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Thomas W. Joo

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A COMPARISON OF LIQUIDATION REGIMES: DODD-FRANK'S ORDERLY LIQUIDATION AUTHORITY AND THE SECURITIES INVESTOR PROTECTION ACT

*Thomas W. Joo**

INTRODUCTION

Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank)¹ in response to the massive financial crisis of 2008. The most dramatic manifestations of the crisis were the failures or near failures of large financial institutions, and the most dramatic policy choices facing the government concerned whether to bail out distressed institutions or allow them to fail. A vocal minority in Washington opposed any bailouts, and the public reaction to the bailouts that did occur was largely negative.

Title II of Dodd-Frank, entitled “Orderly Liquidation Authority” (OLA) is designed to set out a procedure for regulators to address the specter of failure in the future. OLA, which resembles the Federal Deposit Insurance Corporation’s (FDIC) bank-resolution authority in many respects, authorizes the appointment of the FDIC as a receiver to liquidate a failing financial company, but has no provisions for the rehabilitation of a failing company. This Article analyzes OLA in comparison to the resolution regime for securities broker-dealers,² the Securities Investor Protection Act (SIPA). OLA and SIPA each take a class of failing financial institutions out of the bankruptcy regime and provide an alternate regime. SIPA established a not-for-profit corporation, the Securities Investor Protection Corporation (SIPC), to handle the liquidations of insolvent securities broker-dealers

* Professor, UC Davis School of Law. Earlier versions of this paper were presented at the Brooklyn Journal of Corporate, Financial & Commercial Law Symposium on Comparative Approaches to Systemic Risk and Resolution and at the West Coast Law and Society Retreat at Southwestern Law School, both in February 2011. I would like to thank all the participants at both events, as well as Timothy Canova, in particular, for helpful comments. I also thank UC Davis Law School for financially supporting this research.

1. 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.).

2. The term “broker-dealer” is often used in securities-regulation discourse because securities regulation (including SIPA (Securities Investor Protection Act)) generally treats brokers and dealers the same. The securities laws define the terms “broker” and “dealer” as follows: “The term ‘broker’ means any person engaged in the business of effecting transactions in securities for the account of others” but does not include a bank. 15 U.S.C. § 78c(a)(4) (2006). “The term ‘dealer’ means any person engaged in the business of buying and selling securities for such person’s own account through a broker or otherwise” but does not include a bank, or any person insofar as he “buys or sells securities for [his] . . . own account, either individually or in a fiduciary capacity, but not as a part of a regular business.” *Id.* § 78c(a)(5). The breadth of these definitions indicates the broad applicability of SIPA and the SIPC (Securities Investor Protection Corporation) membership requirement. *See infra* Part I.B.

under the oversight of a bankruptcy court. OLA makes a more radical departure from bankruptcy law by vesting considerable discretion in the Secretary of the Treasury (the Treasury Secretary), the President, the Federal Reserve Board of Governors (the Fed), and the FDIC, which serves as receiver. Bankruptcy courts play no part in an OLA proceeding, and the judicial role is greatly reduced overall.

It is no coincidence that both OLA and SIPA were quickly formulated and passed by Congress during periods of perceived economic crisis. Unfortunately, the causes of a major crisis are typically too complex to be dealt with, or even understood, during or immediately after the crisis. Political actors, however, need to portray themselves as doing *something* as a rapid and forceful response.³ Taking time before acting might let government actors gather more information and craft more thoughtful responses, but it would also allow political momentum to dissipate. Both OLA and SIPA in many ways fulfilled short-term political goals more than long-term policy needs. During times perceived as “emergencies,” Congress’ typical response is to permit the executive branch to assume increased power.⁴ OLA, as a response to a particularly unsettling economic crisis, thus, goes much further in that direction than does SIPA.

Bankruptcy is initiated by a debtor firm or its creditors. Under bankruptcy law, a firm’s creditors may force an insolvent firm into bankruptcy, and its estate may be liquidated under the direction of a trustee. But more commonly, a debtor firm remains in control and possession of its assets, subject to creditor input and court supervision, while it either winds down or attempts to reorganize and return to normal operation. Both SIPA and OLA, however, provide only for the seizure of a firm by a government or quasi-government agency, and its liquidation by that agency with significantly reduced input from creditors and courts. SIPA is, in many respects, a bankruptcy proceeding directed by a SIPC-appointed trustee, whereas OLA is a much more radical departure from bankruptcy. Neither statute contains provisions for the rehabilitation of a failing firm,⁵ which is one reason OLA has been criticized.⁶ Neither OLA nor SIPA, however, automatically imposes liquidation in all circumstances. As will be explained

3. See John C. Coates IV, *Private vs. Political Choice of Securities Regulation*, 41 VA. J. INT’L L. 531, 568–69 (2001).

4. See *infra* text accompanying note 92.

5. See 15 U.S.C. § 78fff(a)(4); Dodd-Frank Act § 210(a)(1)(D), 124 Stat. 1461 (codified at 12 U.S.C. § 5390).

6. See Jeffrey N. Gordon & Christopher Muller, *Confronting Financial Crisis: Dodd-Frank’s Dangers and the Case for a Systemic Emergency Fund*, 28 YALE J. ON REG. 151, 190–91 (2011). Others have argued in favor of a reorganization option for financial firms and even for banks. See, e.g., Thomas H. Jackson, *Chapter 11F: A Proposal for the Use of Bankruptcy to Resolve Financial Institutions*, in ENDING GOVERNMENT BAILOUTS AS WE KNOW THEM 217 (Kenneth E. Scott, George P. Schultz & John B. Taylor eds., 2009); David A. Skeel, Jr., *The Law and Finance of Bank and Insurance Insolvency Regulation*, 76 TEX. L. REV. 723 (1998) [hereinafter Skeel, *Bank and Insurance Insolvency*].

below, each statute gives regulators and politicians discretion as to whether to pursue liquidation. Neither statute prohibits alternative responses, such as bankruptcy proceedings, or bailouts by the Fed or Congress, all of which were employed in 2008.

I. SIPA

SIPA was passed in 1970 in response to a wave of brokerage-firm failures. It provides for orderly liquidation of an insolvent brokerage firm under the oversight of SIPC, a government-chartered, non-profit private corporation. At the time (and still today), brokerages were excluded from Chapter 11 of the Bankruptcy Code, and Chapter 7 already contained provisions for the liquidation of insolvent brokerage firms. SIPA added two significant innovations: first, it authorized SIPC to petition a court for the liquidation of a brokerage firm; and second, it established an industry-funded insurance fund, administered by SIPC, to protect the contents of customers' accounts when the debtor firm's assets are insufficient to do so.

A. PURPOSES OF SIPA

Just as FDIC insurance was intended to reassure the retail bank depositor, the stated purpose of SIPA is to bolster "investor confidence" in the securities markets,⁷ and it does so by focusing (at least in principle) on protecting a specific class of a failed brokerage firm's creditors: its customers. SIPA's choice to insure customers is not necessarily optimal from an efficiency standpoint. It can reduce customers' incentive to seek out less risky brokerages.⁸ Moreover, because SIPA insures all broker-dealers without regard to the level of their risk of failure, it reduces firms' incentives to control risk.⁹ But in any event, SIPA is consistent with U.S. securities regulation, which has historically focused on encouraging "investor confidence" even when market conditions would justify caution.¹⁰

Ironically, the immediate impetus for SIPA's passage in 1970 was a rash of brokerage failures that were *not* caused by a lack of customer confidence in brokers. Rather, the string of failures was caused by the "one-two punch" of a "back-office crisis" and a subsequent stock-market slump.¹¹ A bubble market in the late 1960s resulted in trading volume so high that, in those pre-computer days, the trade-processing capacity of

7. See Thomas W. Joo, *Who Watches the Watchers? The Securities Investor Protection Act, Investor Confidence, and the Subsidization of Failure*, 72 S. CAL. L. REV. 1071, 1080–81 (1999).

8. See *id.* at 1130–31. Given customers' relative inability to investigate brokers' financial health, however, this effect is probably not that significant. See *id.*

9. See *id.* at 1133.

10. See, e.g., Donald C. Langevoort, *Managing the "Expectations Gap" in Investor Protection: The SEC and the Post-Enron Reform Agenda*, 48 VILL. L. REV. 1139, 1143–44 (2003).

11. JOEL SELIGMAN, *THE TRANSFORMATION OF WALL STREET* 450–51 (rev. ed. 1995).

firms' "back offices" was overloaded.¹² This resulted in bookkeeping errors, the loss of securities and cash, and in some cases, fraud and theft.¹³ Some firms were thus "forced out of business by having too much business."¹⁴ Other firms exploited the stock bubble by engaging in various kinds of fraud that eventually contributed to their failures.¹⁵ All of these failures could be said to have been caused by customers' *overconfidence* in brokers' technical capability and honesty. Just as the brokerage industry invested heavily in automation and other ways to expand processing capacity, the stock-market bubble burst in 1969, causing even more firms to fail. As in the first stage of the crisis, lack of confidence in brokers was not the problem. Rather, this second wave of failures was caused by a justified lack of confidence in the investment value of securities.¹⁶

The legislative history of SIPA evinces little concern for the brokerage industry itself; rather, it was intended to restore "investor confidence" in securities markets, thereby increasing investment and lifting the market out of its slump.¹⁷ Note that the protected customers under SIPA are not investors in the failed firm; instead, they are creditors of the firm who use the firm as a middleman to invest in securities markets. Moreover, SIPA's main function is to preserve the contents of customer trading accounts; it does not protect investors against declines in the market value of securities (the apparent cause of the second wave of brokerage failures).

Although SIPA does not contain provisions for the rescue or rehabilitation of a failing brokerage firm, it operates as a subsidy of the brokerage industry in that it encourages patronage of the industry by reducing customer risk. Congress seems to have chosen the brokerage industry as an incidental beneficiary of the established government principle of protecting and supporting the securities markets. While SIPC is funded primarily by assessments on the industry itself, SIPA gives brokerage customers insurance coverage that the market did not provide at the time and likely would not have. Furthermore, the SIPA scheme receives taxpayer support in a number of ways: SIPC can borrow from the Treasury; it is tax-exempt; the rates it charges for insurance may be lower than the market would charge; and it is overseen by the Securities and Exchange Commission (SEC) and Congress.¹⁸ Although SIPA does not "bail out" any particular failing firm, it was designed to alleviate financial distress in the brokerage industry and prevent further failures of brokers. Cheryl Block has

12. *Id.* at 450–51.

13. *Id.* at 451.

14. *Id.* (quoting SEC Chairman Hamer Budge).

