

## Can Orderly Liquidation Solve the Problems of Bailouts and Bankruptcies?

By Betty Joyce Nash, Sabrina R. Pellerin, and John R. Walter

In response to the financial crisis of 2007–09, Congress created the Orderly Liquidation Authority (OLA), a new regime for winding down systemically important financial institutions (SIFIs) that become troubled. The OLA provisions address two conflicting goals: mitigating threats to the financial system associated with bankruptcy and minimizing moral hazard associated with government bailouts. This *Economic Brief* compares OLA provisions to bankruptcy procedures. Although the OLA process could be quicker and more flexible than bankruptcy, it may not limit systemic risk without increasing moral hazard.

Title II of the Dodd-Frank Act established the OLA provisions, which authorize the Federal Deposit Insurance Corp. (FDIC), instead of a bankruptcy court, to administer wind-downs of SIFIs. In some cases, this so-called “orderly liquidation” process may be preferable because bankruptcy is a lengthy process and delays could pose greater risk to the financial system.<sup>1</sup> Orderly liquidation was created in an attempt to reduce the excessive risk taking encouraged by expectations of government bailouts. The OLA covers a subset of large financial companies whose failure might have significantly adverse effects on the nation’s financial stability. This subset includes nonbank financial firms supervised by the Federal Reserve, bank holding companies, and broker-dealers registered with the Securities and Exchange Commission.

The process for placing a firm into orderly liquidation starts with a recommendation from the Federal Reserve’s Board of Governors and the board of the FDIC. If the company is a

broker-dealer or an insurance firm, the Securities and Exchange Commission or the newly created Federal Insurance Office would make the recommendation instead of the FDIC. The secretary of the Treasury, in consultation with the president, could then place the company in receivership with the FDIC under the following conditions: the company is in default or in danger of default; its bankruptcy would destabilize the financial system; and no private sector alternative exists to prevent default. The FDIC can manage, sell, transfer, or merge the firm’s assets and, if it deems necessary, provide government funding to promote an orderly liquidation.

In the financial crisis of 2007–09, firms popularly described as “too big to fail” received government assistance, signaling to the market that similar firms also could receive such assistance. This expanded credit subsidies for certain firms and intensified moral hazard. In contrast, under the provisions of the OLA, the FDIC has broad discretion over how it balances the competing

goals of maintaining financial stability and limiting moral hazard. So market participants may find it difficult to predict which goal the FDIC might emphasize in the resolution of future failures.

### **Bankruptcy and Systemic Risk**

The goals of bankruptcy and orderly liquidation are fundamentally different. Orderly liquidation tries to promote the short-term and long-term stability of the financial system, while bankruptcy attempts to maximize recoveries for creditors from the assets of the bankrupt firm.

The U.S. Bankruptcy Code guides the actions of failing firms, but certain provisions can slow the process and make it hard to stop risk from spreading when a SIFI fails. One of those provisions is the “automatic stay” and the exemption from it for qualified financial contracts (QFCs). A second is the limit on sources of funding allowed in bankruptcy.

In bankruptcy proceedings, government funds are typically not available to troubled firms. But firms reorganizing under Chapter 11 may receive debtor-in-possession (DIP) loans, which typically become senior to any of the firm’s former debts. DIP loans, however, may not be an option for SIFIs because they have many hard-to-value assets. DIP loans to SIFIs likely would require higher interest rates to compensate for the time to evaluate such opaque assets in addition to the elevated risk. The time constraint in particular has led to government bailouts of financial firms before or during bankruptcy.

Bankruptcy has a set of creditor and debtor outcomes and an order of payout that are largely inviolable. Senior creditors, for example, are repaid before junior creditors. This absolute priority rule enhances economic efficiency by allowing risks to be borne by those creditors best able to bear them. Creditors with lower risk tolerance choose senior debt; those with higher risk tolerance choose less-senior debt. Under the OLA, however, payouts may be ordered differently.

