sept. 15, 2008, http://www.nytimes.com/2008/09/16/business/worldbusiness/16markets.html?hp; Simon Kennedy, Greg Morcroft & Robert Schroeder, *Lehman Failure, AIG Struggle Drive Financials Lower*, MARKETWATCH (Sept. 15, 2008, 4:48 PM), http://www.marketwatch.com/Story/story/print?guid=8E886D48-E3C7-4CE2-95F4-7099CE1A49DB.

134. Matthew Jaffe, *Lessons to Be Learned One Year After Lehman Brothers Collapse Roiled the World*, ABC NEWS (Sept. 14, 2009), http://abcnews.go.com/Business/lessons-learned-year-financial-crisis-began/story?id=8563814; Fareed Zakaria, *A Lonely Success*: *Don't Forget: the*

in the Gross Domestic Product (GDP), and 1.7 million people lost their jobs in one quarter, the largest drop in employment in sixty-five years.[135] The following day, Barclays announced an agreement to purchase Lehman Brothers' North American investment banking and trading divisions along with its New York headquarters building, subject to regulatory approval.[136] On September 20, 2008, a revised version of that agreement was approved by U.S. Bankruptcy Judge James M. Peck through a § 363 sale under the Code.[137]

In contrast to the federal government's position, other commentators argued that the bankruptcy process was the most effective and efficient way to unwind these large financial companies.[138] They proposed that instead of a new insolvency regime, an additional section should be added to the Code that would specifically handle bank holding companies and nonbank financial companies.[139] The proponents of the bankruptcy process argued that the Code "provides legal certainty, offering a large body of established jurisprudence," predictability which encourages "risk-monitoring measures by creditors" thereby "reduc[ing] . . . moral hazard and . . . increas[ing] . . . market discipline," a process for the "viability of an insolvent firm," and "judicial review."[140]

Even with strong opposition to the creation of the OLA, the federal government viewed Lehman Brothers' failure as an example of the inadequacies of the bankruptcy system.[141] The crippling effects of the Lehman Brothers' bankruptcy on the financial system appeared to solidify the Treasury Department's opposition to the possibility of bankruptcy reform.[142] The Treasury Department's position was that bankruptcy proceedings would likely be too slow to respond, and a resolution regime must be more responsive.[143] Following the Treasury Department's position, Congress rejected bankruptcy reform, and instead established the OLA to wind down these institutions under Title II of Dodd-Frank.[144]

Bailouts Worked., NEWSWEEK, Sept. 19, 2010, http://www.newsweek.com/2010/09/19/zakaria-don-t-forget-that-the-bailouts-worked.html.

135. Zakaria, *supra* note 134.

136. *Barclays Buys Core Lehman Assets*, *supra* note 6.

137. *See Judge Approves $1.3bn Lehman Deal*, BBC NEWS, Sept. 20, 2008, http://news.bbc.co.uk/2/hi/business/7626624.stm.

138. STUDY UNDER BANKRUPTCY CODE, *supra* note 129, at 5.

139. *See* John B. Taylor, *How to Avoid a "Bailout Bill,"* WALL ST. J., May 3, 2010, http://online.wsj.com/article/SB10001424052748703871904575216633061219378.html.

140. STUDY UNDER BANKRUPTCY CODE, *supra* note 129, at 6 (footnote omitted).

141. *See Orderly Liquidation of Lehman Brothers*, *supra* note 132, at 18–19; Press Release, U.S. Dept. of Treas., Treasury Proposes Legislation for Resolution Authority (Mar. 25, 2009), *available at* http://www.treasury.gov/press-center/press-releases/Pages/tg70.aspx.

142. *Treasury Proposes Legislation for Resolution Authority*, *supra* note 141.

143. *Id*.