15. See Joo, *supra* note 7, at 1083–84.

16. For more detail on the crisis, see SELIGMAN, *supra* note 11, at 451–52; Joo, *supra* note 7, at 1076–80.

17. See Joo, *supra* note 7, at 1080–81.

18. See *id.* at 1098–99, 1114–15.

referred to this kind of industry-wide government assistance as a “prospective” “industry bailout.”¹⁹

B. INITIATING A SIPA LIQUIDATION

With few exceptions, every registered broker or dealer of securities must be a SIPC member.²⁰ SIPC may apply to a federal district court for a protective decree if SIPC determines that a member firm has failed or is in danger of failing to meet its obligations to its customers, and if the firm meets one of the following four conditions: it is insolvent; it is subject to a proceeding in which a receiver, trustee, or liquidator has been appointed; it is out of compliance with the rules of the SEC or self-regulatory organizations (SRO) regarding financial responsibility or hypothecation of customer securities;²¹ or it is unable to establish compliance with such rules.²² Individual creditors have no standing to initiate a SIPA proceeding or to compel SIPC to do so.²³

Judicial review of a SIPC petition is limited. If the district court finds that the firm meets certain enumerated criteria indicating financial distress, it “shall forthwith issue a protective decree.”²⁴ The court must then appoint a trustee and an attorney for the trustee, both of whom are selected by SIPC “in its sole discretion.”²⁵ The court then must remove the proceeding to the bankruptcy court of that district.²⁶ SIPC may not give financial assistance to a debtor firm or take any steps to rehabilitate it. SIPA usually appoints a trustee from the private sector who has extensive experience in the securities industry.²⁷ The trustees have often performed previous liquidations, and are supported by SIPC’s experienced and highly specialized staff. Once the petition has been granted, the district court must transfer the proceeding to bankruptcy court, which retains jurisdiction over the remainder of the liquidation.²⁸

19. See Cheryl D. Block, *Overt and Covert Bailouts: Developing a Public Bailout Policy*, 67 IND. L.J. 951, 973, 976 (1992); Joo, *supra* note 7, at 1106 (“Thus, in Professor Block’s analysis, it was a prospective bailout of each member firm and of the industry generally.”).

20. See 15 U.S.C. § 78ccc(a)(2)(A) (2006).

21. Hypothecation refers to the collateral a customer must pledge to secure purchases of securities made on margin (i.e., with loans from the broker). BLACK’S LAW DICTIONARY 334 (3d ed. 2006).

22. 15 U.S.C. § 78eee(a)(3)(A), (b)(1).

23. See *SIPC v. Barbour*, 421 U.S. 412, 425 (1975).

24. Specifically, the court must issue the decree if it finds that the firm is subject to a proceeding in which a receiver, trustee, or liquidator has been appointed; is out of compliance with SEC or SRO rules for financial responsibility or hypothecation of customer securities; or is unable to establish compliance with such rules. 15 U.S.C. § 78eee(b)(1)(B), (C), (D).

25. *Id.* § 78eee(b)(3). The appointment is, however, subject to a hearing with respect to the disinterestedness of the trustee. *Id.* § 78eee(b)(6)(B).

26. *Id.* § 78eee(b)(4).

27. Joo, *supra* note 7, at 1117. A SIPA employee may serve as the trustee for a smaller liquidation. *Id.*

28. 15 U.S.C. § 78eee(b)(4).

Although the decision whether to petition for liquidation is technically up to SIPC, SIPC is in fact influenced by other government actors in determining whether a liquidation occurs. For example, SIPC does not have any power or authority to monitor its members for signs of distress, and thus, it cannot as a practical matter proactively initiate a liquidation.²⁹ The SEC and the SROs, however, do have the ability to monitor broker-dealers, so the initiation of a SIPC liquidation effectively requires a request from the SEC or an SRO.³⁰ In addition, the executive branch has significant influence over whether a SIPA liquidation occurs, and the White House also has political leverage over SIPC itself. Of SIPC's seven board members, who each serve three-year terms,³¹ five are presidential appointees, the sixth is appointed by the Treasury Secretary (from among the Treasury's employees), and the seventh is appointed by the Fed (from among the Fed's employees).³²

SIPA establishes liquidation authority and only liquidation authority, and most brokerage failures are administered under SIPA. But no provision of SIPA *requires* a failing brokerage to be liquidated under SIPA. SIPA does not prevent the SEC, an SRO, or a distressed firm from requesting special assistance from the Treasury, Congress, the White House, or the Fed. Indeed, the executive branch regularly claims and exercises extraordinary powers when it perceives an "emergency," and Congress tends to go along.³³ Thus, SIPA has not always been invoked with respect to brokers that were considered "too big to fail." For example, when Bear Stearns was in danger of failing in 2008, it did not go into liquidation under SIPA or the Bankruptcy Code. Instead, the Fed engineered a soft landing for Bear Stearns by helping finance its purchase by JPMorgan.³⁴

In other cases, firms that were not rescued by the government went into Chapter 11 bankruptcy, despite the fact that the Bankruptcy Code nominally excludes securities brokers and dealers from Chapter 11 and requires them to liquidate under special Chapter 7 provisions or SIPA. The two largest broker-dealers to go bankrupt—Drexel Burnham Lambert in 1990 and Lehman Brothers (Lehman) in 2008—evaded the exclusion by employing "roughly the same strategy": their holding companies filed for Chapter 11

29. See Joo, *supra* note 7, at 1097–98.

30. According to SIPA, if the SEC or an SRO "is aware of facts which lead it to believe that any broker or dealer subject to its regulation is in or is approaching financial difficulty, it shall immediately notify SIPC." 15 U.S.C. § 78eee(a)(1). But neither the SEC nor SRO is under any affirmative duty to actively monitor brokerages for signs of financial distress. Indeed, an SRO that fails in good faith to report the financial distress of one of its members is immune from liability. *Id.* § 78iii(b).

31. See *id.* § 78ccc(c)(4).

32. *Id.* § 78ccc(c)(2).

33. See Eric A. Posner & Adrian Vermeule, *Crisis Governance in the Administrative State: 9/11 and the Financial Meltdown of 2008*, 76 U. CHI. L. REV. 1613, 1649 (2009).

34. See David A. Skeel, Jr., *Bankruptcy Boundary Games*, 4 BROOK. J. CORP. FIN. & COM. L. 1, 12 (2009) [hereinafter Skeel, *Bankruptcy*].

but their brokerage subsidiaries did not file for bankruptcy until after transferring their customer accounts.³⁵ In Lehman's case, this involved some questionable manipulation of statutory procedures.³⁶ Thus, although Lehman's parent holding company, like Drexel, is being liquidated, it is doing so as a debtor-in-possession (DIP) under Chapter 11 rather than under the direction of a Chapter 7 or SIPA trustee.³⁷

The prevalence of "too big to fail" ideology on Wall Street is evidenced by the fact that Lehman's descent into bankruptcy and SIPA proceedings—the ostensibly "normal" statutory regimes for the failure of financial firms—were met with far more surprise than the ad hoc intervention to mitigate Bear Stearns's failure, or subsequent bailout maneuvers such as the opening of the Fed's discount window to investment banks and the Emergency Economic Stabilization Act of 2008 (EESA), which established the Troubled Asset Relief Program (TARP).³⁸

C. SIPA LIQUIDATION, INSURANCE, AND THE SIPC FUND

In most technical respects, a SIPA liquidation resembles a Chapter 7 bankruptcy liquidation.³⁹ But it differs significantly from a bankruptcy in

35. See *id.* at 4.

36. Lehman Brothers Inc., Lehman's broker-dealer subsidiary, was not included in the holding company's Chapter 11 filing and is now being liquidated under SIPA. As David Skeel explains, the main purpose of the holding company's bankruptcy was to quickly sell the business of its brokerage subsidiary (to Barclays) before it lost value. *Id.* The subsidiary was not part of the holding company's Chapter 11 estate, however, and could not be because of the brokerage exclusion; thus, the judge overseeing the Chapter 11 case had no power to approve the sale. *Id.* At the request of Lehman's lawyers, SIPC initiated a SIPA liquidation of the brokerage simultaneously with the bankruptcy court hearing on its sale to Barclays, arguably giving the bankruptcy court jurisdiction to approve the sale. *Id.* at 4–5. See also Ben Hallman, *A Moment's Notice*, AMERICANLAWYER.COM (Dec. 1, 2008), <http://www.law.com/jsp/tal/PubArticleTAL.jsp?id=1202514540922&slreturn=1>; *Credit FAQ: How is the Lehman Brothers Holdings Inc. Bankruptcy Progressing?*, STANDARD & POOR'S 1, 6–7 (2008), available at http://www2.standardandpoors.com/spf/pdf/media/Lehman_Bros_Bankruptcy.pdf. According to Skeel, some parties at the hearing unsuccessfully objected on the (apparently correct) ground that the brokerage business was never part of the Chapter 11 debtor's estate. See Skeel, *Bankruptcy*, *supra* note 34, at 5.

37. See Skeel, *Bankruptcy*, *supra* note 34, at 4.

38. Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, 122 Stat. 3765 (codified in scattered sections of the U.S.C.).

39. Chapter 7 has special provisions for the liquidation of securities brokers (the Bankruptcy Code does not permit them to reorganize under Chapter 11), and SIPA closely resembles this procedure. The key differences are the role of SIPC and the SIPC Fund. In addition, SIPA requires SIPA trustees to satisfy customers' claims for securities with securities to the extent possible (even if this requires using the fund of customer property or SIPC funds to purchase securities). See Joo, *supra* note 7, at 1112 (citing 15 U.S.C. § 78fff-2(d) (2006)). Under Chapter 7, by contrast, the estate must be liquidated, and customers must be paid pro rata in cash. See Kimberley Anne Summe, *Lessons Learned from the Lehman Bankruptcy*, in ENDING GOVERNMENT BAILOUTS AS WE KNOW THEM 59, 67 (Kenneth E. Scott, George P. Schultz & John B. Taylor eds., 2009); 11 U.S.C. § 748 (2006) (requiring Chapter 7 trustee to reduce all securities to money); *id.* § 752 (requiring trustee to distribute customer property ratably). Most broker liquidations are administered by SIPC under SIPA. See 15 U.S.C. § 78fff(b).

that SIPA singles out one type of creditor claim for special treatment: customers' claims for the securities and cash in their accounts.⁴⁰ To this end, SIPA provides customers (but not other creditors) with insurance. Roughly analogous to FDIC deposit insurance, SIPC insurance guarantees the return of the contents of customer accounts up to certain dollar-value limits. Another key distinguishing feature is the SIPC Fund, which is amassed and maintained from regular assessments on broker-dealers. The SIPC Fund covers insurance payments to customers, as well as all of SIPC's other costs,⁴¹ including the administrative costs of a liquidation to the extent that the debtor firm's assets are insufficient to do so.