The “automatic stay” in bankruptcy keeps creditors from seizing assets that, in combination with other

assets, may raise a bankrupt firm’s value in Chapter 7 or Chapter 11. Those assets could include operating equipment for a manufacturing firm or buildings for a financial firm. In a Chapter 7 bankruptcy (liquidation), the trustee typically sells all the firm’s assets before paying creditors to increase the payouts. The average Chapter 7 bankruptcy lasts 709 days. SIFIs could take at least that long. A Chapter 11 proceeding lasts even longer, 828 days on average, though creditors may be paid before the proceeding ends if the firm survives.<sup>2</sup>

Bankruptcy for nonfinancial firms might not spread losses to the financial system because their creditors may be long-term debt holders who don’t need quick repayment. But a financial firm’s creditors likely include investors with loans that could mature in days, even in one day. Such creditors depend on immediate access to funds. If they cannot, in turn, pay their creditors, they might fail as well. Thus the automatic stay could set off a chain reaction in the case of a failing SIFI. Under OLA, the FDIC has the ability to prevent these chain reactions because it can ensure that such creditors have immediate access to funding. For example, it can shift their accounts into newly created, healthy entities known as “bridge companies” that could be funded in part by government loans.

### **Bankruptcy vs. Orderly Liquidation**

With a few notable exceptions, bankruptcy minimizes moral hazard by avoiding bailouts.<sup>3</sup> However, it generally does not address systemic risk. Congress crafted the OLA provisions in an attempt to address systemic risk *without* increasing moral hazard. For example, to address systemic risk, the OLA gives the FDIC great discretion in how it funds the resolution process and how it pays creditors.

The OLA abides by a prioritized repayment schedule, similar to bankruptcy, but the FDIC may alter the schedule under certain circumstances. Some creditors may be paid more than bankruptcy rules allow to minimize losses and continue to operate the firm in a way that maximizes its value. Such discretion may create uncertainty, however, which undercuts the efficiency gained from bankruptcy’s unchanging rules.

Perhaps the most significant feature of the OLA is the FDIC's ability to access Treasury funds. Once appointed as receiver, the FDIC may borrow immediately from the Treasury to pay creditors an amount equal to up to 10 percent of the firm's assets. In the Lehman Brothers failure, for instance, 10 percent of assets would have totaled \$63.9 billion. Once the fair value of the failing firm's assets is determined and plans for liquidation and repayment are in place, the FDIC may borrow another 90 percent of the firm's assets with Treasury approval. The funds are to be repaid from the sale of the liquidated firm's assets. But the act also specifies that if such assets are insufficient, then the FDIC can try to "claw back" a portion of what it paid to certain creditors. If that's not enough, the FDIC can tax financial firms with \$50 billion or more in assets. This implies that creditors may be repaid more than the sum generated by asset sales, more than they could receive in a bankruptcy.

The FDIC's discretion in this repayment regime likely stems from the necessity to lessen systemic risk. Given that some creditors may receive more than they would in bankruptcy, these creditors may be less likely to spread losses to other firms. The discretion and ability to borrow from the Treasury also may allow the FDIC to move more quickly than bankruptcy courts.

But prospective creditors would know that the OLA might allow larger payments to creditors than bankruptcy does. Therefore, they would tend to underprice risks because SIFIs could be resolved under the OLA. Such firms can take on risk at a lower cost and therefore might be inclined to take more risks than they would normally. As a result, SIFIs would tend to make loans that they otherwise would not make, undercutting economic efficiency and increasing systemic risk. It would be up to the FDIC to limit this risk when it liquidates SIFIs, for example, by ensuring that any member of management or the board of directors deemed responsible for the failure is fired. The OLA also requires the FDIC to ensure that shareholders receive no payments until the Treasury funds and other claims are fully paid. These provisions are likely to encourage corporate leaders to limit risk taking. However, the OLA provides for certain creditors to

be treated better than others, which means creditor oversight could be diminished.

### **Treatment of Qualified Financial Contracts**

Certain financial instruments, qualified financial contracts (QFCs), have long been exempt from bankruptcy's automatic stay. Investors who hold these contracts can terminate them and liquidate collateral or net-out contracts immediately upon the firm's bankruptcy filing.<sup>4</sup> While this protection is meant to control systemic effects that might arise if QFCs were subject to the stay, the exemption can produce its own systemic problems, according to some observers. As a result, the OLA places some limits on the QFC exemption.

