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The Effectiveness Of Resolution Mechanisms For Systemically Important Financial Institutions. The Lehman Brothers Case: A Comparative Analysis

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Table of Contents

Chapter 1 ... **13**
1.1 The origins of Insolvency Law ... **13**
1.2 Systemically Important Financial Institutions ... **15**
1.3 Bankruptcy Law ... **16**
1.3.1 The automatic stay ... 17
1.3.2 Exceptions to the stay ... 20
1.4 Fraudulent Transfers ... 24
1.5 Preferential Transfers ... 25
1.6 Reorganization ... **26**
1.6.1 The Plan ... 26
1.7 Restructuring Support Agreement ... 27
1.8 Conversion to Chapter 7 ... 28
1.9 The Dodd-Frank Act ... **28**
1.9.1 Orderly Liquidation Authority ... 29
1.9.2 Single Point of Entry ... 31
1.9.3 Dealing with SIFIs. The Dodd-Frank Act. ... 33
1.10 Chapter 14 ... **36**
1.11 Resolving materially distressed SIFIs ... **39**

Chapter 2 ... **42**
2. History of Lehman Brothers ... **42**
2.1 Operations that led to default ... **43**
2.2 Securitizing subprime mortgages ... 44
2.3.1 Rating Agencies' responsibility ... **45**
2.4 Declaration of Bankruptcy ... **46**
2.5 A decreasing portfolio value. What was done wrongly? ... 47
2.6 How value can be destructed ... 48
2.7 The bailout that never was ... **48**
2.7.1 Too Big To Fail ... 51
2.8 Proposed alternative solutions ... **52**
2.8.1 Destiny of Financial Contracts of the Failing Company ... 56
2.8.2 Bailout ... 57

Chapter 3 ... **60**
The Need For A Discipline Effectively Dealing With Systemically Important Institutions in Distress: United States and Europe. ... **60**
3.1 Towards a common global discipline for Sifis' resolution ... **61**
3.2 Bank's insolvency in Europe. A spectre lingering in Europe ... **67**

3.2.1 Purposes of BRRD....69
3.3 Preparation Measures. The Plans.... 73
3.3.1 Recovery Plans....74
3.3.2 Resolution Plans....74
3.4 Resolution Tools under BRRD 76
3.4.1 Sale of Business or Shares and Creation of Bridge Institution....77
3.4.2 Asset Separation Tool....78
3.4.3 The Bail-in Tool....79
3.5 Financial Contracts and Derivatives.... 82
3.5.1 Attempts made by the regulations to address the financial contracts problem .83
3.5.2 Unresolved Matters: Clearinghouses like Sifis....85
Conclusions 87
Bibliography 90

INTRODUZIONE

L'obiettivo che questo elaborato si propone è di offrire una panoramica sulla disciplina giuridica Americana del fallimento. Più precisamente, mira ad analizzare i punti di forza e le carenze della disciplina in caso di insolvenza delle istituzioni finanziarie che pongono un rischio sistemico (Systemically Important Financial Institutions).
La ragione per cui si assumono queste Istituzioni come parametro al fine di valutare l'efficienza del Bankruptcy Code è che queste, in particolare, minacciano la stabilità finanziaria e pongono problemi di azzardo morale. La stabilità finanziaria viene messa a repentaglio quando al fallimento di un'impresa segue il crollo di altri soggetti facenti parte del mercato, a causa del radicamento e delle strette connessioni dell'impresa all'interno del mercato stesso, mentre l'azzardo morale ha a che fare con il concetto di "Too Big To Fail". Quando una istituzione considera se stessa Too Big To Fail vi è la possibilità che questa intraprenda attività finanziarie azzardate, in quanto immagina il proprio fallimento come l'ultima delle alternative.

Tutte le istituzioni finanziarie che dominavano i mercati finanziari internazionali erano considerate Too Big To Fail prima del 2010. Lehman Brothers era una di queste fino al 15 Settembre del 2008, la data in cui ha perso questo status ed ha cessato di essere la quarta banca d'investimenti più grande degli Stati Uniti, a causa dell' incapacità nel trovare un finanziatore privato e del rifiuto di un salvataggio pubblico. Lehman Brothers ha dichiarato il proprio fallimento in quanto aveva asset per un valore di 639 miliardi di dollari e 619 miliardi in debiti. Di conseguenza non vi era altra possibilità che liquidare e cessare l'attività.
Tuttavia Lehman non ha invocato il Chapter 7 del Bankruptcy Code Statunitense, il Chapter contenente la disciplina della liquidazione delle imprese finanziarie in crisi irreversibile, bensì ha richiesto l'applicazione del Chapter 11, il cui scopo è in verità la

riorganizzazione dell'impresa. La ragione della scelta sembra dipendere dalle garanzie offerte dal Chapter 11. Garanzie soprattutto sotto forma di tutela dei creditori, necessarie in caso di fallimenti colossali come quello di Lehman.
Infatti, le regole contenute nel Chapter 11 mirano a realizzare il migliore interesse e il giusto trattamento dei creditori, i quali partecipano attivamente alla stesura del piano di riorganizzazione.
A partire dall'entrata in vigore, nel 2010, del Wall Street Reform and Consumer Protection Act (il Dodd-Frank Act) la teoria del Too Big To Fail sarebbe dovuta divenire un mero ricordo del passato, in quanto la riforma mira a "*porre fine al too big to fail, a proteggere il contribuente Americano mettendo fine ai salvataggi pubblici"*.
Il Dodd-Frank Act, tuttavia, non ha come obiettivo quello di sostituirsi al Bankruptcy Code e ai suoi meccanismi unici, piuttosto fornisce uno strumento alternativo per la risoluzione di istituzioni finanziare che pongono un rischio sistemico, ovvero la Orderly Resolution Authority (OLA).
Questo elaborato si propone di mettere in luce i singolari strumenti offerti dal chapter 11 del Bankruptcy Code, e al contempo di identificare quelle che fra le varie previsioni, impediscono la massima efficienza del Bankruptcy Code quando la sua disciplina deve applicarsi alle istituzioni finanziarie in crisi.

Il contenuto del Chapter 1 è costituito dall'analisi del Bankruptcy Code Statunitense, con un focus sulla previsione della *automatic stay*. L'*automatic stay* è un meccanismo indicato nel §362 del Bankruptcy Code, il quale impedisce ai creditori di un debitore insolvente che dichiara fallimento di esercitare azioni individuali nei confronti degli asset del debitore. In altri termini, lo scopo dello stay è scongiurare il problema di common pool (che impedirebbe la par condicio creditorum), e rappresenta uno strumento di eccezionale importanza per garantire l'equo trattamento dei creditori.
Data la necessarietà di un tale strumento nell'ambito di una procedura concorsuale l'elaborato intenderà mettere in discussione la portata delle eccezioni allo stay.
Infatti, il §362(b) del Bankruptcy Code elenca una serie di azioni esonerate dallo stay, includendo l'esercizio del diritto di recesso dai contratti finanziari e, dunque, dai contratti derivati.

La possibilità offerta alle controparti del debitore di recedere dai contratti derivati unicamente come conseguenza della dichiarazione di fallimento può gravemente minacciare la par condicio creditorum, in quanto diminuisce il valore dell'attivo che dovrebbe essere ripartito nell'ambito della procedura concorsuale.
Lo stesso Chapter 1 offrirà una panoramica sulla Orderly Resolution Authority introdotta dal Dodd-Frank Act e si proporrà di fare un paragone fra questo meccanismo e gli strumenti offerti dal Bankruptcy Code. Si concluderà che il Bankruptcy Code è più garantista nei confronti dei creditori dell'istituzione.

Il Chapter 2 contiene una breve narrazione della storia di Lehman Brothers e la individuazione delle vicende che hanno portato la banca alla dichiarazione di fallimento. Il capitolo ha come obiettivo quello di fornire un esempio dell'applicazione pratica degli strumenti del Bankruptcy Code al fallimento di una istituzione finanziaria che pone un rischio sistemico al fine di avvalorare la tesi concernente i punti di debolezza del Code esposta nel Chapter 1.
Nel Chapter 2 si tenta di rispondere al quesito seguente: "Come sarebbe stata gestita l'insolvenza di Lehman Brothers se al tempo della crisi il Dodd-Frank Act fosse già stato in vigore?". Inoltre, si speculerà sulla opportunità di un salvataggio pubblico.
Le conclusioni terranno in considerazione che i salvataggi pubblici sono comunemente considerati irrispettosi dei membri della società che sono tenuti a sopportare i costi di una cattiva gestione all'interno del mondo finanziario ma, probabilmente, quando un fallimento pone un rischio sistemico e mette in crisi la stabilità finanziaria ed economica globale il salvataggio pubblico è meno dannoso per la società. Infatti, il bailout è il minore fra due mali quando il suo costo sociale è inferiore al costo della migliore alternativa possibile.

Questo elaborato si concentra sulla disciplina Americana del fallimento e dell'insolvenza ma prende consapevolezza della tendenza più o meno recente ad uniformare la disciplina dell'insolvenza in Europa e al tempo stesso di redigerla sulla base del modello Americano.
Sia il legislatore Americano che quello Europeo si conformano alle linee guida dettate in materia nei Key Attributes of Effective Resolution Regimes for Financial Institutions

(i “Key Attributes”) dal Financial Stability Board. I Key Attributes costituiscono un insieme di principi volti ad affrontare il problema del Too Big To Fail.
Questi principi sono stati resi effettivi nel 2011 in qualità di nuovi standard internazionali per i regimi di risoluzione, che consentono alle autorità di risolvere le istituzioni finanziarie senza coinvolgere i contribuenti e mantenendo la continuità delle attività economiche vitali.

Sulla base dei Key Attributes è stato redatto il Dodd-Frank Act ma anche il legislatore europeo è stato guidato dai principi nell stesura della Bank Recovery and Resolution Directive (la BRRD).
La BRRD è la risposta ai salvataggi pubblici data dal Parlamento Europeo e dal Consiglio.
I Paesi Europei hanno assunto la consapevolezza che quando una banca è vicina al crollo, in assenza di una soluzione di mercato, ha come alternativa o la liquidazione o la sopravvivenza grazie ad un salvataggio pubblico.
Quest’ultima soluzione non è più ritenuta accettabile. Infatti, quando le risorse pubbliche vengono impiegate per il salvataggio delle banche il carico percepito dal contribuente è doppio: comprende il costo del bailout e la recessione con tagli alla spesa pubblica.
Il bailout non è compatibile con la disciplina Europea della concorrenza, in quanto altera la concorrenza nel mercato ed induce all’azzardo morale. Le banche la cui amministrazione ha violato le regole di una prudente gestione sono supportate e rimangono all’interno del mercato in una posizione di vantaggio rispetto agli altri concorrenti, i quali devono affrontare i rischi collegati alle loro attività senza una assistenza esterna.
Di conseguenza, una delle principali misure introdotte dalla BRRD è il bail-in (in contrapposizione al bailout), una procedura in cui in caso di dissesto finanziario dell’istituzione sono coloro che hanno investito nella stessa a sopportarne le perdite per primi: soci e creditori.
Nel Chapter 3 verranno analizzati tutti gli strumenti forniti dalla BRRD, con particolare attenzione ai Piani di Risoluzione o “living wills” che le istituzioni rientranti nelle

categorie indicate dalla Direttiva sono tenute a presentare alle Autorità di Risoluzione al fine di individuare in anticipo le modalità di risoluzione più efficienti.
In particolare ci si chiederà se questi strumenti siano utili a ridurre il rischio sistemico.
Si concluderà con delle osservazioni sui passi mossi dai diversi legislatori verso la realizzazione di una armonizzazione del diritto dell'insolvenza.