144. Dodd-Frank Act, Pub. L. No. 111-203, § 204, 124 Stat. 1376, 1454 (2010) (codified at 12 U.S.C. § 5384 (2010)).

B. PURPOSE AND OBJECTIVES OF THE ORDERLY LIQUIDATION AUTHORITY

Section 204 of Title II states that the purpose of the OLA 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."[145] Furthermore, the authority will be exercised in a manner whereby creditors, shareholders, and management "bear losses consistent with their responsibility, including actions for damages, restitution, and recoupment of compensation and other gains not compatible with such responsibility."[146]

Although §§ 204 and 206 are substantially similar, § 206 is slightly more detailed. Section 206 stipulates six mandatory terms and conditions for all orderly liquidation actions. First, it mandates that the FDIC will only take action for the financial stability of the United States, and not to bail out or rescue a particular failing financial company.[147] Second, shareholders will be the last to receive payment after all other claims have been paid.[148] Third, unsecured creditors' losses and payments, if any, will be made in accordance with the mandated priority provisions in § 210.[149] Fourth, the FDIC, as receiver, will remove management of the failing financial company.[150] Fifth, the FDIC will remove the board of directors of the failing financial company.[151] Sixth, the FDIC cannot take an equity interest in or become a shareholder of a failing financial company. This provision was included to prevent another TBTF bailout.[152]

In addition to the specific objectives set forth under Title II, there are general overarching goals of Dodd-Frank as well. The opening preamble of Dodd-Frank legislation states that it was enacted "[t]o promote the financial stability of the United States by improving accountability and transparency in the financial system, to end 'too big to fail', to protect the American tax-payer by ending bailouts, to protect consumers from abusive financial services practices, and for other purposes."[153]

C. THE FDIC'S POWERS AND DUTIES AS RECEIVER

As receiver, the FDIC will have many powers to effectuate the goals of the OLA, including the ability to: "take over the assets of and operate the . . . [failing] company with all of the powers of the members or shareholders,

145. *Id.* § 204(a).
146. *Id.*
147. *Id.* § 206(1).
148. *Id.* § 206(2).
149. *Id.* § 206(3).
150. *Id.* § 206(4).
151. *Id.* § 206(5).
152. *Id.* § 206(6).
153. *Id.* pmbl.

the directors, and the officers";[154] "collect all obligations and money owed";[155] "perform all functions of the covered financial company";[156] "manage the assets and property" as to maximize asset value;[157] and "provide by contract for assistance in fulfilling any function, activity, action, or duty of the [FDIC] as receiver."[158] The broad nature of these powers enables the FDIC to exercise wide discretion as to the managing and winding down of these financial companies.[159]

These provisions are similar to certain provisions found in the FDIA.[160] Under the FDIA, the FDIC has the authority to continue operations after the closing of a failed depository institution if necessary to maximize the value of the assets in order to achieve the "least costly"[161] resolution, or if necessary to prevent "serious adverse effects on economic conditions or financial stability."[162] Under the least costly requirement, other institutions will pay a premium to acquire the failed bank in order to obtain the sustained depositor relationships, thereby maximizing recoveries and minimizing losses.[163]

In order to accomplish the OLA's objectives, Dodd-Frank empowers the FDIC to treat creditors of the same class differently. Yet, the ability to treat creditors in the same class differently raises substantially the same concerns as the doctrine of necessity does in bankruptcy.[164] To address similar concerns and minimize public uncertainty, the FDIC has sought to create more transparency, and used its authority under § 209 to promulgate a rule that would clarify the categories of creditors to which it may authorize additional payments;[165] however, as this note points out, the FDIC did not go far enough.[166]

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154. *Id*. § 210(a)(1)(B)(i).

155. *Id*. § 210(a)(1)(B)(ii).

156. *Id*. § 210(a)(1)(B)(iii).

157. *Id*. § 210(a)(1)(B)(iv).

158. *Id*. § 210(a)(1)(B)(v).

159. Notice of Proposed Rulemaking, 75 Fed. Reg. 64,173, 64,174–75 (proposed Oct. 19, 2010) (to be codified at 12 C.F.R. pt. 380).

160. *Id*. at 64,175.