SIPC's statutorily authorized assessments on its member firms have historically been nominal, flat amounts, but SIPA authorizes SIPC to make such assessments as "SIPC may deem necessary and appropriate to establish and maintain the fund and to repay any borrowings by SIPC."⁴² After the immense payouts to the former customers of Bernard L. Madoff Investment Securities LLC, SIPC increased assessments on its members in order to restore the size of the SIPC Fund.⁴³ Formerly a trivial \$150 annually, assessments were raised to 0.25 percent of net operating revenue.⁴⁴ The chief executive officer of one moderately-sized firm with 300 representatives and \$25 million in gross revenue estimated that his firm's assessment would rise to \$44,000 per year.⁴⁵ Note that these new assessments are based on firm size and not on firm-specific risk factors. SIPC is statutorily authorized to make risk-based assessments,⁴⁶ but it has never done so. SIPC's chairman has stated that the required actuarial work would be too difficult and costly.⁴⁷

A SIPA liquidation divides the debtor's estate into three parts.⁴⁸ First, securities that are registered and held in the name of the customer are

40. This intended favoritism notwithstanding, customer protection is less than perfect. See Joo, *supra* note 7, at 1121–26; SEC, OFFICE OF INSPECTOR GENERAL, OFFICE OF AUDITS, No. 495, SEC'S OVERSIGHT OF THE SEC. INVESTOR PROT. CORP.'S ACTIVITIES 12–13 (2011) (highlighting the need for increased monitoring of SIPC's activities by the SEC) [hereinafter SEC REPORT ON SIPC].

41. See 15 U.S.C. § 78ddd(a)(1) (stating that "all expenditures made by SIPC shall be made out of the fund").

42. See *id.* § 78ddd(c)(2). The statutory minimum assessment had long been \$150. See 15 U.S.C. § 78ddd(d)(1)(C); Dan Jamieson, *B-Ds Reel from Higher SIPC Fees*, INV. NEWS (Aug. 9, 2009), <http://www.investmentnews.com/article/20090809/REG/308099981>. Dodd-Frank amended this to state that the statutory minimum may be up to 0.02 percent of a member firm's gross revenues from the securities business. Dodd-Frank Act, Pub. L. No. 111-203, § 929V(a), 124 Stat. 1376, 1868 (2010) (codified at 15 U.S.C. § 78ddd(d)(1)(C) (2010)).

43. See Jamieson, *supra* note 42.

44. *Id.*

45. *Id.*

46. 15 U.S.C. § 78ddd(c)(2).

47. See Jamieson, *supra* note 42.

48. See Joo, *supra* note 7, at 1095–96.

referred to as “customer name securities.”⁴⁹ These are returned to the customer outright. Second, the securities and cash held by the debtor for the accounts of investors make up the “fund of customer property.”⁵⁰ This is typically the bulk of a SIPA debtor’s estate. In theory, broker-dealers must maintain sufficient liquidity to satisfy all customers’ claims for their property, as required by broker-dealer regulations. But a distressed firm’s fund of customer property often falls short due to inadvertent or intentional regulatory violations, volatile financial instruments, or deliberate misappropriation.⁵¹ Third, the debtor’s remaining assets make up the general estate, which is treated essentially like a Chapter 7 bankruptcy estate.⁵²

In practice, the first category—customer name securities—is relatively unimportant because securities in a brokerage account are rarely registered in the customer’s name.⁵³ Customers’ claims for the contents of their accounts are satisfied, to the extent possible, out of the fund of customer property. SIPC insurance is designed to protect the contents of a brokerage customer’s account against shortfalls in the fund of customer property. This insurance coverage is limited to \$500,000 per customer, of which a maximum of \$250,000 may be for cash. SIPC insurance is limited to satisfying “claims for customer property”—that is, claims for the contents of customer accounts as indicated by the debtor firm’s records as of the date of filing. SIPC does not provide any coverage for other losses to customers, such as those due to declines in the market value of securities, the broker’s failure to execute customer orders, or the broker’s fraudulent inducement of the customer’s purchase of securities.⁵⁴ The SIPC trustee decides whether a claim for customer property has been established to his or her satisfaction, and if so, the court “shall” authorize its payment.⁵⁵ A customer who objects to the trustee’s determination of his or her claim, however, may file a formal claim with the bankruptcy court.⁵⁶

All unsecured creditor claims other than “claims for customer property” (including the customer claims just noted, or customer claims that exceed

49. *Id.* at 1095.

50. *Id.*

51. *See id.* at 1087–91, 1098–1103.

52. 11 U.S.C. § 726 (2006); 15 U.S.C. § 78fff(d) (2006); *accord* 11 U.S.C. § 507.

53. In order to enhance transferability, customer name securities are more typically held in “street name” (i.e., in the name of the broker or an intermediary). That is, a security (or cash) in the “fund of customer property” is, like money in a bank, not normally the “property” of any particular customer, but rather, part of the resources out of which an institution satisfies its customers’ contractual claims. *See Joo, supra* note 7, at 1095.

54. Under SIPA, customer claims for securities are to be satisfied with those securities, not with cash equivalents. Thus, the statute requires that the trustee, “to the extent that securities can be purchased in a fair and orderly market, purchase securities as necessary for the delivery of securities to customers in satisfaction of their claims.” 15 U.S.C. § 78fff-2(d).

55. *Id.* § 78fff-2(b).

56. *See id.*

the limits of SIPC insurance coverage) are heard by the court like unsecured claims in a Chapter 7 bankruptcy. The claims are satisfied from the general estate in accordance with the priority of claims under Chapter 7.⁵⁷ Among unsecured claims against the general estate, SIPC's costs of administering a liquidation have the highest priority.⁵⁸ These administrative costs include those that benefit only customer-creditors, such as the processing of customer claims (which often includes litigation), transferring securities and cash to customers (which may include the purchase of securities for customers, as described above), and closing out open securities transactions.⁵⁹ The allocation of these administrative costs to the general estate abridges the normal approach to allocating administrative expenses in bankruptcy, under which the costs of administrative tasks are allocated to those creditors who benefit from them.⁶⁰

The costs of administering a SIPC liquidation can be steep, and can deplete the general estate to the detriment of other general creditor claims.⁶¹ The SEC and courts have expressed concern about SIPC's high administrative costs, in particular the fees it pays to trustees.⁶² Due to the complex financial issues involved in a brokerage liquidation, trustees and the law firms they retain tend to be very highly paid Wall Street professionals. Unlike trustee fees in bankruptcy, SIPC trustee fees are not subject to statutory caps and are subject to only limited judicial review.⁶³ If the general estate is insufficient to cover administrative expenses, those expenses are, like SIPC insurance, paid for out of the SIPC Fund. If the SIPC Fund is insufficient to satisfy administrative costs or insurance claims, SIPC may borrow from the SEC, which may in turn borrow from the Treasury.⁶⁴

II. OLA

OLA gives the government broad authority to seek the liquidation of "financial companies," very broadly defined,⁶⁵ under the auspices of the

57. See 11 U.S.C. § 726; 15 U.S.C. § 78fff(d); *accord* 11 U.S.C. § 507.

58. 15 U.S.C. § 78fff(e).

59. *See id.*

60. *See* Joo, *supra* note 7, at 1117–21.

61. *See id.* at 1117.

62. *See* SEC REPORT ON SIPC, *supra* note 40, at 11–12, 17–21.

63. *See id.* at 18–19.

64. 15 U.S.C. § 78ddd(g), (h) (2006).

65. Dodd-Frank Act, Pub. L. No. 111-203, § 201(a)(11)(B), 124 Stat. 1376, 1443 (2010) (codified at 12 U.S.C. § 5381 (2010)) (providing that a company must be chartered in the United States and be a bank holding company, or be engaged in activities that the Fed determines are financial in nature in accordance with 12 U.S.C. § 1843(k) (2006)). "Financial companies" include any U.S.-chartered bank holding company as well as any U.S.-chartered nonbank company that derives 85 percent or more of its revenue from activities that the Fed defines as financial in nature pursuant to § 4(k) of the Bank Holding Company Act. 12 U.S.C. § 1843(k), (n)(2) (defining financial activity under § 1843(k)).

FDIC. As will be explained further below, such a liquidation would differ from a SIPA liquidation in some critical ways. OLA has no insurance component, amasses no fund, and imposes no *ex ante* assessments on firms. More fundamentally, SIPA is the standard response to broker-dealer insolvency, but in practice has not applied to extraordinary failures (i.e., Drexel and Lehman). In contrast, OLA is intended to apply *only* in extraordinary circumstances. Those circumstances, however, are undefined by the statute and left largely up to the discretion of the Treasury Secretary and the President.

Broad discretion afforded to regulators and the executive branch is a hallmark of OLA. Although nominally reserved for failing firms whose resolution by other means would pose a “systemic risk,”⁶⁶ that term is undefined, and the statute provides for only minimal judicial review of the decision to seek liquidation. Moreover, the actions of the FDIC in an OLA liquidation would be subject to far less judicial review than those of a SIPC trustee in a SIPA liquidation.

A. PURPOSES OF OLA

The stated purposes of OLA differ from those of SIPA. While SIPA’s customer-protection goal may be susceptible to criticism, it is consistent with the orthodox approach to securities regulation. Moreover, SIPA’s primary goal of customer protection is relatively clear and narrowly defined, and the Act is narrowly tailored to pursue that goal. The stated goals of Dodd-Frank, however, are vague and conflicting. In contrast to SIPA, OLA does not present itself as a measure to restore investor confidence in the securities markets. Rather, it presents itself as a means of protecting the economy from the depredations of the financial industry, and from future bailouts of the industry. This rhetoric is much more aggressively populist. While SIPA sought to encourage the rank-and-file investor to participate in capital markets, OLA appeals to Main Street’s resentment of Wall Street. It does so, however, in broad and vague terms. The preamble to Dodd-Frank describes it as an act:

To 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 taxpayer by ending bailouts, to protect consumers from abusive financial services practices, and for other purposes.⁶⁷

66. Section 203, entitled “Systemic Risk Determination,” states that a firm should be resolved under OLA if the Treasury Secretary, in consultation with the president, finds that “the failure of the financial company and its resolution under otherwise applicable Federal or State law would have serious adverse effects on financial stability in the United States.” Dodd-Frank Act § 203(b)(2), 124 Stat. 1451 (codified at 12 U.S.C. § 5383).