OVERWIEW

The objective of this work is to provide an overview of the American legal discipline of bankruptcy. More particularly, it aims to analyse both the points of strenght and the shortcomings of bankruptcy law when insolvency affects a Systemically Important Financial Institution.

The reason why we focus on Systemically Important Financial Institutions in order to evaluate the performance of the Bankruptcy Code is that especially these pose considerable risks to financial stability and moral hazard. In fact, financial stability is at stake when a firm's failure brings other players down with it due to its interconnectedness within the market, whereas moral hazard goes hand in hand with the concept of "Too Big To Fail". When an institution considers itself systemically important, or Too Big To Fail, is more likely to engage in inconsiderate business activities as it envisions its bankruptcy as a very last resort. All financial institutions dominating national or international financial markets were considered Too Big To Fail before 2010. Also Lehman Brothers was Too Big To Fail until September 15, 2008, the date in which it lost this status and its position as the fourth-largest investment bank in the United States, due to the impossibility to find a private rescuer and to the denial of governmental bailout. Lehman Brothers filed a petition for bankruptcy protection in the United States as it accounted assets for $639 billion and debts for $619 billion, therefore there was no other possible course of action than to liquidate and cease its activity. Nevertheless, Lehman did not file for Chapter 7 of the U.S. Bankruptcy Code, the Chapter providing for the liquidation of irreversibly financially distressed firms, instead it petitioned Chapter 11, whose ultimate scope is the reorganisation of the troubled petitioner. The reason of this choice has to do with the distinguishable protection afforded to creditors in Chapter 11. In fact, the rules governing in Chapter 11 aim to accomplish the best interest and fair treatment of creditors, who actively participate in the drawing of the reorganisation plan.

Since the enactment, in 2010, of the Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act) the concept of Too-Big-To-Fail belongs to the past, as this reform

has as its main purpose "*[...]to end ''too big to fail'', to protect the American taxpayer by ending bailouts [...]*".
The Dodd-Frank Act, nevertheless, is not meant to substitute the Bankruptcy Code and its unparalleled mechanisms, it rather provides an alternative instrument to deal with financial Institutions of systemic impact, namely the Orderly Resolution Authority (OLA).
This work has the scope to highlight the unique instruments of Chapter 11 of the Bankruptcy Code, while attempting to identify those among the various provisions, which prevent it from being the best performing law applicable to Systemically Important Financial Institutions in distress.

The object of Chapter 1 is the analysis of the U.S. Bankruptcy Code, with a focus on the *automatic stay.* The automatic stay is a device provided for in §362 of the Bankruptcy Code which impedes creditors of an insolvent debtor who files for bankruptcy protection to undertake individual actions towards the assets of the debtor. In other terms, scope of the automatic stay is to address the "common pool" problem, and it represents an instrument of foremost importance to the aim of equal treatment of creditors. What we are going to challenge, therefore, is not the automatic stay but the extent of the so called *exceptions to the stay.* In point of fact, §362(b) of the Code lists a series of actions which are exempted from the stay, including the exercise of termination rights of financial contracts and hence derivatives. The possibility, for counter parties of the debtor to terminate their derivative position by sole reason of the bankruptcy filing might be detrimental for the common pool and therefore undermine one of the baseline rules of bankruptcy, i.e. the equal treatment of creditors.
The same chapter also offers an overview on the Dodd-Frank Act's Orderly Resolution Authority and makes a comparison between this mechanism and the ones triggered by the application of Chapter 11. The findings are in favor of the Bankruptcy Code, given the enanched protection granted to creditors.

Chapter 2 narrates the history of Lehman Brothers and the facts which led to its bankruptcy. The Chapter aims to give an example on how the devices of the Bankruptcy Code have been applied to Lehman's case and intends to support the theories concerning the flaws of the Bankruptcy Code, on which Chapter 1 speculates. Furthemore, it attempts to answer the question "how Lehman Brothers banruptcy would have been dealt with if The Dodd-Frank Act had already been enacted?" and to compare the ideal outcome with the outcome of a governmental bailout. The conclusion takes into account that bailouts are commonly perceived as unfair solutions in respect of the members of the society who are called to bear the costs of the mismanagements occurring in Wall Street but perhaps, in the case of a large SIFI like Lehman Brothers, a bailout would have been less detrimental for the society than the bankruptcy that came about instead. In point of fact a bailout is the *lesser of two evils* when the social costs of it are less than those of the next best alternative.

This work does have as a focal point American bankruptcy and insolvency law but in recent years we have been assisting to an harmonization, whether voluntary or involuntary, of insolvency law within Europe and between Europe and United States. In fact, both the American and the European legislator draw their regulations on the guidelines laid down by the Financial Stability Board in the *Key Attributes of Effective Resolution Regimes for Financial Institutions* ("Key Attributes"). The Key Attributes constitute a set of policies aiming to address the Too-Big-To-Fail problem. G20 Leaders at the Cannes Summit endorsed the implementation of these measures in 2011 as new international standards for resolution regimes that allow authorities to resolve financial institutions in an orderly manner without taxpayer exposure to loss from solvency support, while maintaining continuity of their vital economic functions. The Key Attributes were guidelines for the drawing of the Dodd-Frank Act but also lead the way of the European legislator in the drafting of the *Bank Recovery and Resolution Directive ("the BRRD")*. The *BRRD* is a reaction of the European Parliament and Council to bailouts. All European countries have experienced that when a bank is near to a breakdown in the absence of a market solution, such as a merger or acquisition by other institutions, the only alternative to liquidation is a public rescuing.
This solution is recognized as no more acceptable. As a fact, when public resources are used for banks' bailouts the burden placed on citizens is heavy, because they pay twice, with costs of a taxpayer bailout followed by recession and spending cuts. What is also not compatible with public rescuing is EU Competition Law (art. 101 TFEU). The bail

out distorts competition in the market and is an inducement to moral hazard. Banks whose governance disrespected the rules of prudent management are helped and allowed to stay in the market in an advantage position compared to other competitors, which have to face the risks related to their activities with no external assistance. Therefore, one of the main introduction of the *BRRD* is the so called bail-in, a procedure whereby shareholders and creditors shall bear losses first, should the financial institution they invested in face a financial collapse.

In Chapter 3, all the tools for the resolution of financial institution in distressed will be discussed, with a focus on the Resolution Plans, or "living wills" that the institutions which fall within the categories listes in the *BRRD* are required to submit in order to help Resolution Authorities more easily find the most efficient resolution system. In particular, what will be challenged is the efficacy of these tools in reducing systemic risk.

We will conclude with an evaluation of the steps moved by the legislators towards the realization of a globalwide harmonization in the field of bankruptcy law.

CHAPTER 1

1.1 The origins of Insolvency Law

Every area of the law arose as a consequence of the activities it aimed to regulate. Thus family law came into existence to govern relationships between family members; tort law was a consequence of people infringing others' rights; commercial law ensued trade between merchants. Insolvency law, and consequently, bankruptcy is the result of contracting debt to finance trading activities.

The word "bankruptcy" seems to originate from a combination of the Latin words *bancus* (bench) and *ruptus* (broken). A legend narrates that in Medieval Italy when a banker-who conducted transactions in the marketplace on a bench (or table)- could not fulfill its obligations the bench was broken to symbolize failure.[1]

In the United States the history of federal bankruptcy lawstarts with the drafting of the Constitution. The new federal charter of 1787, which replaced the existing Articles of Confederation, among other prerogatives, conferred on the national government the power to enact "uniform laws on the subject of bankruptcies throughout the United States"[2].The first Bankruptcy Act was enacted in 1800. It was the first federal law regulating bankruptcy and authorized the appointment of non-judicial commissioners to supervise bankruptcy proceedings. It applied only to merchant debtors and to cases initiated by creditors. The Act was repealed in 1803 and so it was for the Act of 1841, repealed in 1843 due to high administrative costs. The first long-term legislation was the Bankruptcy Act of 1898, which was overhauled by the Chandler Act in 1938, reworking amendments into Chapters.

The Bankruptcy Reform Act of 1978 established that bankruptcy courts might hear all matters related to bankruptcy cases. Western numerals were adopted for chapter titles and a new Chapter 11 and Chapter 13 made filing and discharging easier for businesses and individuals.Ultimately the Bankruptcy Abuse Prevention and Consumer Protection Act amended the 1978 Act in 2005.[3]

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[1]For more information visit: http://www.worldwidewords.org/weirdwords/ww-ban1.htm

[2]Skeel, D.A. (2001) Debt's Dominion: A History of Bankruptcy Law in the United States.

[3]For more information visit:
http://www.rib.uscourts.gov/newhome/docs/the_evelution_of_bankruptcy_law.pdf

Bankruptcy legislation is incorporated in Title 11 of the U.S Code and regulates different types of bankruptcy cases. In every bankruptcy case there are necessary participants, which are the debtor and the debtor's creditors but depending on the nature and size of the proceeding there might be some "added" participants, such as the trustee who administers debtor's property in Chapter 7.

With the filing of a bankruptcy petition comes the creation of an estate, with all of the debtor's property vesting in the estate. Either a trustee or a "debtor-in-possession" of the estate may manage the estate. The administration of the estate may involve also creditors formed into "creditors committees". In a Chapter 11 filing, when the debtor is a corporation, owners of the business may also form "equity committees".[4]

Each chapter of the Code is specifically designed to handle the situations arising from a bankruptcy of the debtor they address. Chapters 1, 3 and 5 contain general provisions, usually applicable to all debtors unless specifically exempted, and provide definitions. These Chapters contain some baseline rules of bankruptcy legislation, such as the automatic stay under section 362.[5]

Chapter 7 regulates liquidation and applies to both personal and business bankruptcy. When a debtor files for liquidation under this Chapter her assets are turned over to the bankruptcy court to be sold by a trustee. Section 727 provides that the individual debtor (therefore not corporate debtors) shall be granted a discharge occurring certain conditions. Chapter 9 applies only to the reorganization of a municipality, such as a city or county. States themselves are not eligible. The debtor must be specifically authorized by state law to enter into bankruptcy proceedings. What differentiates this Chapter from other Chapters is that for a municipality to be admitted to the proceeding it must be "insolvent"; in connection with a municipality, insolvency means the debtor is either (i) generally not paying its debts as they become due unless such debts are the subject of a bona fide dispute; or (ii) unable to pay its debts as they become due.[6] When an individual debtor has regular income may be eligible for Chapter 13. Under this Chapter the debtor shall file a plan in which are submitted the portions of income that will be used to repay creditors according to their priority order.Chapter 11 may be invoked only by troubled businesses, which do not want to liquidate yet to reorganize. Chapter 11,

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[4]Understanding Bankruptcy
[5]This provision will further explained
[6]Section 109 Bankruptcy Code.

best known as reorganization, is the most complicated type of bankruptcy;cases protract for several years before their resolution. Lehman Brothers represents the largest bankruptcy case filed under Chapter 11[7].In recent years the Bankruptcy Code has been challenged as not to be the best working solution for financially distressed Systemically Important Financial Institutions.