161. The "least costly" approach requires the FDIC to determine that its exercise of authority is necessary and the total amount of expenditures and obligations taken on by the FDIC to be as inexpensive as possible. 12 U.S.C. § 1823(c)(4) (2006); Notice of Proposed Rulemaking, 75 Fed. Reg. at 64,177 (to be codified at 12 C.F.R. pt. 380).

162. Notice of Proposed Rulemaking, 75 Fed. Reg. at 64,177 (to be codified at 12 C.F.R. pt. 380) (citing 12 U.S.C. §§ 1821(d), 1823(c)).

163. *Id.* at 64,177.

164. Dodd-Frank Act, Pub. L. No. 111-203, § 210(b)(1), (b)(4), 124 Stat. 1376, 1475, 1476 (2010) (codified at 12 U.S.C. § 5390 (2010)); Letter from Comm. on Capital Mkts. Reg. to Robert E. Feldman, Exec. Sec'y, *supra* note 49.

165. Dodd-Frank Act § 209, 124 Stat. 1460 (codified at 12 U.S.C. § 5380).

166. *See id*. § 204(a).

IV. CRITIQUE OF THE FDIC'S DECLARED TREATMENT OF CERTAIN UNSECURED CREDITORS

The Final Rule excludes many types of unsecured creditors from receiving additional payments.[167] As such, it distinguishes long-term unsecured debt from short-term unsecured debt, with the former being excluded.[168] The FDIC did not exclude short-term debt creditors, such as commercial lenders, because those creditors can provide lines of credit and other forms of financing to the failing financial company. This financing can be critical to the company's interim operation and orderly liquidation.[169] The FDIC can enforce lines of credit and agree to repay the lender under the credit agreement.[170] Furthermore, lines of credit can be essential to help reduce funding requests from the Orderly Liquidation Fund (the Fund).[171]

In addition, by distinguishing between long-term and short-term debt, the Final Rule seeks to achieve the goals of Dodd-Frank by creating more transparency to current and future creditors of potential failing financial companies, and maximizing asset value.[172] Allocating additional payments to certain creditors that are critical to the business operation will allow the business to continue to the benefit of all creditors. Allowing the business to operate and continue provides the FDIC with the opportunity to wind down the business or sell certain assets of the company. A structured sale of an ongoing business would allow creditors, favored and disfavored, to receive more than they would in a Chapter 7 liquidation or a "fire sale" of assets that do not necessarily recover the going-concern value.

Furthermore, long-term creditors are in a position to impose market discipline on a financial company.[173] "[T]hese creditors do not share in the potential profits gained from engaging in risky activities," and cannot "exit

167. *See* Notice of Proposed Rulemaking, 75 Fed. Reg. at 64,177 (to be codified at 12 C.F.R. pt. 380); Final Rule, 76 Fed. Reg. 41,626, 41,644 (July 15, 2011) (codified at 12 C.F.R. pt. 380.27).

168. *See* Notice of Proposed Rulemaking, 75 Fed. Reg. at 64,177 (to be codified at 12 C.F.R. pt. 380); Final Rule, 76 Fed. Reg. at 41,634 (codified at 12 C.F.R. pt. 380.27).

169. Notice of Proposed Rulemaking, 75 Fed. Reg. at 64,177–78 (to be codified at 12 C.F.R. pt. 380).

170. Dodd-Frank Act § 210(c)(13)(D), 124 Stat. 1493 (codified at 12 U.S.C. § 5390); Notice of Proposed Rulemaking, 75 Fed. Reg. at 64,178 (to be codified at 12 C.F.R. pt. 380).

171. Dodd-Frank established an "Orderly Liquidation Fund" in the Treasury that is available to the FDIC in connection with its receivership operations under the Act. Upon appointment as a receiver, the FDIC is authorized to issue obligations to the Treasury Secretary (i.e., borrow from the Treasury Department). The FDIC's issuance of obligations in connection with the liquidation of a failing financial company may not exceed: (i) "10 percent of the total consolidated assets" and (ii) "90 percent of the fair value of the total consolidated assets of each . . . company that are available for repayment. . . ." Dodd-Frank Act § 210(n)(6)(A), (B), 124 Stat. 1507 (codified at 12 U.S.C. § 5390); *see also* Notice of Proposed Rulemaking, 75 Fed. Reg. at 64,178 (to be codified at 12 C.F.R. pt. 380).