67. *Id.* pmb1.

In addition to the Dodd-Frank preamble, OLA has its own statement of purpose. OLA states that the general purpose of its liquidation authority is a moderately conservative one: to mitigate “significant risk to the financial stability of the United States”⁶⁸—that is, to protect the status quo. But it also reflects a desire to punish those seen as responsible for financial failure—something the 2008 bailouts are perceived as having failed to do. OLA states that it is meant to “minimize[] moral hazard,” insure that “creditors and shareholders will bear the losses,” remove “management responsible for the [failure],” and make those managers “bear losses consistent with their responsibility, including actions for damages, restitution, and recoupment of compensation and other gains.”⁶⁹ The removal of responsible management and assignment of blame may be justifiable on moral, political, and economic grounds, but would surely be only a small part, in dollar terms, of a major liquidation. Indeed, despite their pride of place in OLA’s statement of purpose, these issues are covered by a few short subsections of OLA’s eighty pages.⁷⁰ Moreover, these symbolic but relatively small steps toward “accountability” of management are also of less systemic significance than the treatment of creditors. As will be discussed below, OLA’s general admonition to allocate losses to creditors would be subject to considerable agency discretion during the course of a liquidation. OLA’s concern for “financial stability” is, of course, a legitimate concern, but it may cut against the notion of accountability by justifying the subsidization of major creditors that implicate systemic stability.

B. INITIATING AN OLA LIQUIDATION

The first step toward an OLA liquidation is a recommendation to the Treasury Secretary. The agencies charged with making such a recommendation differ according to the type of firm in distress. For financial companies in general, the FDIC’s board of directors and the Fed may make a recommendation by a two-thirds vote of both boards.⁷¹ If the financial company or its largest subsidiary were a broker-dealer, the SEC and the Fed could make the recommendation by a two-thirds vote of both.⁷²

68. *Id.* § 204(a).

69. *Id.*

70. *See id.* § 206(4), (5) (removal of officers and directors); *id.* § 204(a)(3) (clawback of compensation awarded to parties responsible for the failure).

71. *Id.* § 203(a)(1)(A).

72. *Id.* § 203(a)(1)(B). Although the language of the statute is unclear, it appears that the FDIC would not have concurrent authority to make recommendations if a financial company (or its largest subsidiary) were a broker-dealer. If the distressed firm were an insurance company, a recommendation of liquidation could be made by the director of the Federal Insurance Office (an agency newly created by Dodd-Frank) and a two-thirds vote of the Fed’s Board of Governors. *Id.* § 203(a)(1)(C). A distressed insurance company, however, would be liquidated under applicable state law, not OLA. *Id.* § 203(e).

The Treasury Secretary could also initiate the process by asking the relevant agencies to consider making such a recommendation. OLA requires the agency recommendation to state its reasons in some detail, including a description of the effect the firm's failure would have on stability and why market solutions and conventional bankruptcy would be inappropriate.⁷³

Upon receiving the recommendation, the Treasury Secretary is to confer with the president and decide whether to petition the U.S. District Court for the District of Columbia for appointment of the FDIC as receiver. The Treasury Secretary and President are to base their decision on their assessment of whether the firm is in default or in danger of default,⁷⁴ as well as a number of even more vague and subjective factors. These include the absence of a "viable private sector alternative . . . to prevent the default"; whether the firm's failure "would have serious adverse effects on financial stability in the United States" if it were to proceed under bankruptcy or other relevant law;⁷⁵ whether the effects of an OLA proceeding on third parties would be "appropriate" in light of a proceeding's positive effects on financial stability; the cost to the public; and the potential for moral hazard.⁷⁶ Thus, it is difficult to state in advance for any particular firm whether the firm's failure would trigger an OLA proceeding. As noted above, regulators intervened in 2008 to prevent some distressed institutions—but not others—from entering bankruptcy and/or SIPA proceedings. Regulators were criticized for approaching the choice with

73. Specifically, Title II requires the recommendation to include:

- (A) an evaluation of whether the financial company is in default or in danger of default;
- (B) a description of the effect that the default of the financial company would have on financial stability in the United States;
- (C) a description of the effect that the default of the financial company would have on economic conditions or financial stability for low income, minority, or underserved communities;
- (D) a recommendation regarding the nature and the extent of actions to be taken under this title regarding the financial company;
- (E) an evaluation of the likelihood of a private sector alternative to prevent the default of the financial company;
- (F) an evaluation of why a case under the Bankruptcy Code is not appropriate for the financial company;
- (G) an evaluation of the effects on creditors, counterparties, and shareholders of the financial company and other market participants; and
- (H) an evaluation of whether the company satisfies the definition of a financial company under section 201.

Id. § 203(a)(2).

74. *Id.* § 203(b)(1).

75. *Id.* § 203(b)(2)–(5).

76. *See id.* § 203(b)(4), (5).

respect to each institution in an ad hoc manner that was neither fair nor in the best interests of systemic stability. OLA does nothing to solve that problem; to be fair, however, it is unclear how it could have done so.

On the one hand, OLA requires consultation among multiple government actors before a liquidation may proceed.⁷⁷ The initial agency recommendation requires a two-thirds vote by both the agency and the Fed. Furthermore, the Treasury Secretary and President must concur and justify their positions with particular findings. On the other hand, the decision to pursue liquidation involves little input from the judiciary and none from Congress. The statute allows for only minimal judicial review of a petition, and key criteria (e.g., “systemic risk” and “serious adverse effects on financial stability”) are undefined.

The scope of the district court’s review is very limited. Although, as noted above, OLA requires the initial agency recommendation to provide further detailed justifications, the statute does not provide for judicial review of these reasons (or even of whether they were made). The court is to review, under the highly deferential “arbitrary and capricious” standard, only the Treasury Secretary’s determination that the financial company is in default or in danger of default, and that it satisfies the statutory definition of a financial company.⁷⁸ If these two determinations are not arbitrary and capricious, the court must issue an order authorizing the Treasury Secretary to appoint the FDIC as receiver. This judicial review is far more deferential than the review of a SIPC liquidation petition, described in the previous section.⁷⁹ Furthermore, the district court has only twenty-four hours from the time of filing to hold a hearing and decide whether to grant the Treasury Secretary’s petition. If the court does not render a decision within twenty-four hours of the petition, the petition will be automatically granted.⁸⁰ Thus, whether to pursue liquidation is largely left to executive discretion.

OLA has been criticized on the ground that liquidation is a more appropriate solution to a relatively isolated firm failure than to a failure that is part of a systemic crisis.⁸¹ But OLA itself does not require the government to liquidate a failing firm. It only *empowers* the government to initiate a liquidation. What OLA really does is prescribe FDIC powers and procedures *if* the government decides to liquidate a company. That decision

77. Indeed, one important source of business law commentary concludes that “[g]iven the many conditions that must be satisfied . . . the Act is weighted against the appointment of the FDIC as receiver of a financial company.” *Summary of the Dodd-Frank Act: Resolution of Failing Financial Institutions*, PRAC. L. CO., <http://us.practicallaw.com/2-502-8818?q=2-502-8818> (last visited Nov. 11, 2011).

78. Dodd-Frank Act § 202(a)(1)(A)(iv), 124 Stat. 1445 (codified at 12 U.S.C. § 5382).

79. But of course SIPA liquidations are not entirely free from political influence. *See supra* text accompanying notes 30–34 (discussing the SEC’s role in SIPA liquidations and the presidential appointment of the SIPC board).

80. Dodd-Frank Act § 202(a)(1)(A)(v)(I), 124 Stat. 1445 (codified at 12 U.S.C. § 5382).

81. Gordon & Muller, *supra* note 6, at 194–95.

is primarily up to the discretion of the Treasury Secretary (in consultation with the President who appointed him or her). *If* the Treasury Secretary were to decide that a troubled institution should be liquidated, he or she could appoint the FDIC as liquidation receiver, subject to only minimal judicial review. In such case, OLA would govern the FDIC's liquidation. But if the Treasury Secretary did not want a company to be liquidated, he or she could simply choose not to file a petition.

The existence of liquidation authority will not necessarily result in its use. Neither SIPA nor OLA poses any situation in which receivership and liquidation would be required and rescue would be prohibited. A report prepared for the American Bankers Association argues that OLA creates confusion because major financial firms “and their equity holders, creditors, borrowers, customers, vendors and counterparties” will be unable to predict “whether financial distress at the company will be dealt with in a Chapter 11 reorganization or a Chapter 7 liquidation under the Bankruptcy Code, or a Federal receivership under Title II [i.e., OLA].”⁸²

While OLA does not authorize any legislative bailouts, it does not prohibit any in the future (indeed, it is difficult to imagine how such a prohibition could be enacted, short of a constitutional amendment). Outside of OLA, Dodd-Frank places some nominal limits on government powers—specifically, on the powers the Fed may exercise in an emergency. Section 1101 of Dodd-Frank amends § 13 of the Federal Reserve Act (12 U.S.C. § 343) to place some limits on the Fed's emergency lending authority. For example, the Fed formerly had broad authority to authorize a member bank to make discounted loans to “any individual, partnership, or corporation.”⁸³ Under the revised law, the Fed may only authorize such loans in the context of a “broad-based” program;⁸⁴ such a program may not be “established for the purpose of assisting a single and specific company avoid bankruptcy [or OLA or any other insolvency proceeding].”⁸⁵ Nor may the Fed authorize such loans to firms in bankruptcy or OLA. Furthermore, the Fed must report on such loans to Congress. In addition, the amended § 13 directs the Fed to pass regulations that “require that a Federal reserve bank assign, consistent with sound risk management practices and to ensure protection for the taxpayer, a lendable value to all collateral for a loan executed by a Federal reserve bank.”⁸⁶

It has been argued that these restrictions on Fed authority will severely limit governmental authority to respond to a crisis, such that liquidation

82. Thomas P. Vartanian, Robert H. Ledig & David L. Ansell, *Title II: Orderly Liquidation Authority*, AM. BANKERS ASS'N (2011), http://www.aba.com/aba/documents/RegReform/TitleII_Summary.pdf.

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

84. *Id.*

85. *Id.* § 1101(a)(6).