1.2 Systemically Important Financial Institutions

"Systemically important financial institutions (SIFIs) are financial institutions whose distress or disorderly failure, because of their size, complexity and systemic interconnectedness, would cause significant disruption to the wider financial system and economic activity"[8]The bankruptcy code currently does not provide for a SIFI failure and even though US bankruptcy law usually does a good job of restructuring industrial firms, it has been said that it cannot restructure financial firms, because bankruptcy's basic rules – which allow the court to consolidate the firm's assets, redeploy them, and sell the rest – do not apply to most financial contracts, like derivatives.

Consider the collapse of Lehman Brothers. When then-US Secretary of the Treasury Henry Paulson decided not to bail out Lehman, the firm filed for bankruptcy and quickly sold off its brokerage operations. But it could not sell its large portfolio of derivatives contracts. By most accounts, Lehman's derivatives portfolio was a winner when it went bankrupt, but bankruptcy exemptions for derivatives allowed Lehman's counterparties to close out their positions rapidly, in ways that were costly for Lehman, chaotic and damaging for financial markets.

In the definition of Systemically Important Financial Institutions two elements must be taken into account: (i) the important presence in the financial market and (ii) the threat to financial stability that their failure would entail.

The reason why we sort out SIFIs for the purpose of assessing the effectiveness of the Bankruptcy Code is that especially these pose risks to financial stability and moral hazard. In fact, financial stability is at stake when a firm's failure brings other players down with it due to its interconnectedness within the market, whereas moral hazard goes hand in hand with the concept of "Too Big To Fail". When an institution considers

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[7] Lehman Brothers bankruptcy was larger than Enron (2001) and WorldCom (2002) cases.

[8]http://www.fsb.org/what-we-do/policy-development/systematically-important-financial-institutions-sifis/

itself systemically important, or Too Big To Fail, is more likely to engage in inconsiderate business activities as it envisions its bankruptcy as a very last resort.
After Lehman's collapse in 2008 and the consequent global financial crisis, different alternatives to the bankruptcy code have been put forward by the Government (i.e. the Dodd-Frank Act) and by various authors, having as a starting point the minimization of the impact of financial distress of SIFIs on financial stability. In order to determine whether the Bankruptcy Code is still a good solution to resolve a firm's crisis we will first examine the purpose of bankruptcy law and its main aspects (points of strenght and shortcomings).

1.3 Bankruptcy Law

Depending on the nature of the debtor, insolvency law has at least two purposes. Justice Sutherland in Local Loan Co. v. Hunt illustrates that the first and main purpose of the Bankrupcty Act is to "relieve the honest debtor from the weight of oppressive indebtedness, and permit him to start afresh free from the obligations and responsibilities consequent upon business misfortunes"[9]. Therefore, the fresh start is a benefit given to the debtor who is honest but unfortunate, which means that those who engaged in fraudulent behaviors are left out of this category. The other goal is to treat creditors fairly by respecting classes and priorities and, consequently, by maximizing the extraction of value from the debtor's assets. If insolvency law has these functions we may infer that in a world without bankruptcy, should a debtor become unable to repay debts as they become due a few issues may arise. First of all, the entrepreneur with bad luck would not easily be utterly discharged from liabilities and hence would not get a second chance to have success in business. For instance he not only would have to pay his debts until the last cents out of his income and sale of assets, but he would also have to surrender types of property that are safeguarded by bankruptcy law in order to preserve debtors' dignity and to allow them to live on even though they have been hit by misfortune[10].Another problem that might occur in the absence of insolvency rules is the one known as the "common pool problem". JACKSON makes an amusing

[9] *Local Loan Co. V. Hunt*, 292 U.S. 234, 244 (1934).
[10] These goods are indicated under the "Exemptions" in Bankruptcy Code Section 522 and include among others clothing, furniture, linens, some types of interests in property, social security and retirement benefits.

example to explain the issue[11]. He imagines somebody who owns a lake. There are fishes in the lake and its owner might catch all the fishes one year and sell them for $100,000. The amount is not bad but the fishing could be even more profitable if he left some fishes in the lake every year so that they could multiply and be sold the next years. In this way he would have a perpetual annuity with a present value much higher than the $100,000 that he would make by selling them all at once. The sole owner of the lake might easily make this decision but perhaps he would not behave this way if he were not the only one who could fish in this lake. In fact, if the lake ownership were shared with other people the optimal solution would still be to leave fishes every year and make them multiply but the egoistic interest of each fisherman would lead them to catch as many fishes as possible as they cannot control the others to make sure that there will be any more fishes the next year.

At this point we might be wondering how the fishing relates to bankruptcy, and the answer is quite easy to give. When a debtor is not capable of repaying his creditors they are tempted to try and seize the debtor's property immediately because if they lag behind they might not get full repayment. It is none of their concern whether the other creditors will be satisfied or if the debtor's assets are more valuable held together. Bankruptcy law enters the picture to make all creditors act as one by imposing a collective and compulsory proceeding on them[12]. If they were one they would make sure to extract the maximum value from the pool of assets. Therefore bankruptcy law aims to make creditors better off as a group.

Bankruptcy is a collective debt-collection device and as such it should only make sure that the existing rights are vindicated to the extent possible, whereas it should not address the problem of how assets are deployed. How much the creditors are given after the bankruptcy procedures depends on how efficiently bankruptcy has worked and on what they are supposed to receive under general rules (or nonbankruptcy law).

1.3.1 The automatic stay.

In order for bankruptcy law to attain the goal of preventing creditors from attacking and

[11] Jackson, H.J. (1986) *The Logic And Limits Of Bankruptcy Law.* U.S.A: Harvard University Press.
[12] Jackson, H.J. (1986) *The Logic And Limits Of Bankruptcy Law.* U.S.A: Harvard University Press.

hence undermining the common “pool” there is need of some mechanisms that impede or stop individual actions already undertaken by creditors individually. Here the “automatic stay” enters the picture. This remedy is set out in section 362 of the Bankruptcy Code. In particular, section 362 provides that “a petition filed under section 301, 302 or 303 of this title or an application filed under section 5(a)(3) of the Securities Investor Protection Act of 1970, operates as a stay, applicable to all entities, of-

(1)the commencement or continuation, including the issuance or employment of process, of a judicial, administrative, or other action or proceeding against the debtor that was or could have been commenced before the commencement of the case under this title, or to recover a claim against the debtor that arose before the commencement of the case under this title;

(2) the enforcement, against the debtor or against property of the estate, of a judgment obtained before the commencement of the case under this title;

(3) any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate;

(4) any act to create, perfect, or enforce any lien against property of the estate;

(5) any act to create, perfect, or enforce against property of the debtor any lien to the extent that such lien secures a claim that arose before the commencement of the case under this title;

(6) any act to collect, assess, or recover a claim against the debtor that arose before the commencement of the case under this title;

(7) the setoff of any debt owing to the debtor that arose before the commencement of the case under this title against any claim against the debtor; and

(8) the commencement or continuation of a proceeding before the United States Tax Court concerning a tax liability of a debtor that is a corporation for a taxable period the bankruptcy court may determine or concerning the tax liability of a debtor who is an individual for a taxable period ending before the date of the order for relief under this title.”[13]

This section has the purpose of giving the debtor some breathing space and prohibits most judicial and administrative proceedings as well as informal actions by creditors. Furthermore it is a device that helps hold the assets together, which is essential when

[13]Section 362(a) Bankruptcy Code.

the firm is considered more valuable as a going concern than torn apart. The automatic stay is one of the fundamental debtor protection afforded by the bankruptcy code. Besides stopping all harassments by creditors and foreclosures, it also gives time to the debtor to file a reorganization plan and relieves him of the financial pressure that drove him into bankruptcy in the first place. The stay implements at least two goals. First, the stay preventsthe diminution or dissipation of the assets of the estate during thependency of the bankruptcy case. Second, it enables the debtor to avoid
the multiplicity of claims arising against him in different forums.The automatic stay is a device designed toprevent a chaotic and uncontrolled scramble for thedebtor's assets in a variety of uncoordinated proceedings in differentcourts. The stay insures that the debtor's affairs will be initially centralizedin a single forum in order to prevent conflicting judgments fromdifferent courts and to harmonize the interests of all creditors.[14]Although this breathing space is important in any case, it is especially significant in Chapter 11 cases, where the debtor-in-possession needs time to negotiate with creditors before proposing a plan.Acknowledging the importance of this tool helps us further discuss the consequences of its violations. There is, in fact, a split between the courts on the consequences that a breach may entail; in particular a debate exists over whether a violation of the stay is void or voidable[15]. The practical consequences of embracing one or the other opinion concern the party burdened to challenge the violation. If the actions are considered void *ab initio*the debtor does not need to look out for his assets because any actions undertaken against them have no effect; he can focus on its reorganization instead of addressing the court for the annulment of potential damaging acts. Of course the situation reverses if we back the opinion according to which actions in violation are simply voidable. In this case it would be up to the courts to decide case-by-case if the stay is necessary or it may be disregarded, and as a result the debtor who wants to keep his property together needs to put a lot more effort to make it happen. There is not a proper solution to this debate but perhaps we should consider the ratio of the stay to decide which one of the two views meets the scope. The ratio of the stay is to provide the debtor with "breathing room to arrange his or her

[14]Murphy, J. F. (1986) The Automatic Stay in Bankruptcy. *Cleveland State law Review.* 34. P.567-635
[15]Lichtenstein, M. J. (2004) Violations Of The Automatic Stay: Void or Voidable?*American Bankruptcy Institute Journal.* XXII (4). p.20-53.

affairs”[16], if the actions against his property are considered not void but only voidable this breathing room would as a matter of fact become narrower, because the debtor would be busy asking the court to annul creditors’ actions. Therefore it seems that supporting the opinion that holds actions in breach of the stay to be void is a preferable solution.

1.3.2 Exceptions to the stay

Even though the automatic stay is pivotal for the achievement of the preservation of assets’ value and equal treatment of creditors, there are relevant exceptions that free some creditors from the general provision. These exceptions are set forth in section 362(b) of the Code which is formulated in a way to make a list of the exempted operations by saying that “The filing of a petition under section 301, 302, or 303 of this title, or of an application under section 5(a)(3) of the Securities Investor Protection Act of 1970, does not operate as a stay” of a series of actions among which criminal actions, civil actions for the establishment of paternity, family and domestic obligations.As far as Sistemically Important Financial Institutions are concerned the most important and controversial among the exceptions to the stay are those set out in section 362(b)(6) and (7) regarding derivative, or more generally, financial contracts. Under section 362(b)(6) the filing of a petition in voluntary, involuntary or joint cases does not operate as a stay “of the exercise by a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency of any contractual right (as defined in section 555 or 556) under any security agreement or arrangement or other credit enhancement forming a part of or related to any commodity contract, forward contract or securities contract, or of any contractual right (as defined in section 555 or 556) to offset or net out any termination value, payment amount, or other transfer obligation arising under or in connection with 1 or more such contracts, including any master agreement for such contracts”[17], and also under section 362(b)(7) “of the exercise by a repo participant or financial participant of any contractual right (as defined in section 559) under any security agreement or arrangement or other credit enhancement forming a part of or related to any repurchase agreement, or of any

[16]Ferriel, J., Janger, E. (2013) *Understanding Bankruptcy.* 3rd Ed. U.S.A: LexisNexis.
[17]Section 363(b)(6) bankruptcy code.

contractual right (as defined in section 559) to offset or net out any termination value, payment amount, or other transfer obligation arising under or in connection with 1 or more such agreements, including any master agreement for such agreements".The filing of a bankruptcy petition does not operate as a stay of derivative contracts and hence counterparties of the debtor in a derivative contract may terminate his position when this one goes bankrupt.