172. *See* Notice of Proposed Rulemaking, 75 Fed. Reg. at 64,177 (to be codified at 12 C.F.R. pt. 380).

173. *See* Alison M. Hashmall, Note, *After the Fall: A New Framework to Regulate "Too Big to Fail" Non-bank Financial Institutions*, 85 N.Y.U. L. REV. 829, 842 (2010).

quickly" if the company fails.[174] Thus, they are incentivized to prefer more conservative investments.[175]

In contrast, short-term creditors are more likely to engage in risky practices.[176] This risky behavior has the ability to pose a significant threat to the financial system, while exacerbating moral hazard among short-term creditors if it remains unchecked.[177] For example, in the financial context, moral hazard refers to the risk that creditors, shareholders, or investors of large financial institutions will take fewer precautions because they know they will be rescued or bailed out by the government.[178] Having fewer precautions leads to risky behavior, which can lead to a systemic problem. In order to prevent systemic risk, however, regulators may need to rescue short-term creditors in order to prevent multiple failures throughout the market.[179] Therefore, a government response "may contribute to the exact instability that government backing is trying to prevent."[180] While this note does not dispute the need to provide additional payments to creditors, which are necessary to the failing financial company, it does dispute the FDIC's decision not to provide any framework or structure as to its exercise of discretion with regard to short-term creditors. Implementing a standard will convey a message to short-term creditors that the FDIC is unlikely to use its discretion unless it is of the utmost necessity. This will have the effect of reducing moral hazard, while still permitting the FDIC the ability to use its discretion in the event that systemic risk is a possibility.

V. RECOMMENDATION

Although the Final Rule is a step in the right direction by the FDIC to elucidate the categories of creditors that will be excluded from additional payments, it falls short, and further clarification is needed. The Final Rule failed to address how the FDIC will use its discretionary power regarding additional payments to short-term creditors, or creditors that were not automatically excluded.[181] In the absence of any standard, the FDIC still has authority to exercise wide discretion to treat short-term creditors dissimilarly.[182] This discretion presents the same dilemma that courts have debated when applying the doctrine of necessity: how is a critical vendor distinguishable from other creditors?

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174. *See id.* at 842.
175. *See id*.
176. *See id*. at 843.
177. *See id*.
178. Ayotte & Skeel, *supra* note 16, at 485.
179. Hashmall, *supra* note 173, at 842–43.
180. Ayotte & Skeel, *supra* note 16, at 486.
181. Notice of Proposed Rulemaking, 75 Fed. Reg. 64,173, 64,174–75 (proposed Oct. 19, 2010) (to be codified at 12 C.F.R. pt. 380); Final Rule, 76 Fed. Reg. 41,626, 41,644 (July 15, 2011) (codified at 12 C.F.R. pt. 380.27).
182. *See FDIC's New Power*, *supra* note 26.

It is this note's position that adopting a clear standard to determine a short-term creditor's necessity will not only comply with the OLA's stated objectives in a more effective manner, but will also allow the FDIC flexibility. The standards set forth in *Kmart* and *CoServ* present the optimal balance. In *Kmart*, the court highlighted essential factors that must be shown before a critical vendor payment may be allocated.[183] First, the disfavored creditors will benefit from the payment of favored creditors because it will allow the business to continue; and second, the supposedly critical vendors would cease deliveries or supplies if pre-petition debt is not paid.[184] Adopting similar reasoning, in *CoServ*, the court adopted a three-pronged test that creates a clear standard which critical vendors must meet, including demonstrating the creditor's indispensability to the debtor, the probable realization of economic gain, and a lack of practical alternatives.[185]

Therefore, this note recommends the following standard be met before additional payment to a short-term creditor is made. First, the creditor must be virtually indispensible to the profitable operations or preservation of the value of the assets. Second, the creditor would discontinue business with the failing financial company if no additional payment is made. Third, creditor payment should either further the objectives of the OLA to maximize value or prevent serious economic harm to the distressed company. Lastly, no other practical alternatives are available other than payment to the certain creditor.