86. *Id.*

under OLA will become the only available avenue for massive intervention.⁸⁷ This overstates the significance of these amendments. As noted above, OLA does not prohibit legislative bailouts. Moreover, § 13's new limits on the Fed seem to leave significant wiggle room. The restrictions on "broad-based" programs are not terribly restrictive: they could be satisfied, for example, by any program established to help at least *two* firms avoid bankruptcy. Indeed, OLA's central premise—that certain firms have systemic importance—holds that one firm's collapse could trigger multiple failures; thus, it could easily be argued that even an action whose immediate effect was to save one firm was "established for the purpose" of helping multiple firms avoid failure. One of the most visible of the Fed's responses to the crisis in 2008—opening the discount window to investment banks—was intended to help a small number of major firms, but would have satisfied OLA's definition of a "broad-based" program.

Moreover, even with respect to aiding a single, specific firm, the amended § 13 seems to restrict only assistance that is meant to "avoid bankruptcy" or other insolvency proceeding. It would, of course, be easy to defend assistance to a single firm on the ground that it was not meant to help the firm avoid bankruptcy because bankruptcy was not inevitable, that assistance to a single firm would help *multiple* firms avoid bankruptcy, or that the Fed's actual intent was something other than avoiding bankruptcy (such as protecting "financial stability").⁸⁸ Section 13's collateral requirement could conceivably limit the Fed's lending ability, but note that the statute only instructs the Fed to pass rules requiring collateral.⁸⁹ Like much financial regulation, the statute's actual effect depends on the content of the rules, but the statute itself gives little guidance as to that content. Obviously, the Fed has no incentive to pass a very strict rule.

Finally, even to the extent that the amendments do place limits on the Fed, it is unclear whether or how such limits could be enforced. The courts have thus far not allowed either private plaintiffs or members of Congress to sue to enforce legal restrictions on the powers of the Fed.⁹⁰ Furthermore, § 13, by its terms, applies only to the Fed's publicly-appointed Board of Governors and not to the individual regional Federal Reserve *Banks* (most notably the New York Fed), which are privately-owned entities with their own boards of directors.⁹¹

87. Gordon & Muller, *supra* note 6, at 192–93, 196–97.

88. Section 13 would also have no effect on other kinds of assistance from the Fed, such as the DIP financing reportedly provided to facilitate (not avoid) Lehman's liquidation in Chapter 11. See *Lehman Files for Chapter 11 Bankruptcy*, THE STREET (Sept. 15, 2008, 9:50 AM), <http://www.thestreet.com/story/10437261/lehman-files-for-chapter-11-bankruptcy.html>.

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

90. See Timothy A. Canova, *Closing the Border and Opening the Door: Mobility, Adjustment, and the Sequencing of Reform*, 5 GEO. J.L. & PUB. POL'Y 341, 404–05 (2007).

91. See *id.* at 404 n.310.

Whatever Dodd-Frank's limitations on the Fed, it places no limits on future actions by Congress or, moreover, the executive branch. As noted above with respect to SIPA, the executive branch always has the option of claiming new powers on the grounds that an "emergency" has arisen. In response to emergencies both economic and military, the executive branch consistently requests, or simply asserts, new powers. Congress and the judiciary typically acquiesce or actively comply by granting requests for authority or ratifying new powers after the fact.⁹² Dodd-Frank does nothing to contain the executive's option of requesting or seizing new powers, and does nothing to require greater independence by future Congresses or courts.

Prior to OLA, the government lacked the specific authority to liquidate nonbank financial firms (other than in SIPA proceedings), but the government also took many actions in 2008 that were not expressly authorized under existing law. Some of these actions were defended at the time under the Fed's broad emergency powers, some under the general authority of the President and Treasury, and some obtained ad hoc, fast-track congressional approval. The Fed arguably exceeded its authority—with impunity—in assisting AIG in 2008. In exchange for an \$85 million credit line to AIG, secured by all of AIG's assets, the Treasury obtained beneficial ownership of 79.9 percent of AIG stock, and the Fed gained certain control rights over AIG's business.⁹³ The Fed cited its emergency lending authority under 12 U.S.C. § 343 as authority to make this deal. As Posner and Vermeule argue, however, "the transaction was a purchase in substance: the Fed was given the incidents of ownership in the form of most of the stock. If the transaction was in substance a purchase of AIG, then it was not authorized by the statute, which permitted only loans."⁹⁴ There are of course political impediments to actions that are not expressly authorized by law. Vociferous political opposition, however, did not prevent the government's emergency acts in 2008. In short, it is a mistake to assume that today's legislation will circumscribe the government's responses to tomorrow's crises.

OLA is likely to have a modest effect on the executive's exercise of its discretion. It will probably create at least some degree of political pressure to consider liquidation of a troubled firm rather than a bailout. At the very

92. See Posner & Vermeule, *supra* note 33, at 1640–51 ("The upshot is that in cases of emergency lawmaking, Congress lets the executive have most, although not all, of what it wants. . . Congress can modify and push back to a degree, but the public, motivated by some mix of fear, urgency, and rational apprehension, demands that *something* be done."). See also Thomas W. Joo, *Presumed Disloyal: Executive Power, Judicial Deference, and the Construction of Race Before and After September 11*, 34 COLUM. HUM. RTS. L. REV. 1, 22–25, 34–38 (2002) (discussing judicial acquiescence when the executive branch invoked threats to national security to justify the Japanese internment and antiterrorism legislation).

93. Posner & Vermeule, *supra* note 33, at 1629.

94. *Id.* at 1630.

least, it sets up FDIC liquidation as the path of least resistance. But it does not prohibit the bailout of a failing firm. Moreover, even if the OLA route is chosen, the FDIC has discretion and funding options allowing it to bail out a failing firm's creditors, as the following section will discuss.

C. THE CONDUCT OF AN OLA PROCEEDING

1. Reduced Judicial Oversight

As noted above, a petition to invoke OLA would be subject to far less judicial review than a SIPC petition. OLA also provides for a significantly reduced judicial role during the liquidation. Like a bankruptcy, a SIPA liquidation occurs under the jurisdiction of a bankruptcy court, and the SIPC trustee is, in most respects, a Chapter 7 bankruptcy trustee who reports to the court. By contrast, the FDIC under OLA (as in its traditional role as a bank receiver under the Federal Deposit Insurance Act (FDIA)) is a statutory receiver that is not subject to direct court supervision. Thus, the statute envisions the FDIC's discretion being cabined more by the administrative rulemaking process than by direct judicial review.⁹⁵

General creditor claims in a SIPC proceeding are determined by the bankruptcy court. For customer claims, the trustee makes the initial determination, but an objecting customer may file a claim with the bankruptcy court. An OLA liquidation, however, would be an administrative proceeding, not a judicial one. Neither the District Court for the District of Columbia (where an OLA petition must be filed) nor the bankruptcy court of that district would retain jurisdiction to oversee the process. As in an FDIC receivership, creditor claims in an OLA proceeding would not be filed with a court, but instead directly with the FDIC as receiver. The FDIC would have authority to allow or disallow all claims. Unlike in bankruptcy or a SIPA liquidation, OLA creditors' objections would not be heard as part of an ongoing, unified judicial proceeding. Rather, objecting creditors would each have to file a lawsuit in the district court where the firm had its principal place of business.⁹⁶ Filing a stand-alone lawsuit for each objection would likely be far more cumbersome and expensive (for both the creditor and the court system) than filing a bankruptcy claim as part of a larger judicial proceeding. Since systemically important financial firms are likely to be multinational, multiservice firms

95. OLA empowers the SEC and the FDIC to implement the statute through joint rulemaking. Dodd-Frank Act, Pub. L. No. 111-203, § 209, 124 Stat. 1376, 1460 (2010) (codified at 12 U.S.C. § 5389 (2010)). By the summer of 2011, the FDIC had apparently promulgated only two sets of rules or proposed rules under OLA: an Interim Rule, 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 FDIC Orderly Liquidation Authority]; and a Notice of Proposed Rulemaking, 75 Fed. Reg. 64,173 (proposed Oct. 19, 2010) (to be codified at 12 C.F.R. pt. 380).

96. Dodd-Frank Act § 210(a)(4)(A), 124 Stat. 1466 (codified at 12 U.S.C. § 5390).

with numerous subsidiaries, lawsuits might have to be brought in multiple forums, burdening creditors and requiring multiple, uncoordinated courts to familiarize themselves with the liquidation. The “principal place of business” for a given claim might be an inconvenient forum for a creditor-plaintiff; indeed, simply determining the relevant “principal place of business” could be a challenge and become the subject of litigation.

Neither SIPA nor OLA authorizes the rescue of any *firm* subject to resolution. They may, however, subsidize—that is, “bail out”—certain *creditors*. SIPA, for better or worse, obviously singles out a class of creditors (i.e., customers) for subsidy, but at least the legislative mandate to do so is specifically and narrowly expressed. The reduced judicial discretion under OLA increases the danger that the FDIC might favor certain creditors, whether due to poor economic reasoning or political considerations.

SIPA and the FDIC resolution of depository banks are primarily focused on protecting customers, and thus, they typically transfer customer accounts and quickly wind down or sell the failed institution. Unlike SIPA, however, the FDIC also has power to offer “open bank” assistance—that is, to help failing depository institutions avoid insolvency and resolution.⁹⁷ When numerous banks approached failure in the 1980s, the FDIC used this power to assist some of them, particularly larger banks considered “too big to fail.”⁹⁸ These interventions had the highly controversial effect of bailing out uninsured depositors (i.e., those whose losses exceeded FDIC insurance limits), other unsecured creditors, and bank shareholders.⁹⁹ This led to stricter legislative limits on open bank powers.¹⁰⁰ These limits, however, had specific exemptions for banks whose failure “would have serious adverse effects on economic conditions or financial stability.”¹⁰¹

OLA does not have any direct creditor subsidy analogous to SIPA’s customer protection. As with the FDIC’s open bank powers, however, OLA potentially enables the FDIC to bail out creditors at its discretion. OLA is specifically geared toward the broad and vague mission of protecting “financial stability.”¹⁰² OLA gives the FDIC broad powers to lend to the firm, purchase its assets or debts, assume its obligations, and guarantee new obligations.¹⁰³ OLA also specifically authorizes the FDIC to treat similarly

97. Gordon & Muller, *supra* note 6, at 186.

98. *Id.* at 187–89.

99. *Id.* at 186.

100. *Id.* at 187–89.

101. 12 U.S.C. § 1823(c)(4)(G)(i)(I) (2006).

102. Dodd-Frank Act, Pub. L. No. 111-203, § 204(a), 124 Stat. 1376, 1454 (2010) (codified at 12 U.S.C. § 5384 (2010)) (“It is the purpose of this title 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.”).