Derivatives.

Derivative is not a defined term. The SEC's Chief Account in a report issued on June 15, 2005 defined it as a "financial instrument which has a value determined by the price of something else"[18]. A derivative is essentially a security whose value depends on the value of an underlying asset, reference rate or index[19].Derivatives are highly complex financial instruments; so complex that also large companies fail to fully understand the risks associated with them. Notwithstanding their complexity they are of significant importance to the global economy. The notional global amount of outstanding "Over The Counter" derivatives exceeded $492 billion in the second semester of 2015.[20]They are traded in two ways: in regulated exchanges or through bilateral agreements (over the counter orOTC). When they are traded over-the-counter the trading is conducted directly between dealers over the phone or by computer. These derivatives offer companies more flexibility because, unlike the "standardised" exchange-traded products, they can be tailored to fit specific needs, such as the effects of a particular exchange rate or commodity price over a given period. When we talk about risks stemming from derivatives transactions we refer to six basic risks: (1) derivatives may involve *systemic risk*, where a problem in one market has the potential of affecting the entire financial system, even on a global scale; (2) *credit risk*, which takes place when one party defaults to meet its financial obligations with a counterparty; (3) *market risk*, triggered by the volatility of the market and the exposure to significant losses from

[18]Report and Recommendations Pursuant to Section 401(c) of the Sarbanes-Oxley Act of 2002 On Arrangements with Off-Balance Sheet Implications, Special Purpose Entities, and Transparency of Filings by Issuers, at 72. Available at: https://www.sec.gov/news/studies/soxoffbalancerpt.pdf.
[19] Wiggins, R. Z. & Metrick, A. (2015) The Lehman Brothers Bankruptcy G: The Special Case Of Derivatives. *Yale Program On Financial Stability* [Online]. Available from: http://ssrn.com/abstract=2593080. [Accessed: August 2nd 2016].
[20]Bank For International Settlements, Semiannual OTC Derivatives Statistics. Available at: http://www.bis.org/statistics/d5_1.pdf

unfavorable price movements. (4) *operational risk* is increased by potential failure of eachparty's internal control systems, human error, or fraud;(5) *legal risks*, in which incur major institutions due to the losses suffered from derivatives contracts; (6) *market/product liquidity risk,* in the case when one party is unable to close out its positioneither because of insufficient activity in the market or because of too great a price spread.[21]

As mentioned, derivatives are given special treatment in bankruptcy. The legislative history to the various provisions of the Bankruptcy Code dealing with derivative and financial contracts, which we might refer to as the "safe harbor provisions", indicates a policy carried out by the Congress to protect American financial markets and institutions from the ripple effects resulting from a bankruptcy filing by a major participant in the financial markets. These provisions are designed to protect the financial markets from systemic risks.

Senator Dole in a statement made in 1982 claimed that "*It is essential that stockbrokers and securities clearing agencies be protected from the issuance of a court or administrative agency order which would stay the prompt liquidation of an insolvent's positions, because market fluctuations in the securities markets create an inordinate risk that the insolvency of one party could trigger a chain reaction of insolvencies of the others whocarry accounts for that party and undermine the integrity of those markets.*"[22]

Most derivatives are documented under the ISDA Master Agreement[23]. The International Swaps and Derivatives Association (ISDA) is a trade organization of participants in the market of OTC derivatives. The ISDA was the creator of the Master Agreement, which is a documentagreed between two parties that sets out standard terms that apply to all the transactions entered into between those parties. Each time that a transaction is entered into, the terms of the master agreement do not need to be re-negotiated as they apply automatically. Under the ISDA Master Agreement upon a party's default the other party may terminate the transaction or the contract may contain

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[21]Vasser, S. (2005) Derivatives in Bankruptcy. *The Business Lawyer.* 60 (8). P.1507-1542.
[22]*Supra* note 14. p.1510
[23]The International Swaps and Derivatives Association (ISDA) published a standardized form of agreement for derivative transactions.

a provision for automatic termination. To be more specific, the ISDA Master Agreement upon a party's default ("Defaulting Party"), permits the non-defaulting party to do any of the following: (1) terminate (or close out) and value on a net basis all transactions documented under the ISDA Master Agreement; (2) apply collateral to the net terminated (or closed-out) position upon the bankrupt counterparty's insolvency; (3) withhold, suspend ("Payment Suspension Clause"), or walkaway ("Walkaway Clause") from any payments otherwise due and owing to the bankrupt counterparty under the ISDA Master Agreement; (4) elevate, or flip, its position in payment priority provisions ("Flip Clause") contained in structured finance transactions; or (5) exercise the right of setoff between or among different affiliates of thebankrupt counterparty ("Triangular Setoff Clause").[24]

Under the Master Agreement the bankruptcy of one party falls within the events of default that allow early termination of a contract.

In order to evaluate the impact of termination of derivative transactions we need to bear in mind that parties of these transactions are mostly large financial institutions with a portfolio including thousands of derivative positions[25].

There is large debate on whether the exemption of derivatives from the automatic stay is detrimental for the property of the bankrupt debtor. Some authors (EDWARDS & MORRISON)[26]recognize that is, in fact, accurate toexempt derivatives from the stay but challenge the true reason why they may be exempted. They are convinced that the rationale for untying derivatives from the automatic stay is not the one offered by Congress, which has a lot to do with minimizing systemic risks. These types of risks, they say, are triggered only when the collapsing firm is so large that its unexpected financial distress may cause lack of liquidity in the market[27] or when its counterparties have been very incautious in their dealings with the distressed firm. By contrast, they focus their analysis on the rationale of the stay –which is to avoid dismemberment and to favor reorganization and equal treatment of creditors- and conclude that derivatives

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[24]ISDA Master Agreement 2002.

[25]Lehman Brothers was a party to more than 900.000 derivative transactions when it filed for Chapter 11 protection.

[26]Edwards, F.R. & Morrison, E.R. (2004) Derivatives and the Bankruptcy Code: Why the Special Treatment? *Columbia Law School Working Paper No. 258* [Online]. Available from: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=589261. [Accessed: August 2nd 2016].

[27]See *supra* note 12. This might happen if the firm is a large market player and enters into high volume and numerous derivative transactions.

do need to be treated differently but for an alternative reason. Derivative contracts are fungible and replaceable assets and not firm-specific assets. Their termination or substitution does not affect the value of the firm as a going-concern and therefore allegedly it does not dismember debtor's assets. Other authors (ROE), instead, observed that the exemption of derivatives from the stay (the safe harbors) destroy the shared value of the portfolio, especially when this one is made up in great part of financial contracts, allowing creditors to rip it apart[28]. This second theory seems more convenient, as an abrupt termination of derivative contracts will for sure preserve liquidity on the market but it contrasts with the purposes of the automatic stay, not allowing the debtor to reorganize its business by turning to good use its active positions and therefore taking away assets from other creditors, especially those subject to the automatic stay.[29]

1.4 Fraudulent Transfers

The automatic stay is not the only device that prevents the estate from being torn apart and decrease its value; section 544 of the Bankruptcy Code provides against other actions that might diminish the value of the property. These actions fall within the category of so-called fraudulent transfers. When the bankruptcy trustee avoids an absolute transfer of property that property then becomes property of the estate, and this contributes to increase the value of the property itself.

A transfer includes the creation of a lien, the retention of title as security interest, the foreclosure of a debtor's equity of redemption, a voluntary or involuntary property disposal[30]. The transfer is fraudulent when it is made with the actual intent to hinder, delay or defraud an entity to which the debtor was or became indebted[31]. The most controversial part of this definition is the actual intent, which is hard to investigate. Direct evidence of actual intent is rare, so it has been developed a list of factors called "badges of fraud", which are strong indicia of actual fraudulent intent. Examples of "badges of frauds" are transfers to family and friends, inadequacy of consideration and

[28]Roe, M. & Adams, S.D. (2015) Restructuring Failed Financial Firms in Bankruptcy: Selling Lehman's Derivatives Portfolio.
[29]The topic will be discussed in depth in Chapter 2.
[30]See section 101 (54) Bankruptcy Code.
[31]See section 548 Bankruptcy Code.

secrecy of transfer. We will try to illustrate a typical case of "badges of frauds". Let us pretend that Richard is suing John and John is worried that Richard will manage to obtain a judgment against him and consequently a sheriff levy to seize and sell his car. Richard wants to preserve his car from the levy and enters into contract with his uncle Matt, to whom he sells the car. The car is sold but John continues keeping possession and using the car. When Richard tries to have the sheriff levy on the car John might say that it has been sold to uncle Matt but Richard will still get the car because of the "badges of fraud" indicating John's fraudulent intent.(*Adds)*

1.5 Preferential Transfers

The goal of avoiding fraudulent transfers is common to the one of avoiding preferential transfers.With the avoidance of preferential transfers by a trustee a two-fold purpose is met[32]. First, by avoiding pre-bankruptcy transfers that occur in a short period before bankruptcy, the trustee discourages creditors from running to the courthouse to seek to dismember the debtor. Second, the preference rules make possible the equal distribution among creditors of the debtor. If they have received by means of a pre-bankruptcy transfer a greater payment than others of his class, they are required to surrender so that all may participate equally. A debtor may favor some of his creditors outside bankruptcy but he cannot prefer one to another inside bankruptcy.At this point we need to answer the question: when is a transfer preferential?

Section 547(b)[33] sets out some requirements that must characterize the transfer in order for it to be preferential. First, the transfer was "to or for the benefit of a creditor" and it was made for an antecedent debt; the debtor was insolvent at the time of the transfer; the transfer was made within 90 days before the filing of the bankruptcy petition *or* it was made to an insider between 90 days and 1 year before the filing; the transfer increases the amount that the transferee would receive in a chapter 7 case (liquidation)[34].

The first two requirements are easy to apply. For example, a pledge of stock to secure a new loan is not a preferential transfer, while in order to prove the insolvency it is

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[32]Epstein, D. G. et al. (2010) *Bankruptcy Materials And Cases*. 3rd Ed. U.S.A: West, a Thomson business.
[33]Bankruptcy Code.
[34]See *supra*note 13.

necessary to establish what were the value of assets and amount of debts at the time of the transfer. What makes the scrutiny of the operations difficult is that in order to find a preference every single one of the elements must be satisfied.

1.6 Reorganization

As mentioned before, when a company is no more capable to run the business and pay creditors, and decides to declare its bankruptcy, it might choose to take one of two paths: either liquidation or reorganization. Often individuals and small firms decide to liquidate and therefore sell their assets and distribute the amount gathered among creditors respecting priorities and classes. The completion of liquidation procedures allows individuals to experience the so-called “fresh start”.

While the second goal of bankruptcy law can potentially always be achieved[35], the fresh start is not a solution for businesses that go bankrupt, as they either cease to exist after being liquidated or decide to follow the path of reorganization. In reorganization the firm continues to operate and debts are deferred or reduced. This path is more complicated than simple liquidation and has as its core a reorganization plan.