This note's standard in conjunction with the FDIC's Final Rule will accomplish the mandated objectives of the OLA in the most effective manner for several reasons. First, the proposed standard is in accordance with the FDIC's stated intent that the dissimilar treatment of creditors will only be exercised when it is necessary to maximize asset value.[186] Only on a "case-by-case basis" will the payment of creditors be made, and in accordance with all statutory requirements.[187] Implementing a standard to distinguish the necessary unsecured creditors from other unsecured creditors will accomplish this goal more effectively. By applying the proposed standard, it will further narrow the possibility of granting additional payments to creditors that are not necessary to maximize the value of the assets.

Second, the implementation of a clear standard will create more transparency in the liquidation process, an overarching objective of the

183. *See In re* Kmart Corp., 359 F.3d 866, 872 (7th Cir. 2004).
184. *See id.*
185. *In re* CoServ, L.L.C., 273 B.R. 487, 498 (Bankr. N.D. Tex. 2002).
186. Notice of Proposed Rulemaking, 75 Fed. Reg. at 64,177–78 (to be codified at 12 C.F.R. pt. 380).
187. *Id*. at 64,178.

legislation.[188] In addition, it may alleviate concerns regarding the political aptitude of those exercising discretion and the administration that is in office at the time.

Third, this note's proposed standard will minimize moral hazard more effectively than the FDIC's Final Rule. Without any clear standard that addresses the FDIC's reluctance to grant additional payments to short-term creditors, these creditors may still engage in risky practices. If the proposed standard is implemented, however, they will be on notice that the FDIC's authority will only be exercised in extreme cases. Thus, a rational creditor would not anticipate additional payments, and it would reduce moral hazard. Furthermore, putting forth a standard by which the FDIC will operate sends a strong message to the marketplace that additional payments will be a drastic measure, and not made regularly. This can reduce moral hazard and risk taking as well. One can argue that the recent downgrade by Moody's of the long-term credit of Citigroup, Inc., Wells Fargo & Co., and Bank of America Corp. was an example of the effects that Dodd-Frank and FDIC regulations can have on the marketplace.[189] Moody's downgraded these banks because of an increased possibility that the government would allow these large financial institutions to fail, taking the view that contagion could be limited.[190] The credit downgrade signifies that the anti-bailout position embraced under Dodd-Frank has affected at least one credit agency's view as to the level of risk associated within these institutions.[191] A riskier investment is usually accompanied by increased costs, which can affect how other parties in the market interact with a specific company.[192]

Although this note's standard applies in most instances, there may be a limitation for a certain type of creditor that should be noted. Generally, under the Code, contractual agreements that include provisions which allow a party to terminate the contract upon a debtor filing for bankruptcy or some other event related to the debtor's financial condition are not enforceable and subject to the automatic stay.[193] One exception to this rule is for a "qualified financial contract" (QFC), which is "any securities contract, commodity contract, forward contract, repurchase agreement, swap agree-

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188. U.S. S. COMM. ON BANKING, HOUS. & URBAN AFFAIRS, BRIEF SUMMARY OF THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT (2010), *available at* http://banking.senate.gov/public/_files/070110_Dodd_Frank_Wall_Street_Reform_comprehensive_summary_Final.pdf.

189. *See* Hugh Son, Dakin Campbell & Donal Griffin, *BofA, Wells Fargo Downgraded by Moody's*, BLOOMBERG, Sept. 21, 2011, http://www.bloomberg.com/news/2011-09-21/bank-of-america-credit-rating-downgraded-by-moody-s-on-waning-u-s-support.html; Joe Rauch & David Henry, *Moody's Downgrades Big Banks on Changed Policy*, REUTERS, Sept. 21, 2011, http://www.reuters.com/article/2011/09/22/us-bankofamerica-downgrade-idUSTRE78K4P020110922.