Under bankruptcy law, QFCs include most types of derivatives as well as repurchase agreements (repos). One important explanation for exempting QFCs is that delaying creditor recovery in these markets by imposing a stay on QFC counterparties is especially destructive compared to staying creditors operating in other markets.<sup>5</sup> When the automatic stay was first created in 1978, these protections were intended to "prevent the insolvency of one commodity firm from spreading to other brokers or clearing agencies and possibly threatening the collapse of the market."<sup>6</sup>

The QFC exemption may limit QFC holders' losses, and prevent contagion of those losses to their creditors (or to their own counterparties), but the exemption itself may create another type of systemic risk. Because QFC holders are likely to retrieve and sell collateral immediately, the simultaneous termination of many QFCs may produce "asset fire sales." For example, of Lehman's 930,000 derivatives counterparties, 733,000 sought to terminate contracts when the firm filed for bankruptcy on Sept. 15, 2008.<sup>7</sup> On the following day, the government bailed out AIG, but if AIG's counterparties had been forced to sell significant numbers of mortgage-related securities posted as collateral on QFCs, mortgage values might have fallen even further than they did.

Some experts suggest bankruptcy's current exemption of QFCs also may weaken market discipline.<sup>8</sup> The exemption allows QFC counterparties to get

out of contracts while other creditors cannot, which reduces incentives to screen and monitor the debtor prior to bankruptcy and make accurate pricing and investment decisions. This increases moral hazard and leads to market distortions because debtors favor short-term repo financing (which benefits from the QFC exemption) over traditional funding sources that typically are not considered QFCs. This promotes a more fragile liability structure. For instance, at the time of Bear Stearns' failure, a quarter of its assets, about \$100 billion, were funded by repos. Mark J. Roe, a professor of law at Harvard University, suggests that without the priority given to these instruments in bankruptcy, Bear Stearns might have financed a larger proportion of its assets through longer-term debt, a more stable funding structure during financial turmoil.<sup>9</sup>

The OLA addresses these systemic and moral hazard concerns by subjecting QFCs to a one-day stay, compared to no stay under bankruptcy. The one-day stay lasts until 5 p.m. on the business day following the FDIC's appointment as receiver. During this period, the FDIC must determine how to manage a SIFI's portfolio of QFCs. The FDIC may opt to retain the QFCs in receivership, transfer them to a third party, or reject them.

If the FDIC retains a counterparty's QFCs in receivership, the counterparty may liquidate the contracts. If the FDIC transfers a counterparty's QFCs to a third party, the counterparty can neither terminate nor close out the contracts. This may help preserve their value by removing counterparties' ability to terminate QFCs early and sell off collateral at fire-sale prices.<sup>10</sup> Moreover, after the one-day stay, a QFC counterparty may find its contracts held by a more stable counterparty or temporary bridge institution, and thus have no incentive to terminate, leaving the market undisrupted. Finally, the FDIC may reject the QFCs of a given counterparty, effectively closing them out at their current market values and reimbursing the counterparty for any damages.

The FDIC, however, may not have enough time to identify which firms should receive the failed institution's portfolio, so the FDIC may simply transfer all

QFCs of a given party to a bridge firm, essentially guaranteeing them in full because of the potential for systemic risk. If the FDIC doesn't protect all contracts, then nondefaulting counterparties may liquidate contracts after the stay expires, leading to potential fire sales. An extension of the automatic stay, from one to three days, would help the FDIC, according to Thomas Jackson, a business and political science professor at the University of Rochester. He has proposed a new Bankruptcy Code chapter tailored to SIFI resolution.<sup>11</sup>

Jackson and other observers contend that QFCs should be subject to the automatic stay provisions in the bankruptcy code, though views differ on the length of the stay and whether all QFCs should be treated equally. The automatic stay provides a firm with "breathing space" to find a third-party source of liquidity or to carry out an "orderly, supervised, wind-down," according to Harvey R. Miller, Lehman's lead attorney in its bankruptcy proceedings.<sup>12</sup> Nearly 80 percent of Lehman's derivatives counterparties terminated contracts when the firm filed for bankruptcy. Miller also maintains that Lehman's failure might have been less challenging to the system, or avoided altogether, had its QFCs not been exempt.