1.6.1 The Plan

The bankrupt firm and its managers may propose the first plan of reorganization to the court and the court will not listen to other plans put forward by creditors during the first 120 days after the filing. There are, in fact, three “types” of plans: the one proposed by the firm and its managers; the one that creditors might agree upon among themselves; and the one which the judge may “cram down” should any issues on the first two plans arise. Of course the plan, in order to be accepted, needs to comply with the requirements set out in section 1129 of the Bankruptcy Code but must also follow the absolute or strict priority rule. The absolute priority rule requires the plan to be both fair and equitable and not unfairly discriminative. Fairness and equity standards relate to vertical fairness, hence priority among classes; non-discrimination concerns horizontal fairness or non-discrimination among creditors within the same priority.It has been observed that the application of the absolute priority rule is not an easy task for several reasons. Let’s consider a firm that has undergone a period of financial distress, is overwhelmed

[35]We are referring to the goal of treating creditors equally and fairly.

by debts and has as its only way out filing for bankruptcy protection under Chapter 11, in the attempt to reorganize its business. It owes money to different classes of creditors, senior creditors, and general creditors. It might seem straightforward calculating what they are owed and distribute it among them. In point of fact the first issue arises because the distribution of the proceeds does not follow an actual sale but it is based on a hypothetical sale, the plan depends on the imputed value of the firm and valuations, also from unbiased experts, may differ to a certain extent[36]. The priority position of each creditor is also not always certain, especially when it has to be established with respect of real estate or intellectual property, and creditors are owed not only what they lend but also interests and fees if there is enough collateral. Moreover, another cause of uncertainty is the coin with which each creditor is paid. In reorganization, creditors' old stakes in the old firm are exchanged for stakes in the reorganized firm, whose value respects their entitlement under bankruptcy priority rules. The reorganization plan must provide an interest rate compliant with the bankruptcy code rules. Therefore we may conclude that instead of absolute priority, the one that is in place is a system of approximate absolute priority[37].

Notwithstanding this approximation the plan may be accepted by the court, pursuant to section 1129(8), if with respect to each class of claims or interests either the class has accepted the plan or the class is not impaired by the claim.

1.7 Restructuring Support Agreement

Due to the difficulties of making everyone happy with the plan and in order to prevent the risk of non-acceptance of the plan by creditors, a special device may be put into place: the restructuring support agreement, often referred to as "lockup" agreement. This agreement is an out-of-court workout and endorses a bargain between the debtor and each creditor who wants to take part in it[38]; those who have signed it are obliged to vote in favor of the plan. When a company manages to strike a deal with its major creditors it can engage into a form of "prenegotiated" bankruptcy filing and therefore

[36]Baird, G.D. (2016) Bankruptcy's Quiet Revolution. *Chigago Coase-Sandor Institute for law and Economics. Working Paper No. 755.* [Online] Available from:

[37] See *supra* note 22.

[38]See *supra* note 22

incorporate the lockup agreement in the reorganization plan to implement it and bind the holdouts to it.

The complexity of putting forward this type of agreement lies in its relationship with bankruptcy law.

Pursuant to section 1125(g) of the Bankruptcy Code, votes in favor of or against a chapter 11 plan that were obtained before the bankruptcy filing are considered valid if "solicitation" of the vote complies with applicable nonbankruptcy law. By contrast, section 1125(b) provides that postpetition votes in favor of a plan can be solicited only after creditors or shareholders receive a court-approved disclosure document containing "adequate information"[39].

1.8 Conversion to Chapter 7

A debtor who has filed for bankruptcy with the aim to reorganize can decide to convert the bankruptcy proceedings under Chapter 11 into Chapter 7 and hence file for liquidation. Conversion may take place under certain conditions: the debtor must be a debtor in possession, the petition must be voluntary one and if the case was previously converted into a Chapter 11 case it must have been the debtor who required it. The conversion or the dismissal may also occur if the court is convinced that the appointment of a trustee is in the best interest of creditors and the estate[40].

1.9 The Dodd-Frank Act

In 2010 president Barack Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act ("the Dodd-Frank Act" or "the Act") with the promise that "the American people will never be asked again to foot the bill for Wall Street mistakes"[41]. The Act has been enacted by Congress with the objective "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

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[39]The concept of "adequate information" is defined in section 1125(a) of the Bankruptcy Code.
[40]Section 1112 Bankruptcy Code.
[41]http://www.rollingstone.com/politics/news/how-wall-street-killed-financial-reform-20120510

ending bailouts, to protect consumers from abusive financial services practices, and for other purposes."[42]

The Dodd-Frank act consists of sixteen titles. It changes the existingregulatory structure, increasing oversight of specific institutions regarded as atsystemic risk and promoting transparency. The act has twodistinct aims: the first is to limit the risk's exposure of financial companies;the second is to limit damages for investors that the failure of a financial firmcould provoke.

1.9.1 Orderly Liquidation Authority

As far as investment banks and financial companies are concerned, the Dodd-Frank Act establishes an alternative resolution to Chapter 11 in case of financial distress. This alternative tool is the Orderly Liquidation Authority (OLA) and it is only a potential substitute of Chapter 11, as it is put in place only when invoked by financial regulators and approved by the District Court within 24 hours.[43]

OLA is regulated in Title II of the Act and it applies exclusively to financial companies. The Federal Deposit Insurance Corporation (FDIC), an independent agency created by the Congress to maintain stability and confidence in the financial system[44], in this case, plays the major role, and particularly the OLA expandsthe power of the FDIC in bank receivership.When a bank is put under receivership its board of directors lose the decision-making authority and a receiver, who takes custodial and managing responsibilities of the company's assets and guides the liquidation process, replaces it. A financial company for the purpose of the Act is defined in section 201(11) as (A) a company that is incorporated or organized under any provision ofFederal law or the laws of any State; (B) a bank holding company; (C) a non-bank financial company supervised by the Board of Governors of the Federal Reserve; (D) any company engaged in activities that have been defined as financial by the Board of Governors.The commencement of Orderly Liquidation takes place with a Petition to District Court. If the company satisfies the criteria under section 203 the Secretary of the Treasury will

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[42]The Dodd-Frank Wall Street Reform and Consumer Protection Act. Available at: https://www.sec.gov/about/laws/wallstreetreform-cpa.pdf

[43]Lubben, S.J. (2013) OLA After Single Point of Entry: Has Anything Changed? *Seton Hall Public Law Research Paper No.2353035*. Available from: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2353035. [Accessed: August 5th, 2016]

[44]https://www.fdic.gov/about/strategic/strategic/mission.html

notify the FDIC and the financial company that the FDIC will be appointed as a receiver.

In establishing when a financial company should be placed in receivership under Title II, the Secretary of the Treasury applies a two part test. The test falls within section 202's systemic risk determination. First, the Secretary looks at whether the company is in default, or in danger of default. A company is in default when is likely to file for bankruptcy, has incurred debts that will deplete all or most of its capital, has greater debts than assets, or will likely be unable to pay its debts in the normal course of business[45].Second, the Secretary must evaluate the systemic risk involved in the potential default of the financial company.Therefore, the Secretary must consider the effect of default on financial stability, and on creditors, shareholders, and counterparties.The Secretary also considers the likelihood of bankruptcy or private sector alternatives, and what future actions can be taken If these issues are considered, and the FDIC believes it should be appointed as receiver, the FDIC will take control of the assets, obligations, and operations of the company.

Before cataloguing the powers of the FDIC as a receiver, we might want to investigate the purpose of the creation of the OLA as an alternative solution to an already existing system of resolving financial distressed institutions, which is Chapter 11 bankruptcy. The answer was given by Congress in the very same Act in section 204, where it is stated that the purpose of the title on OLA is "to provide the necessary authority to liquidate failing financial companies that pose a significant risk to the financial stability of the United States in a manner that mitigates such risk and minimizes moral hazard"[46] and further specifies that this objective is attained when creditors and shareholders bear the losses of the company but also when the management which put the firm in those conditions in the first place is not kept and its responsibilities are recognized and, if the case, sanctioned. If we hold on to the concept of moral hazard as a belief that whatever misdoing will be forgiven due to the necessity of saving a company rather than punishing it, it seems that the Act intended to narrow moral hazard by imposing some burdens on the misconduct of the management.

As we mentioned before, the FDIC becomes the receiver of the financial company under the OLA and therefore it replaces the board. The powers and duties of the FDIC

[45]Section 203(c)(4) Dodd-Frank Act.
[46]Section 204 Dodd-Frank Act.

are set forth in section 210 of the Act. General powers consist of succeeding to the all rights, titles, powers, assets of the covered financial company and to its stockholder, member, officer and director. Furthermore it gains title to the company's books, records and assets.

The FDIC may exercise all the powers to which the members of the financial companies were entitled, including conduct business and collect obligations owed to the company but it also has some special, or, as defined in section 210(d) additional powers. These powers include liquidating and winding-up affairs of the company, and with respect to failing subsidiary of a covered financial company, to set up a bridge company for the transfer of assets and liabilities.

1.9.2 Single Point of Entry

The bridge company is an interesting and useful creation of the Dodd-Frank Act and helps solve a few issues. Large financial firms are generally structurally complex, the real financial suffering might be a concern of some and not all of the entities of a large firm. The regulators under the Dodd-Frank would have a difficult choice to make when picking the right entities to put into receivership. The decision to pick some of them is called "multiple point of entry" and would present serious challenges for regulators as they would have to make a complex evaluation with little information on the impact of this evaluation on counterparties and other entities of the group not placed in receivership.[47] In order for regulators to circumvent this risk the FDIC has proposed "single point of entry" (SPOE). Under SPOE, the FDIC would not decide ex ante which of a firm's hundreds or thousands of subsidiaries or affiliates to liquidate; it would look only at the parent entity, and seize that one.That entity would be placed in receivership, its assets (subsidiaries) remaining technically outside the process. A "bridge" financial company would continue to perform the same functions as the holding company of the covered financial company, which would then convert to a "NewCo" successor to the failed firm.[48]Independent experts would evaluate the bridge financial company, and upon the FDIC's approval of the value, payments of claims in the receivership would be made through issuance of securities in a securities-through-claims exchange. Equity

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[47]Concentration complexity and capture Jonathan lipton
[48]id

holders of the parent likely would be eliminated, and debt- holders of the corporate parent would become its new shareholders.

The FDIC believes that the SPOE resolution strategy would minimize disruption and instability because the subsidiaries would continue to perform critical operations for the financial system instead of causing disruption by closing.The FDIC also claims that spillover effects to counterparties would be dramatically reduced because the subsidiaries would remain in operation and the bridge financial company would assume any obligations supporting subsidiaries' contracts.