103. *Id.* § 204(d). *See infra* (discussing how these funds would be obtained in the first instance by borrowing from the Treasury).

situated creditors differently in order to maximize the value of the failed firm's assets or "to initiate and continue operations essential to implementation of the receivership or any bridge financial company."¹⁰⁴ There is no explicit provision for judicial review of such decisions;¹⁰⁵ rather, discretion is to be governed by agency rulemaking.¹⁰⁶

OLA also empowers the FDIC to establish and fund "bridge financial companies" to assume a firm's liabilities or purchase its assets or "perform any other temporary function which the [FDIC] may, in its discretion, prescribe."¹⁰⁷ A bridge company would assume the rights and powers of the failed company without judicial approval¹⁰⁸ and could exist for up to five years.¹⁰⁹ The FDIC could provide operating funds to these companies or authorize them to issue capital stock or other securities.¹¹⁰ The FDIC has similar authority to establish a "bridge bank" in the bank receivership context. SIPA, however, does not give SIPC or its trustees explicit authority to create bridge firms.¹¹¹ The FDIC's discretion to assign "temporary functions" to a bridge company would presumably allow it to continue some of the firm's business operations on the grounds that doing so would maximize the value of the estate. The FDIC would decide what assets and liabilities to transfer to the bridge company without judicial approval.¹¹² In deciding what assets to transfer, the FDIC is expressly authorized to treat similarly situated creditors differently in order to maximize asset value.¹¹³

Furthermore, although it lacks the direct subsidy of customer-creditors found in SIPA or the FDIA, OLA does explicitly favor a certain type of creditor. While an OLA proceeding stays most other actions against the failed firm, it does not stay counterparties from exercising their rights under

104. *Id.* § 210(b)(4)(A)(ii).

105. As noted above, a disallowed creditor could file suit. *See supra* text accompanying note 96. But there is no explicit provision for judicial review of the *favorable* treatment of a creditor. *See id.*

106. As of this writing in July 2011, the FDIC has released one brief set of interim rules under OLA, some of which purport to limit the FDIC's discretion to favor certain narrowly specified classes of creditors. *See* FDIC Orderly Liquidation Authority, 76 Fed. Reg. 4,202, 4,215 (proposed Jan. 25, 2011) (to be codified at 12 C.F.R. pt. 380).

107. Dodd-Frank Act § 210(h)(1)(B)(iii), (2)(G), 124 Stat. 1496, 1497 (codified at 12 U.S.C. § 5390).

108. *Id.* § 210(h)(2)(E).

109. *Id.* § 210(h)(12).

110. *Id.* § 210(h)(2)(G)(iii), (v).

111. SIPA does give SIPC broad authority "to enter into contracts, to execute instruments, to incur liabilities, and to do any and all other acts and things as may be necessary or incidental to the conduct of its business and the exercise of all other rights and powers granted to SIPC by this chapter." 15 U.S.C. § 78ccc(b)(8) (2006). It also explicitly authorizes the trustee to transfer customer accounts to other SIPC member firms. *See id.* § 78fff-2(f). This is standard practice in liquidations and tends to obviate the need to continue the debtor's business through a bridge company or otherwise.

112. Dodd-Frank Act § 210(h)(5)(D), 124 Stat. 1499 (codified at 12 U.S.C. § 5390).

113. *Id.* § 210(h)(5)(E).

“qualified financial contracts.”¹¹⁴ OLA defines “qualified financial contract” (QFC) to include any contract for the purchase, sale, or loan of securities, “commodity contract, forward contract, repurchase agreement, [or] swap agreement.”¹¹⁵ OLA further authorizes the FDIC to pass rules extending the exemption to other “similar agreement[s].”¹¹⁶

The QFC exemption appears in other U.S. insolvency regimes as well. QFCs were first exempted from the Bankruptcy Code in 1978,¹¹⁷ and that exemption is incorporated into SIPA.¹¹⁸ The OLA exemption is apparently copied from a nearly identical provision in the FDIA.¹¹⁹ The QFC exemption is explained on the ground that it mitigates the spillover effects of a failure.¹²⁰ In the FDIA context, the FDIC has justified the special treatment of QFCs on the ground that they facilitate “appropriate liquidity and hedging operations in financial institutions” and are “conducted in a highly regulated industry providing further safeguards.”¹²¹ The automatic stay in the resolution of a bank or financial firm could create extensive losses to QFC counterparties as market values decline, or so the argument goes.¹²² But, of course, the automatic stay potentially imposes losses on every kind of creditor to which it applies.

Any benefits of the exemption may be outweighed by its potential harms. Indeed, exempting QFCs from a stay during any insolvency proceedings—under OLA, SIPA, the FDIA, or bankruptcy—has been criticized as an invitation to a “run” by QFC counterparties that could exacerbate financial distress rather than alleviate it.¹²³ Harvey Miller, the lawyer heading Lehman’s bankruptcy, has testified before Congress that the QFC exemption resulted in a “massive destruction of value.”¹²⁴ Like many exemptions to the automatic stay, the special treatment of QFCs seems to be the product of successful special interest lobbying rather than good policy.¹²⁵

114. *Id.* § 210(c)(8)(A). See *infra* (discussing the imposition of a one-day delay).

115. *Id.* § 210(c)(8)(D)(i).

116. *Id.*

117. See 11 U.S.C. § 362 (2006).

118. 15 U.S.C. § 78eee(b)(2)(C)(i), (ii) (2006). A SIPA application or protective order, however, “may operate as a stay of the foreclosure on, or disposition of, securities collateral pledged by the debtor.” *Id.* § 78eee(b)(2)(C)(ii).

119. See 12 U.S.C. § 11(e)(8)(A) (2006).

120. William F. Kroener III, *Expanding FDIC-Style Resolution Authority*, in *ENDING GOVERNMENT BAILOUTS AS WE KNOW THEM* 179, 182 (Kenneth E. Scott, George P. Schultz & John B. Taylor eds., 2009).

121. FDIC, Statement of Policy on Qualified Financial Contracts (Dec. 12, 1989), <http://www.fdic.gov/regulations/laws/rules/5000-1100.html>.

122. Kroener, *supra* note 120, at 182.

123. Skeel, *Bankruptcy*, *supra* note 34, at 12.

124. Summe, *supra* note 39, at 76–77.

125. See Letter from James H.M. Sprayregen & Stephen E. Hessler, partners at Kirkland & Ellis LLP, to Federal Reserve Board (2011), available at <http://online.wsj.com/public/resources/documents/KirklandDoddFrank.pdf> (submitting a “[r]esponse to [the] Federal Reserve Request

OLA attempts a compromise by delaying the exemption until the end of the first business day after the filing. OLA in effect imposes a one-day stay on QFCs that does not apply in a bankruptcy or SIPA proceeding.¹²⁶ Like the QFC exemption itself, this provision is borrowed directly from the FDIA's bank-resolution scheme.¹²⁷ In theory, the FDIC would use this time to transfer some of the failed firm's contracts to solvent firms or to new bridge companies.¹²⁸ But even assuming one day is sufficient to transfer QFCs in the routine bank-resolution context, a massive, "systemically important" financial institution would have innumerable and highly complex QFCs. The failure would probably take place in a highly volatile, if not panicked, market, making valuing the contracts and finding transferees even more difficult. Thus in the OLA context, a one-day stay would probably be insufficient to facilitate significant transfers of QFCs or to prevent a run by counterparties after the first day had passed.

2. OLA and SIPA Interaction

If a financial company being liquidated under OLA were a SIPC member, OLA seems to envision that some portion of its business would be liquidated according to SIPA under the auspices of SIPC.¹²⁹ This is *not* to say that brokerage accounts would be cleanly severed and administered under SIPA. Most financial firms fit the broad definitions of "broker" or "dealer"¹³⁰ and are thus likely to be SIPC members. But OLA gives little guidance as to which assets and liabilities of such firms would be part of the SIPA estate and which would be administered under OLA. OLA seems to give the FDIC considerable discretion with respect to this issue. If appointed receiver of a covered broker-dealer, the FDIC "shall" appoint SIPC as receiver,¹³¹ but SIPA shall apply to—and only to—those claims and assets that the FDIC does *not* transfer to a bridge financial company.¹³² As noted above, the FDIC has broad authority to determine which assets and liabilities will be transferred.

OLA seems to envision the transfer of customer accounts to a solvent SIPC member firm; SIPC trustees typically do this promptly upon being appointed. Customers thus regain access to their accounts, and may file

for Information Relating to Dodd-Frank Act Section 216 Study Regarding the Resolution of Financial Companies Under the Bankruptcy Code" entitled "Too Much Discretion to Succeed: Why a Modified Bankruptcy Code is Preferable to Title II of the Dodd-Frank Act").

126. 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)).

127. See 12 U.S.C. § 1821(e)(10)(A) (2006).

128. Dodd-Frank Act § 210(c)(9), 124 Stat. 1489 (codified at 12 U.S.C. § 5390) (specifically authorizing the FDIC to transfer QFCs).

129. *Id.* § 205(a)(1).

130. See *supra* text accompanying note 2.

131. Dodd-Frank Act § 205(a)(1), (2)(A), 124 Stat. 1456 (codified at 12 U.S.C. § 5385).

132. *Id.* § 205(a)(2)(B), (b)(1).

customer claims in the SIPC proceeding for any shortfall in the contents of their accounts. In an OLA proceeding, however, it may be difficult to transfer the myriad accounts of a failed megafirm, particularly in a time of systemic distress. If customer accounts are not transferred to a new brokerage, and the FDIC has established any bridge companies, OLA requires the FDIC to transfer all customer accounts to one of those bridge companies.¹³³

As noted above, the fundamental characteristic of SIPA is its requirement that the fund of customer property be preserved and applied in the first instance toward satisfying customer claims. OLA does not seem to impose the same requirement. The transfer rules described above do not seem to *require* that customer accounts be transferred to a new brokerage. Rather, the statute states that if they are not transferred to a new brokerage, they must be transferred to a bridge company unless doing so “would materially interfere with the ability of the Corporation to avoid or mitigate serious adverse effects on financial stability or economic conditions in the United States.”¹³⁴ The transfer of customer accounts does not require court approval or customer assent.¹³⁵ On its face, all this seems to suggest that if a new brokerage home for customer accounts is available, the FDIC will have some discretion as to whether to transfer customer accounts to the new brokerage or transfer them to a bridge company. The statute’s intent to give the FDIC this discretion is further evidenced by its express statement that the FDIC’s power to transfer assets to a bridge company is not limited in any way by SIPA (despite SIPA’s focus on reserving the fund of customer property to satisfy customer claims).¹³⁶

OLA does contain a general proviso that the FDIC may not operate bridge companies in such a way as to “adversely affect the ability of customers to promptly access their customer property.”¹³⁷ It is unclear, however, whether this provision means the FDIC must transfer accounts and make other efforts to make accounts accessible (as SIPC does), or whether it simply means the FDIC should not deliberately obstruct access to accounts. In any event, this provision would be extremely difficult to enforce, as it would surely be reviewed under the deferential “arbitrary and capricious” standard normally applied to agency action.