190. Son, Campbell & Griffin, *supra* note 189; Rauch & Henry, *supra* note 189.

191. Son, Campbell & Griffin, *supra* note 189; Rauch & Henry, *supra* note 189.

192. Son, Campbell & Griffin, *supra* note 189; Rauch & Henry, *supra* note 189.

193. 11 U.S.C. § 541(c)(1)(B) (2006); FERRIELL & JANGER, *supra* note 73, at 236–37.

ment, and any similar agreement."[194] Due to this exception, in a bankruptcy proceeding, a "non-defaulting QFC counterparty" can "close out, terminate, [or] net" their position, whether the trustee approves or not.[195] The rationale for the QFC exception can be attributed to concerns over systemic risk and market uncertainty, thereby creating liquidity issues and contagion effects on the economy.[196] Many large financial institutions (e.g., Lehman Brothers) that invest heavily in "certain specialized markets for financial assets" have extensive QFC exposure.[197] The deleterious consequence of this was exemplified when Lehman Brothers filed for bankruptcy, and most of the counterparties to the QFCs terminated their contracts immediately upon the bankruptcy filing.[198] Those terminations resulted in the loss of billions of dollars in market value to the bankruptcy estate almost instantaneously.[199] Although the QFC exemption was intended to prevent systemic risk, some commentators have argued that it actually increased systemic risk.[200] They contend that the exemption alters the incentives so that counterparties do not monitor or impose discipline on the debtor, creating "counterparty runs" that have "spillover effects" on other creditors and the market as a whole.[201]

In order to rectify this detrimental effect, Title II imposes a one-business-day delay on all QFC terminations by counterparties.[202] The purpose of the one-business-day delay is to allow the FDIC to transfer assets, contracts, and other property of the failing company to another solvent company or to a newly created bridge financial company.[203] By transferring the assets, counterparties cannot terminate their positions or contracts due to insolvency of the failing company as they did in the Lehman Brothers bankruptcy.[204] This prohibition is intended to provide "market certainty and stability" and, in the event of sale to a third party, "preserves the value represented by the contracts."[205]

In the event that the FDIC does not transfer assets of the failing financial company to either a third-party purchaser or a bridge financial company, this note's standard would be inapplicable. For instance, if neither transfer happens within the one-business-day delay period, the "non-defaulting QFC counterparty . . . can take actions to exercise its contractual rights," as

194. Dodd-Frank Act, Pub. L. No. 111-203, § 210(c)(8)(D)(i), 124 Stat. 1376, 1482 (2010) (codified at 12 U.S.C. § 5390 (2010)).

195. STUDY UNDER BANKRUPTCY CODE, *supra* note 129, at 15.

196. *Id.* at 17–18.

197. *Systemically Important Institutions*, *supra* note 25; *Orderly Liquidation of Lehman*, *supra* note 132, at 8.

198. *See Orderly Liquidation of Lehman Brothers*, *supra* note 132, at 3–4.

199. *Id.*

200. STUDY UNDER BANKRUPTCY CODE, *supra* note 129, at 16.

201. *Id.*

202. Dodd-Frank Act, Pub. L. No. 111-203, § 210(c)(10)(B), 124 Stat. 1376, 1491 (2010) (codified at 12 U.S.C. § 5390 (2010)).

203. *Id.* § 210(c)(9); *Orderly Liquidation of Lehman Brothers*, *supra* note 132, at 8.

204. *Orderly Liquidation of Lehman Brothers*, *supra* note 132, at 8.

205. *Id.* (footnote omitted).

it did in Lehman Brothers.[206] Therefore, it would not matter whether a standard had existed because the failing financial company would have little or no value remaining after the QFC counterparty terminates. Despite the possibility that the FDIC could fail to create a bridge company in time to prevent QFC termination or facilitate a transfer to a new purchaser, it is doubtful that this situation would occur. In fact, the FDIC already has this authority under the FDIA, and orchestrated a similar transaction in 2008 with Indy Mac Bank, as a "pass-through conservatorship."[207]

In the likely event that the FDIC does form a bridge financial company, it could create more than one. For example, the FDIC could transfer all the assets and other property that can be sold to a third party into one company, which we shall call the "Good Bridge Company."[208] The FDIC could also create another bridge company, which we shall call the "Bad Bridge Company," to which all liabilities and other defaulted obligations that cannot be sold will be transferred.[209] Other possible bridge companies can be formed to hold all QFCs or other property.