In order to better explain the innovation brought by the SPOE we may make an example. When Lehman Brothers the holding company filed for bankruptcy on September 15 2008, its subsidiaries had to terminate derivatives as the contracts provided that the failure of a holding company triggered an immediate right to terminate the trade. Under the mechanism proposed in the Act the FDIC would keep the holding company—and its worldwide operating subsidiaries—afloat by taking over the holding company, eliminating existing claimants of that company, and selling new equity in the holding company to recapitalize it. The FDIC enforces rules that prohibit termination of a derivative because of the OLA filing of a parent company.Counterparties to most of the financial company's derivative contracts would have no legal right to terminate and net out their contracts. Such action would prevent a disorderly termination of these contracts and a resulting fire sale of assets.It has been actually said (LUBBEN[49])that the SPOE is the result of one lesson learnt from Lehman Brothers, though he recognizes that this mechanism is not flawless. He believes that SPOE is a good start but also holds that it could be more realistic[50] as it focuses on holding companies as the direct source of financial distress but this is not always true. If the operating subsidiaries will have to be recapitalized by the forgiveness of the intercompany debt owed to the parent company managers and regulators should be good enough to predict the right place and amount when consigning the debt, and this is very unlikely. So he suggests that a starting point is to acknowledge that this system would lead to the creation of a post-OLA intercompany debt funded by the parent's own borrowing.

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[49]LUBBEN see*supra* note 29.
[50]LUBBEN, Thoughts on Single Point of Entry
http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2392450

Other commentators (SKEEL[51]) have said that not imposing a time requirement for the FDIC to act was a big mistake as too much discretion on when to take a measure will always result in a dangerous lag. He also criticizes the full protection granted to derivative counterparties in case of default. This protection results in a premature recognition of a SIFI's distress and serves as an incentive to enter into derivative and other short-term transactions, which are risky way of financing as the 2008 financial crisis has taught.

1.9.3 Dealing with SIFIs. The Dodd-Frank Act.

The OLA instroduced by Title II of the Dodd-Frank Act is only to be used as a "last-resort approach" when a bankruptcy might entail adverse consequences on the US financial stability[52]. To that end, significant efforts have been expended to improve the resolvability of SIFIs under the current Bankruptcy Code pursuant to Dodd Frank's Title I Resolution Plan provision. Title I, Section 165(d) of the Dodd-Frank Act requires that some designated SIFIs [53] prepare Resolution Plans—or "living wills"—to demonstrate how the company would be resolved in a rapid and orderly manner under the Bankruptcy Code in the event of the company's financial distress or failure. These "living wills" must be submitted to the FDIC and the Federal Reserve for assessment. In order to clarify the aim of these Plans the FDIC stated that the goal for these Resolution Plans is to identify "each firm's critical operations and core business lines, map out those operations and core business lines to each firm's material legal entities, and identify[ ] the key obstacles to a rapid and orderly resolution in bankruptcy."[54] These plans must include, among other things, a strategicanalysis of the company's plan for a rapid and orderly resolution in the eventof material financial distress or failure, a description of the company's corporategovernance structure for creating the resolution plan,a detailed outlineof the company's organizational structure, an inventory of the company'smanagement information systems, and a map of the interconnections

[51]http://poseidon01.ssrn.com/delivery.php?ID=079089104119084108110110087120119002008008057008067026100071099124083028097086018092032006026040009032042068087120029111013088108018031000036117008087121116108069063044094113001017122016097099115082092101024075122069112095113112122024119025079093081&EXT=pdf
[52] See section 203(b)(2) Dodd-Frank Act
[53] Among which bank holding companies with more than $50 billion in total consolidated assets.
[54]Hearing Before the Subcomm. on Oversight & Investigations of the H. Comm. on Fin. Servs. 113th Cong. 55 (2013)

andinterdependencies among the company and its various entities. The "sanction" inflicted to the Institution in case of failure to submit a credible Plan is set out in section 165(5)(A) in which is established that "the Board of Governors and the Corporation may jointly impose more stringent capital, leverage, or liquidity requirements, or restrictions on the growth, activities, or operations of the company, or any subsidiary thereof, until such time as the company resubmits a plan that remedies the deficiencies". These provisions of the Dodd-Frank Act have the aim to facilitate an orderly liquidation in case of default of a SIFI. However a few issues have been registered. So far, 535 companies have filed at least one round of Resolution Plans under section 165(d) Resolution Plans and the FDIC have published portions of those Plans on its website[55]. Nevertheless, Moreover, in August 2014, the FDIC determined that the section
165(d) Resolution Plans submitted by the first wave filers were "not credible and do not facilitate an orderly resolution under the U.S. Bankruptcy Code."[56] The FDIC cited problems in the firms' legal structures, derivative contracts, and plans to ensure the continuation of critical services throughout the resolution process. Even though the Federal Reserve did not make a similar finding on the lack of credibility, it agreed on the shortcomings of the Resolution Plan sas outlined by the FDIC. Perhaps, it has been said, that many of the problems arising from the completion of the Resolution Plan have a lot to do with the lack of creditor participation.
In Chapter 11 Bankruptcy, the Reorganization Plan, which is a prerogative of the debtor for 120 days after the filing, needs to be respectful of the different classes of creditors and is followed by negotiation with creditors on the terms of the plan, which have to be accepted by each class of creditors[57] . The importance originally given by the Code to the acceptance of the Plan by creditors underlines the significance of their consent for an effectively working Plan.

Being privy of the attempt undertaken by the Dodd-Frank to fill the gaps of the Bankruptcy Code, we might try to make a comparison between the newly introduced OLA and the Bankruptcy Code in terms of protection offered to the debtor and its creditors. As we have stressed above, on the one hand, bankruptcy proceedings under

[55] https://www.fdic.gov/regulations/reform/resplans/ [Accessed: September 5th, 2016]
[56] comparison dodd-frank / bankruptcy code in resolution of SIFIs
[57] section 1129(8) Benkruptcy Code.

the Code are mindful of the equal treatment and absolute priority rules, thus aim to ensure that all the creditors and stakeholders as a group may benefit from the highest value of the "common pool". The OLA, on the other hand, is less protective of pre-insolvency property rights and simply intend to make "the best interest of creditors"[58]. Moreover in bankruptcy under the Code, creditors may know accurately how they will be treated in the proceedings, whereas resolutions under the OLA encounter the broad discretion of the FDIC. It is also true that bankruptcy offers no flexibility, as all operations need the approval of a court and failure to act promptly may be disastrous for the financial system. The lack of flexibility also emerges from the fact that bankruptcy does not provide for the setting up of a bridge entity for the transfer of operations without approval of creditors or a court.
By contrast, the FDIC may take a broad range of actions without obtaining consent from counterparties, creditors or court. In fact, when the FDCI is appointed to resolve a bank, it may act as either a conservator or receiver of the bank. As a receiver the FDCI is in power to take control of a bank for a limited time and rehabilitate it, reorganize it, recapitalize it and return it to the private sector. There is no necessity to liquidate the institution. Furthermore, under a conservatorship creditors are stayed from exercising close-out rights based merely on the insolvency of the bank. Under a receivership the FDIC has instead the task to liquidate the failed institution.[59] The OLA has been created to wind down SIFIs in a way that allegedly does not create the systemic risk of a bankruptcy like Lehman's Chapter 11 case.

When a Systemically Important Financial Institution (SIFI) suffers from huge financial distress the main two measures that might be undertaken under current legislation are taxpayer funded bailouts or disorderly liquidation. The first occurs when there is an injection of public money into the insolvent firm in the form of equity capital or unsecured debt in order to dampen the losses that creditors and shareholders would have to bear in a liquidation or reorganization. Hence in reality, not the firm but its creditors, managers and employees are bailed out. This solution may seem reasonable to some extent but perhaps a major issue in this case would be moral hazard. If a big financial institution is considered too big to fail and therefore is aware that whatever high the cliff

[58] Guynn, R.D. (2012) Are bailouts inevitable? *Yale Journal On Regulation* 29(1)
[59]Guynn. See *supra* note 31.

from where she jumps she will land on a two-ply cushion, she will not refrain from taking risks and engaging in operations that can lead to default.

The alternative to a taxpayer bailout is a "disorderly liquidation", meaning by that a liquidation which destroys the value of financial assets of the firm or a reorganization that is hauled for so long that by the time it is approved the firm has lost most of its value. Since the lesser is the value of the firm, the more are the losses borne by creditors and shareholders, sometimes this second solution to the financial distress does not prove to be the best one.

Sheila Bair, former Chairman of FDIC, has once said that whenever governments had chosen bailouts it was not because they wanted to offer bailouts but they looked in the abyss and chose bailout as the lesser of two evils.[60] Both fire-sale liquidation and taxpayer-funded bailouts involve social costs but a bailout is necessary when the social costs related to it are less than those of liquidating a firm in a disorderly manner. In fact sometimes, for the purpose of preserving the gross going-concern of a firm it is less costly to recapitalize it than to sell it in scraps.

1.10 Chapter 14

In August 2009 The Hoover Institution, a group of experts from various institutions founded the "Resolution Project" with the scope to find a solution to the exploding collapse of financial institutions[61]. The Project identified several objectives that the law of resolution for insolvent financial firms should attain. One objective is to set up a system which allows creditors to seize and realize on the assets of the firm collectively and in an orderly manner, an efficient procedure to maximize recoveries and reducing losses.

Another objective, which is almost universally recognized as of major importance, is to retain the "going-concern-value" of parts of the business that can still be operated through a reorganization. As we have stressed before a firm is generally more valuable considered in its entirety than torn into pieces, and this is especially true for financial

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[60]Guynn. See *supra* note 31.

[61]Jackson, T.H. et al. (2011) Resolution of Failed Financial Institutions: Orderly Liquidation Authority and a New Chapter 14. *Studies by the Resolution Project at Standford University's Hoover Institution Working Group on Economic Policy.* Available from: https://www.federalreserve.gov/SECRS/2011/June/20110620/OP-1418/OP-1418_061511_81311_544434921739_1.pdf.

firms, whose value depends mostly on the organizations, skills and knowledge of its personnel and their relationships to clients, rather than in their real estate and machinery. A third goal, which applies in case of Systemically Important Financial Institutions is to avoid a breakdown of the entire financial system.

The Project envisions a Chapter 14 of the Bankruptcy Code which deals with financial companies and their subsidiaries with more than $100 billion in consolidated assets. Uncertanties need to be minimized, so counterparties will know what procedure shall apply in case of distress.

Under chapter 14 cases may be initiated on the grounds of “balance sheet” insolvency, which takes place when assets are less than liabilities or the capital is small.

Since judges who dealt with bankruptcy had to develop the skills required to handling complicated cases on the field and this did not seem to be efficient, the Resolution Project puts forward the institution of specialized sections of district court judges with special expertise to oversee these cases.

As we know, under Bankruptcy Code proceedings, management (as the "debtor-in-possession" or "DIP") remains in control of the business, and has an exclusive period (120 days) in which to file a plan of reorganization. Upon creditor petition, the bankruptcy court may turn control over to a "trustee in bankruptcy." Under Chapter 14, the financial company's primary federal regulator could initiate the proceeding, and could require having the FDIC appointed as a trustee. FDIC could choose whether to pursue reorganization to maximize the business's value for benefit of creditors, rather than being forced to liquidate it. In addition, Chapter 14 would cut off the period in which only management could propose a plan of reorganization; both the FDIC and a creditor's committee would be given concurrent rights to file such a plan[62].

Bankruptcy rules of absolute priority, avoiding powers, transfers and preferences will apply; dispositions of cash and of assets outside the ordinary course of business require creditor notice and opportunity for hearing, particularly on the value being received. Plans of reorganization are subject to approval votes. Furthermore the Project imagines provisions that impede the 363 sales to act in fact as a sub rosa plan to avoid the votes

[62] id

of dissenting creditors[63].