If customer accounts were transferred to a bridge company, they would remain part of the FDIC’s OLA receivership and not part of a SIPA proceeding.¹³⁸ OLA, however, requires the FDIC as receiver to give

133. *Id.* § 210(a)(1)(O)(i).

134. *Id.*

135. *Id.* § 210(a)(1)(O)(iii).

136. *Id.* § 205(b)(2).

137. *Id.* § 210(h)(2)(H)(iv).

138. As noted above, SIPA would apply only to those claims and assets not transferred to a bridge financial company. *Id.* § 205(a)(2)(B), (b)(1).

customers securities or payments in the same amounts they would have received in a SIPA liquidation.¹³⁹ It would seem to follow that, in the event of a shortfall in the fund of customer property, the SIPC Fund would pay for claims handled by SIPC, and OLA's Orderly Liquidation Fund¹⁴⁰ would cover claims handled by the FDIC. OLA is unclear on this issue, as it both directs SIPA to "satisfy customer claims . . . as if the appointment of the [FDIC] as receiver had not occurred," *and* directs the FDIC to satisfy customer claims in the amount that the customer would have received had the firm "been subject to a proceeding under the Securities Investor Protection Act."¹⁴¹

In any case, there seems to be little reason why the FDIC would retain customer accounts rather than leave them to a SIPA proceeding. A more likely consequence of the OLA-SIPA overlap would be competition between the FDIC and SIPC over the resources of the failed firm. The FDIC could, for example, leave all or most of the fund of customer property subject to the SIPA proceeding, but transfer all or most of the general estate to a bridge company. This would relieve burdens on the FDIC's funding sources (discussed in the following section) by transferring them to SIPC. The lack of a general estate would deprive the SIPA liquidation of its primary source of administrative funding and thus require drawdowns from the SIPC Fund. Depletion of the SIPC Fund could require SIPC to borrow from the Treasury and/or increase its assessments on its member firms.

D. OLA FUNDING

The most obvious distinctions between SIPA and OLA are the SIPC Fund and SIPC insurance, which have no counterparts in OLA. As noted above, SIPA has a member-financed fund that is available for administrative costs and to insure a narrowly defined set of creditor claims. By contrast, OLA does not provide for insurance, nor does it impose regular assessments or establish prefunding of any kind. An earlier version of Dodd-Frank would have imposed SIPC-like assessments to create a fund to

139. *Id.* § 205(f)(1). Note, however, that a customer seeking to enforce this provision would have to file a suit in the district court for the district where the firm's "principal place of business" was located. *See id.* §§ 205(e), 210(a)(4).

140. The "Orderly Liquidation Fund" is the funding source for OLA proceedings. *See infra* text accompanying Part II.D.

141. Dodd-Frank Act § 205(f)(2), 124 Stat. 1458 (codified at 12 U.S.C. § 5385).

pay for liquidations,¹⁴² but this scheme was rejected after politicians and commentators vilified it as a “bank tax.”¹⁴³

OLA nominally establishes an “Orderly Liquidation Fund” as a “separate fund” within the Treasury.¹⁴⁴ This so-called “Fund,” however, is merely a grant of authority to the FDIC to borrow unlimited amounts from the Treasury.¹⁴⁵ The FDIC, after submitting an “Orderly Liquidation Plan” to the Treasury Secretary, can borrow money from the Treasury to cover the costs of liquidation.¹⁴⁶ The FDIC’s costs are the highest-priority unsecured claims against the firm.¹⁴⁷ If the firm’s assets prove insufficient to cover the amounts borrowed from the Treasury, the FDIC may impose post-hoc, risk-based assessments on financial firms.¹⁴⁸

A typical insurance pool would use an insured’s risk of failure to determine the amount it pays toward the costs of future potential failures (which of course might include its own). OLA, however, envisions a post-hoc assessment scheme that would use an insured’s current risk of failure to determine the amount it pays toward the costs of the *past* failures of *other* firms. Having been increased recently to make up for the Madoff payouts, SIPC assessments can be said to have a partially post-hoc character.

This post-hoc approach certainly seems less than ideal at first glance. Most obviously, the cost is imposed not on failed firms, but on their surviving competitors—presumably, the *least* risky firms. Furthermore, firms cannot anticipate or budget for post-hoc assessments, and the ability to recoup costs after the fact reduces an agency’s incentive to contain costs. Finally, while assessments nominally impose costs on the relevant industry, the industry can simply pass them on to its customers. The Madoff experience, however, arguably provides some pragmatic justification for a post-hoc approach. The amount of funding required to deal with massive, system-threatening failures simply cannot be known in advance, and it seems potentially wasteful to collect huge amounts in advance without knowing whether they will ever be used. The power to impose or increase assessments to pay for major failures ex post insures that the cost falls on the industry and protects the public fisc. Moreover, to the extent that an

142. Wall Street Reform and Consumer Protection Act of 2009, H.R. 4173, 111th Cong. § 1609(n)(1)(A)(ii) (2009); Restoring American Financial Stability Act of 2010, S. 3217, 111th Cong. § 210(n)(2) (2010). The version of OLA under H.R. 4173 was called the “Enhanced Dissolution Authority,” and its assessment-based fund was called the “Systemic Dissolution Fund.” H.R. 4173.

143. See, e.g., Editorial, *The Uncertainty Principle: Dodd-Frank Will Require at Least 243 New Federal Rule-Makings*, WALL ST. J., July 14, 2010, at A18, available at <http://online.wsj.com/article/SB10001424052748704288204575363162664835780.html>.

144. See Dodd-Frank Act § 210(n)(1), 124 Stat. 1506 (codified at 12 U.S.C. § 5390).

145. See Gordon & Muller, *supra* note 6, at 190–92 (citing Dodd-Frank Act § 210(n)).

146. Dodd-Frank Act § 210(n)(9), 124 Stat. 1506 (codified at 12 U.S.C. § 5390).

147. *Id.* §§ 204(d), 210(b)(1)(A)–(B).

148. *Id.* § 210(o). In the bank resolution context, the FDIC is to recoup the cost of “open-bank assistance” via similar post-hoc assessments. 12 U.S.C. § 1823(c)(4)(G)(ii) (2006).

OLA proceeding is meant to preserve the financial *system*, surviving financial firms are indeed its main beneficiaries. Thus, there may be something to be said for the post-hoc approach, although it does nothing to reduce or disincentivize the risky behavior that may lead to failure.

Yet, it may not be feasible to implement the assessment scheme OLA envisions. Unlike OLA's post-hoc assessments, SIPC's post-Madoff assessments were based on firm *size* and not on risk. While basing assessments on a firm's risk profile would in theory enhance both fairness and efficiency, implementing a risk-based system is easier said than done. As noted above, SIPC has never used its statutory power to impose risk-based assessments; its current chairman argues that doing so would be prohibitively difficult and costly.¹⁴⁹ In the more complex and unfamiliar context envisioned by OLA, these obstacles would be even greater.

The cost of liquidations can be immense and difficult to contain. A recent report by the SEC Office of Inspector General argued that SIPC administrative fees lack regulatory oversight and review.¹⁵⁰ As of March 2011, the costs of administering the Madoff SIPA liquidation had surpassed \$100 million. The costs of the SIPA liquidation of Lehman had reached \$420 million.¹⁵¹ The SEC noted that both liquidations were far from finished and that further costs could threaten the \$2.5 billion SIPC Fund and potentially require loans from the Treasury.¹⁵² Note that these figures pertain only to SIPA proceedings; they do not include the costs of Lehman's much larger Chapter 11 bankruptcy.

OLA only applies to firms so large and/or complex that their failures would pose "systemic risk."¹⁵³ The liquidation of such a firm would be accordingly large and complex, and thus extremely costly. Note that the costs of an OLA proceeding would not be limited to purely incidental administrative costs. They could also include providing a financial megafirm with operating capital. Although the firm must ultimately be wound down, the FDIC has broad powers to finance loans to the firm, purchase its assets or debts, assume its obligations, and guarantee new obligations, as well as to establish and fund bridge financial companies.¹⁵⁴ Thus, as Jeffrey Gordon and Christopher Muller point out, the FDIC's ability to borrow money to fund a liquidation in effect guarantees a source of DIP financing during the wind-down, which could include the continued

149. See *supra* text accompanying notes 48–49.

150. SEC REPORT ON SIPC, *supra* note 40, at vi–vii.

151. *Id.* According to the SEC Report, "the hourly rate for trustees assigned to the Madoff case ranged from \$698 to \$742. For the Lehman liquidation, SIPC's trustee fee chart combined both the trustee's and the counsels' time, and the hourly rate ranged from \$437 to \$527." *Id.* at viii.

152. *Id.*

153. See *supra* text accompanying note 66.

154. Dodd-Frank Act, Pub. L. No. 111-203, § 210(a)(1), (h)(1), 124 Stat. 1376, 1460, 1496 (2010) (codified at 12 U.S.C. § 5390 (2010)).

operation of its business via bridge companies for a period of years.¹⁵⁵ In a bankruptcy, the market, not a statute, would determine whether such financing became available, and a court would supervise how it was used.

This is not to say that government-subsidized DIP financing is a complete departure from past practice. Recall that in 2008 the Fed provided loans on favorable terms to help finance Lehman's bankruptcy proceedings. But in any event, OLA's codification of government power to finance wind-downs—which could in effect subsidize certain creditors—demonstrates that OLA's anti-bailout rhetoric is overstated. Such subsidies may not always be unjustified, but OLA buries them in the liquidation process and thus reduces political and judicial oversight.

E. INSURANCE

Gordon and Muller have proposed supplementing OLA with an insurance component—that financial companies should pay risk-based assessments to create a \$1 trillion fund to protect creditors.¹⁵⁶ Shortfalls in the fund could be supplemented with borrowing from the Treasury, to be repaid with post-hoc assessments on surviving firms, as they would be under OLA.¹⁵⁷ As with SIPA, insurance could raise the specter of moral hazard. As argued above, certain creditors, especially those considered “too big to fail,” may expect to be bailed out in order to preserve stability. However, the risks that such a fund seeks to mitigate—destabilizing chain reactions throughout the financial system—are significantly greater than those that SIPA seeks to mitigate: small investors' unwillingness to use broker-dealers. In Gordon and Muller's words, “it is a prudential measure against possibilities we may not project, notwithstanding efforts to avoid them.”¹⁵⁸ Furthermore, the moral hazard typically associated with insurance is significantly reduced because, as argued above, it is simply unclear whether and in what circumstances OLA would be invoked and which creditors would benefit. Most importantly, an OLA proceeding could potentially bail out creditors;¹⁵⁹ thus industry-paid prefunding and insurance would be more fair (as well as more predictable and fiscally prudent) than OLA's system of paying costs via open-ended borrowing and post-hoc assessments.