## Conclusion

While bankruptcy may be an excellent resolution mechanism for the failure of most corporations, it may not work well for SIFIs. Their balance sheets are opaque, and they depend on short-term funds, so a long automatic stay during the bankruptcy process might create financial distress for the troubled firm's counterparties. Also, debtor-in-possession funds may be hard to arrange in a timely manner. Because of these weaknesses, handling a SIFI through bankruptcy may risk the stability of the financial system.

The OLA provisions empower the FDIC to adjust the treatment of QFCs and how creditors are paid. But in the attempt to mitigate systemic risk and minimize moral hazard, reducing one inevitably leads to an increase in the other. The one-day QFC exemption fails to resolve potential risks to financial stability, and it falls short of reducing moral hazard. Perhaps most significantly, the FDIC's ability to pay some creditors

more than they would receive in bankruptcy may increase moral hazard in order to reduce systemic risk.

The threat of a SIFI's failure presents policymakers with a daunting challenge that neither bankruptcy nor the OLA seems capable of fully resolving. ■

Betty Joyce Nash is a writer, Sabrina R. Pellerin is a bank structure manager, and John R. Walter is a senior economist and research advisor in the Research Department of the Federal Reserve Bank of Richmond.

## Endnotes

- <sup>1</sup> For a more detailed comparison, see Sabrina R. Pellerin and John R. Walter, "Orderly Liquidation Authority as an Alternative to Bankruptcy," Federal Reserve Bank of Richmond *Economic Quarterly*, First Quarter 2012, vol. 98, no. 1, pp. 1–31.
- <sup>2</sup> Arturo Bris, Ivo Welch, and Ning Zhu, "The Costs of Bankruptcy: Chapter 7 Liquidation versus Chapter 11 Reorganization," *Journal of Finance*, June 2006, vol. 61, no. 3, pp. 1253–1303.
- <sup>3</sup> Both General Motors and Chrysler received aid from the federal government during their bankruptcy reorganizations in 2009. Earlier cases of government aid include Penn Central Railroad in 1970, Lockheed Aircraft in 1971, and Chrysler in 1980.
- <sup>4</sup> Contracts exempt from the automatic stay are referred to as safe harbor contracts in the U.S. Bankruptcy Code. The Federal Depository Institution Act and the Dodd-Frank Act also refer to safe harbor contracts as qualified financial contracts or QFCs.
- <sup>5</sup> A Sept. 30, 1998, letter from U.S. Secretary of the Treasury Robert Rubin to George W. Gekas, chairman of the Subcommittee on Commercial and Administrative Law, Committee on the Judiciary, argued that applying traditional insolvency laws, such as the stay, to QFCs could cause a "possible domino effect that could turn the failure of one market participant into a failure of the market."
- <sup>6</sup> See House of Representatives Report No. 97-420, at 2 (1982).
- <sup>7</sup> Testimony of Harvey R. Miller at hearings on "Too Big to Fail: The Role for Bankruptcy and Antitrust Law in Financial Regulation Reform," Subcommittee on Commercial and Administrative Law, House of Representatives Committee on the Judiciary, October 22, 2009.

- <sup>8</sup> Franklin R. Edwards and Edward R. Morrison, "Derivatives and the Bankruptcy Code: Why the Special Treatment?" *Yale Journal on Regulation*, January 2005, vol. 22, no. 1, pp. 101–133.
- <sup>9</sup> Mark J. Roe, "The Derivatives Market's Payment Priorities as Financial Crisis Accelerator," *Stanford Law Review*, March 2011, vol. 63, no. 3, pp. 539–590.
- <sup>10</sup> See Hollace T. Cohen, "Orderly Liquidation Authority: A New Insolvency Regime to Address Systemic Risk," *University of Richmond Law Review*, May 2011, vol. 45, no. 4, pp. 1143–1229.
- <sup>11</sup> See Thomas Jackson, "Bankruptcy Code Chapter 14: A Proposal," Hoover Institution Resolution Project, February 28, 2012.
- <sup>12</sup> See Miller's testimony referenced above.

This article may be photocopied or reprinted in its entirety. Please credit the authors, source, and the Federal Reserve Bank of Richmond and include the italicized statement below.

*Views expressed in this article are those of the authors and not necessarily those of the Federal Reserve Bank of Richmond or the Federal Reserve System.*