Lastly, it is significant to recall how qualified financial contracts (QFCs) are treated according to Chapter 14.

We have observed that the exemption from the automatic stay of these contracts might be detrimental for the overall value of the distressed firm's assets and could end up to drain liquidity in a market while trying to increase it in another market. Chapter 14 makes a distinction in the treatment of QFCs. Repo's would be treated as secured loans, and the counterparty given the right to immediately sell the collateral *if* highly-marketable securities. This would preserve the use of repo's as nearly risk-free short term financing, but only under conditions where the sale of collateral would not have drastic market price effects. All other swaps and derivatives with a counterparty would be subject to a three day stay, giving the debtor a window to assume (for example, if 'in the money') or reject them all (or transfer them in bulk to a new counterparty), and also to some preference limits[64].

The idea for a new Chapter 14, which defines the financial institutions to which it is applied, is very innovative and interesting but its functioning has been questioned by other experts. LUBBEN, for example,believes that "the Chapter 14 proposal throws away most of the benefits of using the existing bankruptcy system by calling for cases to be heard by Federal District Court judges" because, he thinks, that Chapter 11 works well especially for the experience of bankruptcy judges, particularly in New York City and Delaware.

He also does not approve the financing mechanism set forth by Chapter 14, which he calls a "ridiculous financing mechanism"[65]. If the purpose is to avoid the interference of government in the process it seems unlikely that the DIP financing will work. Since the funding would need to be massive, it is unthinkable not to resort to the government and therefore to call for its intrusion[66].

Lubben further criticizes the penalty inflicted to the provider of DIP financing if this financing is used to "overpay" creditors.If a counterparty received a 50 percent upfront

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[63]Jackson, T.H. et al. See *supra* note 34.

[64]id

[65]Lubben, S. J. (2013) http://dealbook.nytimes.com/2013/04/10/whats-wrong-with-the-chapter-14-proposal/?_r=1

[66]Lubben, S. J. (2012) Resolution, Orderly and Otherwise: B of A in OLA. *University of Cincinnati Law R*eview. http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2037915

recovery thanks to the debtor-in-possession financing, and unsecured creditors later received only 35 percent in the Chapter 14 case, the proposal would subordinate the debtor-in-possession lenders' claim by that extra 15 percent.. He holds that this system provides the wrong incentives on the failure of a big financial institution because it runs afoul with the stabilization of the debtor's business that the DIP financing aims to attain. As Lubben puts it "if the lender gets penalized for providing too much stability, there is every incentive to be stingy with the debtor-in-possession financing"[67]

1.11 Resolving materially distressed SIFIs

After the material crises of numerous Sistematically Important Financial Institutions a lot has been tried to do in order to avoid the collapse of the whole financial system. No one definitive cause has been pinpointed as the cause of the 2008 financial crisis; rather, multiple theories have abounded. The theory that ultimately
influenced the regulatory reform enacted in the wake of the crisis, however, is grounded in the notion that there existed a pervasive failure of market discipline among all players in the financial system. This theory
points in large part to the government's historical use of bailouts as perpetuating a market assumption that certain financial institutions were "too big to fail".
Bear Stearnswas saved from failure by an acquisition by JPMorgan Chase & Co. ("JPMorgan"),facilitated by a $29 billion loan by the Federal ReserveBank of New York. The Federal National Mortgage Association and theFederal Home Loan Mortgage Corporation were placed into government controlledconservatorship and guaranteed access to capital investments of upto $100 billion each from the U.S. Treasury. American International Group,Inc. was provided with an $85 billion line of secured credit from the FederalReserve, which eventually rose to $182.3 billion. Thiswas just the beginning of the bailouts. Lehman Brothers,however, was denied access to public funds in the form of either acquisitionassistance or capital investments. As a result, it was forced to file forchapter 11 bankruptcy protection under the Bankruptcy Code.The bankruptcy of Lehman caused systemic problems throughout the economy and amplification of the crisis is said to have been caused by two aspectsof Lehman's failure: (1) Lehman's interconnectedness within the market,which caused the

[67]Lubben, S. J. (2013) see *supra* note 38.

unwinding of its business positions to bring down otherswith it, creating substantial direct collateral damage; and (2) regulators' refusalto uphold the TBTF subsidy and issue a bailout to save Lehman fromfailure, which caused panic and contagion in the market, creating substantialindirect collateral damage. Although the extent to which Lehman's bankruptcyactually resulted in direct collateral damage has been questioned, thecontagion effects derived from the market uncertainty it created are undeniable.All the choices made by regulators throughout the financial crisis were hardly criticized.
On the one hand bailouts were criticized as taking money frominnocent taxpayers,for fueling moral hazard,and for generally involvinggovernment in business activity. On the other hand, the decision toallow Lehman to seek bankruptcy protection was critiqued for disruptingboth domestic and international markets and for destroying large amounts ofvalue unnecessarily.The industry was condemned for its overall lack of precrisisoversight, in particular its inability to prevent these failures in the firstplace. This condemnation culminated in the partially examined Dodd-Frank Act and in other solution envisaged by many authors (such as the provision for a new Chapter 14).

We have acknowledged that Chapter 11 of the Bankruptcy Code was not originally designed for dealing with Sistemically Important Financial Institutions and we assumed that this is especially due to the fact that the Code exempts from the automatic stay, which is a basic rule of corporate reorganization in bankruptcy, derivatives and in general financial contracts. Since SIFIs rely on financial contracts as a significant part of their portfolio the abrupt termination that the safe harbor provisions under section 362(b) of the Code allow have the ability to dismember an already financially distressed firm and influence negatively the composition of the assets that will be deployed between creditors after the approval of the Reorganization Plan under section 1129.
As we have tried to hold, the rules set forth by the Bankruptcy Code, such as the *absolute priority rule, fraudulent transfers, preferential transfers,* are very protective of the interests of creditors, and, as stressed, they aim to make the interests of all creditors, or of "creditors as a whole".
Therefore the Bankruptcy Code is still the best solution to address the crisis of a SIFI, though with a few adjustments tailored on the systemic risk that these institutions might trigger.

The main adjustment necessary would be to place a “stay” of a short amount of time on financial contracts, in order to allow the financial institutionto net out its active (or in-the money) positions on these contracts and include in the Reorganization Plan these added assets.
The provision in the current Title 11, Chapter 11 of the Bankruptcy Code might be written as follows:

Treatment of Qualified Financial Contracts
“Notwithstanding sections 362(b)(6) and 362(b)(7) a petition filed by Covered Financial Institutions, operates a stay of 48 hours after the commencement of the case, applicable to all entities, of the exercise of contractual rights-

(1) to net out any termination value or payment amount under a qualified financial contract of the debtor.

Definitions:
Covered Financial Institutions
“are those referred to as “Systemically Important Financial Institutions”, financial institutions whose distress or disorderly failure, because of their size, complexity and systemic interconnectedness, would cause significant disruption to the wider financial system and economic activity.

CHAPTER 2

2. History of Lehman Brothers

The foundation of the fourth-largest investment bank in the United States dates back to 1850. During that year Henry Lehman, who emigrated from Germany and settled in Alabama, was joined in the business by his brothers Emanuel and Mayer and they named the newly formed partnership Lehman Brothers.

Soon after its founding Lehman Brothers evolved from a general merchandising business to a commodities broker that bought and sold cotton for the planters in Alabama. In 1858 a New York office was created boosting the presence of the firm in the commodities trading business. In 1870 the firm established the New York Cotton Exchange, the first commodities futures trading venture. At this time, they also helped in the formation of the Coffee Exchange and the Petroleum Exchange, as well as financing many railroads across the United States. In 1887 Lehman Brothers joined the New York Stock Exchange transforming itself in a merchant banking firm and offering sizeable securities trading and financial advisory services. The ability of identifiyng growth industries led the firm to massive achievements over decades. In 1906 Emanuel's son Philip took over the firm and created a partnership with Goldman, Sachs & Co to bring to market several corporations, the first of which was the General Cigar Co. Lehman Brothers, during the following two decades, underwrote almost one hundred new issues, many of them in conjuction with Goldman, Sachs.

Robert Lehman, the son of Philip Lehman, became a partner in the firm during the 1920s and moved into the leadership role after his father's retirement. Robert Lehman was the firm's senior partner, a position he held from 1925 until his death in 1969. Under his leadership, Lehman Brothers cultivated and maintained its interest in retail merchandising and became particularly noted for financing and consolidating firms from the air transportation, entertainment and communication industries. In 1929 the firm formed Lehman Corporation, its own investment company, which traded its stocks and bonds on the New York Stock Exchange and proved one of Lehman Brothers' most successful creations.[68]

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[68]Oasis Harvard Library.(2007) *Lehman Brothers. Lehman Brothers Records, 1868-2007 (inclusive): A Finding Aid.* [Online] Available

The break in the tradition by which only family members could join the firm made possible in 1973 the coming in of Peter G. Peterson, president and CEO of Bell and Howell Corporation, who answered the call to lead the company in order to rescue it from the economic difficulties it was facing.
Having Peterson as a leader the firm merged in 1977 with Kuhn Loeb & Co. and gave rise to Lehman Brothers, Kuhn, Loeb Inc., the fourth-largest investment bank of the United States, behind Salomon Brothers, Goldman Sachs and First Boston.
In 1984, Lehman Brothers was acquired by American Express and merged with its retail brokerage Shearson to form Shearson Lehman Brothers. American Express began to divest its financial services by business lines in 1992 and eventually, one year later, the firm was spun off and once again became known solely as Lehman Brothers.[69]
Unfortunately, the epilogue of Lehman's history is not as successful as its origination and evolution. The firm could not survive the subprime mortgage crisis in 2008 and seeking protectionfiled for Chapter 11 bankruptcy.

2.1 Operations that led to default

A lot has been said about the causes of the default of Lehman Brothers and even though the topic is still to a certain extent controversial it seems that the reasons of the fall are to be identified with the involvement of the investment bank in the subprime mortgage market and the general lack of regulation when playing in the field of risky operations.
The collapse of the U.S subprime housing market brought the company to its knees. Between 2003 and 2004, in the attempt to benefit from the U.S. housing boom, Lehman acquired five mortgage lenders including subprime and Alt-A lenders, confident that the bubble would not burst anytime soon. Unexpected record revenues ensued from these acquisitions making Lehman yearn for more. In fact, Lehman made its profits grow through the securitization of these loans, overlooking the fact that they belonged to the subprime market.

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from:http://oasis.lib.harvard.edu/oasis/deliver/deepLink?_collection=oasis&uniqueId=bak00042http://oasis.lib.harvard.edu/oasis/deliver/deepLink?_collection=oasis&uniqueId=bak00042. [Accessed: 21st June 2016].
[69] Harvard Business School Library. *History of Lehman Brothers*. [Online] Available from: http://www.library.hbs.edu/hc/lehman/history.html. [Accessed: 23rd June 2016].