This note's standard can be an effective mechanism whether the failing financial company's property is transferred to the Good or Bad Bridge Company, but with varying effects. In a Good Bridge Company scenario, a central concern is to preserve a lasting relationship with a creditor so that the company can remain intact. Continued operations will have the effect of facilitating the maximization of asset value when it is sold to a third party.[210] Yet, the issue that arises again is: are these creditors in fact necessary? Since the automatic stay would prohibit the cancellation of certain obligations, exclusive of QFCs, it may not be necessary to make prepayments because the receiver can determine whether to accept or reject certain contracts.[211] Even in a Bad Bridge Company scenario, the standard is useful because it also preserves the relationship of the creditors, especially when there are no contracts with creditors, but rather an open account relationship. It would still be the goal of the receiver to sell these assets for some value, and paying certain short-term creditors may be the best way to maximize asset value.[212] Thus, a standard to determine the necessity of these unsecured short-term creditors would still be beneficial and facilitate the process in either a Good or Bad Bridge Company situation. Furthermore, if a bridge company is created within the one-business-day delay period, all QFCs could be transferred, and the FDIC would afford the same discretio-

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206. STUDY UNDER BANKRUPTCY CODE, *supra* note 129, at 15.
207. *Orderly Liquidation of Lehman Brothers*, *supra* note 132, at 7 n.39.
208. *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, 185 (2011); Dodd-Frank Act § 210(h), 124 Stat. 1496 (codified at 12 U.S.C. § 5390).
209. Gordon & Muller, *supra* note 208, at 185.
210. *See id.* at 185–86.
211. Dodd-Frank Act § 210(c)(1), 124 Stat. 1477 (codified at 12 U.S.C. § 5390).
212. *See id.* § 210(a)(1)(B)(iv).

nary treatment as it does to the other short-term unsecured creditors. Thus, this note's standard would still apply.

CONCLUSION

Under Dodd-Frank, Congress has granted the FDIC wide discretion and authority as receiver under the OLA.[213] In an effort to adhere to the OLA's mandated objectives, the FDIC clarified how it would exercise its authority when granting additional payments to certain creditors over others of the same class.[214] As this note argues, however, the FDIC only addresses half of the issue by failing to propose a standard that indicates its intended treatment toward short-term creditors. This note proposed a standard, which would further clarify the manner in which the FDIC would exercise its authority to treat short-term creditors differently by incorporating bankruptcy standards that have proven useful and effective.[215]

Thus, this note recommends that the FDIC, in conjunction with the FSOC, propose a rule, which includes this note's standard to address the FDIC's treatment of short-term creditors under the OLA. Creating a clear standard to determine if a creditor is necessary will have the effect of promoting transparency within a recently created, and never before used, liquidation regime, minimizing moral hazard among short-term creditors, maximizing the assets of the failing financial company, harmonizing the OLA and existing insolvency regimes, and maintaining FDIC flexibility.[216]

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213. *FDIC's New Power*, *supra* note 26.

214. Notice of Proposed Rulemaking, 75 Fed. Reg. 64,173, 64,181 (proposed Oct. 19, 2010) (to be codified at 12 C.F.R. pt. 380); Final Rule, 76 Fed. Reg. 41,626, 41,644 (July 15, 2011) (codified at 12 C.F.R. pt. 380.27).

215. *See In re* Kmart Corp., 359 F.3d 866, 872 (7th Cir. 2004); *In re* CoServ, L.L.C., 273 B.R. 487, 498 (Bankr. N.D. Tex. 2002).

216. *See infra* Part V.

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