As Gordon and Muller point out, a lack of prefunding may make regulators hesitant to intervene even when necessary.¹⁶⁰ But prefunding

155. Gordon & Muller, *supra* note 6, at 191–92.

156. *Id.* at 204–06.

157. *Id.* at 206; *cf.* Dodd-Frank Act § 210(o)(1)(B), 124 Stat. 1509 (codified at 12 U.S.C. § 5390).

158. Gordon & Muller, *supra* note 6, at 210.

159. *See supra* Part II.C.1. Gordon and Muller also propose that the fund could be used to bail out failing firms in some cases. Gordon & Muller, *supra* note 6.

160. Gordon & Muller, *supra* note 6, at 192.

may create the opposite problem—an excessive readiness to intervene. One commentator, formerly FDIC’s general counsel, has argued that the FDIC (in its traditional role as bank regulator) has historically been too quick to determine that receivership is necessary to avert “systemic” consequences, and that the creation of a fund for OLA would exacerbate that tendency.¹⁶¹

Whatever the policy justifications, a prefunding scheme is unlikely to survive political objections, and the securities industry is unlikely to support it. Similarly, risk-based assessments are likely to be too costly and difficult to administer; they are also likely to be challenged by the industry. As further noted above, an earlier proposal for assessments was assailed as a “bank tax” (notwithstanding the fact that the proceeds would have benefited the banks). The proposed fund was criticized by others as a “bailout” fund (notwithstanding the fact that it would have obviated the use of public funds to finance liquidations). The insurance fund would make transparent the purpose of protecting creditors. This may be preferable to OLA’s potential for disguising creditor subsidies in the liquidation process, but would make the proposal politically unpalatable. Furthermore, as Gordon and Muller acknowledge, the fund would require authority to borrow from the Treasury as a backstop, a feature that seems unlikely to survive political opposition.¹⁶²

CONCLUSION

As noted above, Congress passed SIPA in order to increase investor confidence and shore up the depressed securities market in the wake of the back-office crisis and subsequent market slump. Whatever the merits of protecting customers, it could be argued that the loss of investor confidence was justified by market conditions, such that SIPA’s larger goal was misconceived.¹⁶³ Unfortunately, OLA also has confused goals and does little to prevent failure. Like SIPA, OLA is mainly concerned with mitigating the consequences of failure. Whether it is even suited to meet that goal has been questioned: it has been argued that its firm-by-firm liquidation approach is suited to isolated failures but inappropriate for addressing a systemic crisis.¹⁶⁴

OLA was precipitated by anti-bailout sentiment and purports to be an anti-bailout measure. But despite this rhetoric, OLA does little, if anything, to prevent bailouts in the future. OLA’s stated purposes include “improving accountability” and “ending too big to fail.” Forcing the liquidation of insolvent financial firms would arguably hold them “accountable” for their

161. Kroener, *supra* note 120, at 183–84.

162. Gordon & Muller, *supra* note 6, at 191–93.

163. Furthermore, recent SEC data suggests many brokerage customers are unaware of SIPC insurance, suggesting that while insurance may reimburse customer losses after the fact, it may not serve its goal of encouraging investment. SEC REPORT ON SIPC, *supra* note 40, at 28.

164. Gordon & Muller, *supra* note 6, at 194–95.

failures (whether that would enhance stability, however, is of course debatable). But as discussed above, OLA only specifies a procedure for liquidation; it does not require it. The open-ended resolution process creates opportunities for creditor bailouts—the antithesis of “improving accountability.” While OLA does not authorize bailouts—whether for “too big to fail” reasons or other grounds—it does nothing to prevent them either. As Roberta Karmel points out in her contribution to this Symposium, the largest surviving financial firms are even larger now than they were in 2008, having purchased the assets of failed firms and taken over their market share, sometimes with the direct assistance of the government.¹⁶⁵ The liquidation of a megafirm under OLA would repeat this process: only the surviving megafirms would have sufficient capital to purchase the assets of the failed firm. That is, concentration would only increase further. Dodd-Frank establishes the Financial Stability Oversight Council (FSOC) to look into such issues,¹⁶⁶ but it remains to be seen whether the FSOC will have any effect on the concentration of financial power.

The FDIC’s broad discretion under OLA to pursue the vague goal of “financial stability” creates the danger that the FDIC could bail out certain favored creditors at the expense of other unsecured creditors and taxpayers. Although the government always has the option to bail out favored creditors, the resolution process might make such actions politically easier by providing layers of cover.¹⁶⁷ For this reason, some commentators have argued that the resolution of major financial firms should assign a greater role to bankruptcy courts and less discretion to government agencies.¹⁶⁸

Some commentators have argued that excluding financial companies from bankruptcy is unnecessary.¹⁶⁹ Statutory resolution regimes are often justified as exceptions to bankruptcy on the ground that regulatory agencies have specialized industry expertise that generalized bankruptcy judges lack. SIPC, for example, deals exclusively with broker failures, has a highly specialized and experienced staff, and appoints trustees with experience in

165. Roberta S. Karmel, *An Orderly Liquidation Authority is Not the Solution to Too-Big-to-Fail*, 6 BROOK. J. CORP. FIN. & COM. L. 1 (2011). Most famously, the Fed assisted JPMorgan in financing its purchase of Bear Stearns in March 2008. See Skeel, *Bankruptcy*, *supra* note 34, at 12.

166. See Dodd-Frank Act, Pub. L. No. 111-203, § 123, 124 Stat. 1376, 1412 (2010) (codified at 12 U.S.C. § 5333 (2010)) (directing the FSOC to conduct a study of the size and complexity of financial institutions).

167. For example:

The government will always have the capability of bailing out favored claimants on an ad hoc basis, whether for reasons assertedly economic or actually political. The best that can be done is to try to design a resolution process that makes it somewhat less justifiable economically and less attractive politically.

Kenneth E. Scott, *Evaluating Failure Resolution Plans*, in ENDING GOVERNMENT BAILOUTS 253, 258 (Kenneth E. Scott, George P. Schultz & John B. Taylor eds., 2009).

168. See, e.g., Jackson, *supra* note 6, at 219–20.

169. See, e.g., *id.* at 258. See also Skeel, *Bank and Insurance Insolvency*, *supra* note 6, at 725.

the area. Analogously, the FDIC has expertise in the resolution of banks. Bankruptcy-based alternative proposals address the expertise issue through such devices as special masters and agency participation (including agency power to file involuntary petitions).¹⁷⁰ It is unclear, however, whether the FDIC, or, to be fair, any agency, has the skill and resources to handle the kind of massive liquidation contemplated by OLA.

The exclusion of brokerage firms from Chapter 11, David Skeel has argued, may have been appropriate in the 1960s, when firms were typically general partnerships that primarily provided brokerage services, but not today.¹⁷¹ Today's firms are typically large corporations (often publicly-traded) with complex capital structures, multiple related entities, and significant proprietary trading activity.¹⁷² As noted above, the two largest brokerage failures in history, Drexel and Lehman, were resolved primarily under Chapter 11, despite SIPA and the nominal exception of brokerages from Chapter 11.

Some believe that the destructive effects of Lehman's failure could have been mitigated if the government had had clear authority and procedures by which to wind it up.¹⁷³ The panic caused by Lehman's "disorderly" descent into bankruptcy is often cited as a justification for OLA, but this argument makes little sense. Indeed, the Lehman experience seems to demonstrate the power and adaptability of bankruptcy, not its shortcomings. Lehman's failure caused panic because the market expected a bailout, particularly after the Fed engineered the sale of Bear Stearns to JPMorgan. That is, the panic was caused not by Lehman's Chapter 11 filing per se, but by the absence of a government rescue.¹⁷⁴

I do not mean to advocate for bailouts, but rather to say that nothing about Lehman (or the rest of the financial crisis) clearly justifies yet another exception to bankruptcy. The Lehman bankruptcy seems to have proceeded relatively smoothly so far. Indeed, once Lehman was "allowed" to fail, its customer accounts and other good assets were quickly transferred using a combination of Chapter 11 for the holding company and SIPA for the Lehman Brothers, Inc., brokerage subsidiary.¹⁷⁵ As described above, lawyers, SIPA, and the bankruptcy court had to engage in some questionable sleight of hand to evade the exclusion of brokerages from Chapter 11.¹⁷⁶ As Skeel argues, this episode illustrates the pointlessness of the Chapter 11 exclusion and suggests that the bankruptcy process is indeed up to the task of handling massive financial failures.

170. See Jackson, *supra* note 6, at 227, 232, 238.

171. Skeel, *Bankruptcy*, *supra* note 34, at 4.

172. *Id.*

173. Kenneth E. Scott, *Dodd-Frank: Resolution or Expropriation?* (Stan. L. Sch., Working Paper Aug. 25, 2010), available at <http://ssrn.com/abstract=1673849>.

174. See Sprayregen & Hessler, *supra* note 125.

175. See *supra* text accompanying notes 35–36.

176. See *id.*

During and after the congressional debates that led to Dodd-Frank and OLA, a number of prominent commentators argued in favor of a modified Chapter 11 proceeding that would incorporate agency expertise but take place under the supervision of a bankruptcy court.¹⁷⁷ Indeed, a bill was introduced in the House that would have added a new Chapter 14 to the Bankruptcy Code to deal with financial institutions.¹⁷⁸ Congress, however, rejected court-centered bankruptcy in favor of OLA's agency-led resolution regime. This expansion of executive power is startling in light of the criticism leveled at the Treasury, the Fed, and the White House for their handling of the crisis. It is, however, consistent with Congress' historical tendency to respond to emergencies by delegating increased power and discretion to the executive branch.

177. See Jackson, *supra* note 6; Skeel, *Bankruptcy*, *supra* note 34, at 15–20; Sprayregen & Hessler, *supra* note 125.

178. The legacy of this failed proposal can be seen in OLA's provision for a study concerning possible modifications of the Bankruptcy Code for financial institutions. See Dodd-Frank Act, Pub. L. No. 111-203, § 215, 124 Stat. 1376, 1518 (2010) (codified at 12 U.S.C. § 5394 (2010)).