2.2 Securitizing subprime mortgages

In a traditional banking system loans are granted through a standard procedure. Lenders estimate the financial reliability (credit rating) of the borrower, they extend the loan making sure that the money is used for the declared purpose and then take the money back, increased with interests.In the subprime mortgage market mortgages are granted to people who do not offer proof of income or have questionable credit histories. Of course subprime borrowing comes with a higher interest rate in order to balance out the high risk of default.[70] The financial instrument that enabled massive profits for investment banks is a Derivative, to be specific the CDO, collateralized debt obligation.[71]The mortgage houses which began to sprung up all over the country would lend and provide capital for house purchases, capital that they had to borrow themselves in the first place from proper banks. They would package thousands of mortgages together and sell them to Lehman, explaining that the money had been loaned at an adjustable rate that would be adjusted upwards within a couple or three years and that it was fully collateralized by the property deeds.

Lehman only had to buy the loans and create a bond by securitizing the debt. The investment vehicle resulting from the process could then be sold to investors. Investors from everywhere were then“owners" of the houses bought via subprime mortgage and all they had to do for the tenure of this position was collecting interest coupons from their investments.[72]

As long as house prices rose the bubble grew and there was no chance of default because loans could be refinanced.

2.3 Bubbles burst, eventually

Signals of a crack occurred by the first quarter of 2007, when defaults on subprime mortgages rose to a 7 year high.[73] On August 22, 2007 Lehman Brothers amputated its suprime lender BNC Mortgage as delinquencies in subprime loans soared[74].

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[70]Stiglitz, J. (2010) *Frefall. America, Free Markets, And The Sinking Of The World's Economy.* United States: W.W. Norton & Company

[71]see McDonald, L., Robinson, P. (2009) *A Colossal Failure of Common Sense. The Inside Story Of The Collapse Of Lehman Brothers.*United States: Three Rivers Press. As pointed out by the authors Lehman's biggest derivative positions were in RMBS, residential mortgage-backed securities.

[72]See *supra* note 4.

[73] For more information visit: http://www.investopedia.com/articles/economics/09/lehman-brothers-collapse.asp

On March 17, 2008, following the near-collapse of Bear Stearns - the second-largest underwriter of mortgage-backed securities - Lehman shares fell as much as 48% due to the general concern on its possible failure. Confidence in the company returned to some extent in April, after it raised $4 billion through an issue of preferred stock that was convertible into Lehman shares. However, as we have seen in the movies, it did not take long for hedge funds managers to realize that Lehman's portfolio was not in reality as valuable as they wanted it to seem, and this questioning of quality made the stock decline once more.[75]

2.3.1 Rating Agencies' responsibility

One could reasonably wonder how it is possible that a company operating in the banking field and trading assets on regulated markets increases its profits even though the securities it is trading are sorts of empty boxed passed from an investor to another but in reality not backed by any liquidity. The answer to the dilemma is to be found in the services of the rating agencies, especially the so-called "Big Three", i.e. Standard and Poor's, Moody's Investor Service and Fitch Ratings, that dominate the credit rating market for mortgage-backed securities[76].Certain rating agencies, including the Big Three, are recognized by the Government as NRSROs (National Recognized Statistical Rating Organizations). Due to this privileged recognition they operate as an oligopoly (REISS J.R.)[77] and the lack of rating from one of them equals to a "*death sentence for a residential mortgage-backed securities (RMBS) offering*". During the period when the housing bubble was inflating and new financial products were being generated a major role was played by rating agencies. As a matter of fact, the agencies' services went far beyond rating the CDOs for risk; it emerged that they helped combining the CDOs, putting in each of them a share of good-quality homeowners who were expected to pay

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[74]Kulikowski, L. (2007) Lehman Brothers Amputates Mortgage Arms. *The Street.* [Online] 22nd August. Available from: https://www.thestreet.com/story/10375812/1/lehman-brothers-amputates-mortgage-arm.html [Accessed 23rd June 2016]

[75] Different movies were made on the topic, the latest *The Big Short* (2015) Film. Directed by Adam McKay. [DVD]. U.S.A: Regency Enterprises & Plan B Entertainment.

[76]REISS, J.R. (2009) Rating Agencies. Facilitators of Predatory Lending in the Subprime Market. In Kolb, R. W. (ed.) *Lessons From The Financial Crisis. Causes, Consequences, and Our Economic Future.* Hoboken, New Jersey: John Wiley & Sons, Inc.

[77]see *supra* note 9.

on time every month and groups of borrowers with lower credit scores, so as to lessen the risk of giving out totally unsafe products.

The riskiness of investing in these securities lies in the likelihood that the debt issuer will fail to make timely interest payments on the debt.

Ratings of financial products are usually characterized by a letter grade, the highest and safest being AAA, with lower grades moving to double and then single letters (AA or A) and down the alphabet from there.

Due to the complexity of finance and the enshrinement of their status in the Security and Exchange Commission (SEC) regulation, the ratings handed out by these agencies were supposed to be what investors could most of all rely on.

In 2008, when the financial crisis spread out globally, the Big Three were accused of misrepresenting the risks associated with these types of securities, and what is worse is that they were gaining profits from these operations.

It is straightforward to understand the role of this misreprentation in the bankruptcy of Lehman Brothers. If toxic assets had not been rated triple A perhaps many investors would not have bought any of these high-interest yielding products and the cycle, though already triggered, would have not kept going on.

2.4 Declaration of Bankruptcy

On September 15, 2008 Lehman Brothers declares its bankruptcy. The bank's website reveals concisely " *Lehman Brothers Inc. has filed for bankruptcy protection in the U.S."*[78]. The bank is admitted to Chapter 11, the chapter of the United States Code which regulates reorganization,as it accounts debts for $613 billion. A controversial issue on Lehman's filing for bankruptcy are the circumstances in which the firm laid when it declared its demise. Before the crucial day negotiations were going on with both Barclays and Bank of America in order to save the good assets of the bank through an acquisition but the acquirers changed their plans when it was made clear that there would have been no bail out by the government. [79]

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[78] For more information see: http://www.traderpedia.it/wiki/index.php/Lehman_Brothers

[79] It will be further discussed the possibility of a bail out.

Admission to "reorganization" bankrupcy may occur, according to section 301 of title 11 U.S. Code[80] , as a result of either a voluntary filing or a petition of creditors meeting certain requirements (section 302 title 11, U.S. Code). The former was the case of Lehman Brothers.In his Affidavit, Ian T. Lowitt, Chief Financial Officer of Lehman Brothers, states that the bank "*filed this Chapter 11 so that it could preserve its assets and maximize value for the benefit of all stakeholders.*"[81]

As a part of the process, the bank had to hand in to the Court the reorganization plan in which were indicated the classes of claims and interests and the measures which it intended to take for the implementation of the plan.

2.5 A decreasing portfolio value. What was done wrongly?

The attentive analysis of Lehman's reorganization plan allows to detect flaws in the way bankruptcy under Chapter 11 was dealt with. It clearly emerges that as much as $75 billion value of the firm was distroyed by the filing of bankruptcy.[82]The reason of this may be found in baseline bankruptcy rules, especially those known as safe harbors (ROE M.). In the view that the firm as a whole may be worth more than the sum of its parts, creditors are barred from collecting from the bankrupt debtor, other than trough a plan of reorganization or authorized by the court.[83]All creditors are subject to this rule except for safe-harbored creditors. This class of creditors is made up of counterparties holding financial contracts. It comes straightforward to wonder what justifies this special treatment.[84] Many have said that the justification for early termination is the systemic risk, as the ability to terminate financial contracts when insolvency occurs "enhances market stability" but this may not in any ways compensate the flipside of the portfolio value destruction.

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[80]Chapter 11 U.S.A Code. Available at: https://www.law.cornell.edu/uscode/text/11/301

[81]see: http://www.wsj.com/public/resources/documents/lehmannarrative20080916.pdf

[82] McCracken, J. (2008) Lehman's Chaotic Bakruptcy Filing Destroying Billions In Value. *The Wall Street Journal* [Online] 29 December. Available from: http://www.wsj.com/articles/SB123050916770038267 [Accessed: 23rd June 2016].

[83]Roe, M., Adams, S. (2014). Restructuring Failed Financial Firms In Bankruptcy: Learning From Lehman. *The Harvard John M. Olin Discussion Paper Series.* [Online] Discussion Paper n.796. Available from: http://www.law.harvard.edu/programs/olin_center/papers/796_Roe.php. [Accessed: 10 July 2016].

[84]Lubben, S. (2015) Lehman's derivative portfolio. Available from: http://ssrn.com/abstract=2698234. [Accessed: 10 July 2016].

2.6 How value can be destructed

When Lehman Brothers filed for bankruptcy, the U.S. estate reported that it was a counterparty to 930,000 derivatives transactions[85]. In a transaction there are two or more parties exchanging goods or services; one party holds simultaneously an active and passive position. Starting from this very basic definition it seems easy to understand that the safe harbors rules which exempted derivative contracts from the "automatic stay"[86] though helped counterparties to rush out also cut abruptly Lehman's active positions. The day before the filing Lehman was owed money from its counterparties on its open derivative positions. But after that, counterparties filed claims for a total of $51 billion. Approximately 80 percent of Lehman's derivatives were terminated within five weeks after the declaration of bankruptcy, and this decreased the total value that could have been distributed among all creditors in the bankruptcy proceedings.

It has been noted that portfolio deconstruction also derived from close-outs beneficial to the counterparties (ROE M.), this can be considered "transferred value" rather than loss of value, being the value transferred from the failed firm to the counterparties. But costs of transaction for these terminations are never recovered, so value is once and for all burnt!

Harvey Miller, Lehman's lead counsel, said that the fallout from Lehman bankruptcy could have been avoided if regulators have stepped in "not necessarily to save Lehman but, perhaps, to head off the meltdown that followed"[87]

2.7 The bailout that never was

When thechair of the Fed Ben Bernanke, who was in charge to take measures over the Lehman's situation, was asked why they had let the bank sink he answered " in the case of Lehman there was just a huge $40 billion, $50 billion hole that we had no way to fill and no money, no authorization, no way to do it, so we had to let it fail. We had no

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[85] Summe, K. (2011) An Examination of Lehman Brothers' Derivatives Portfolio Post-Bankruptcy and Whether Dodd-Frank Would Have Made Any Difference. Available from: http://www.hoover.org/sites/default/files/kimberly-summe-dodd-frank-20110421.pdf [Accessed: 10 July 2016].

[86]Automatic stay , under Chapter 11 Bankruptcy Code preserves going-concern value by preventing creditors from picking apart the debtor one asset at a time.

[87] See: http://www.nytimes.com/2008/12/14/business/14miller.html?_r=0

choice."[88]To evaluate whether, as Bernanke said, there was no room for government action, we need to examine all the instruments that the Fed had at the time of Leman Brothers collapse. As a response to the financial crisis, on October 3, 2008 the United States government approved TARP (Troubled Assets Relief Program), which enabled the Treasury to buy toxic assets for up to $700 billion[89] from financial institutions in order to promote financial stability. Unfortunately the program came out a bit late, as at that time Lehman had already gone bankrupt. So indeed TARP could not have been invoked to save it. If we argue that Lehman was insolvent, then the Fed may not have had authorization to save it, as Section 13.3, let.B (ii)[90] imposes the Federal Reserve to adopt measures in order to prohibit borrowing from insolvent corporations. But a group of Fed's officials, whose names were not disclosed to respect Fed's unofficial vow of silence, found out in their analyses that perhaps Lehman had enough solid assets to back a loan from the Fed[91], and in this case, pursuant to the former section 13.3 of the Fed Act, the Fed in unusual and exigent circumstances could lend to any institution, as long as the loan was "secured to the satisfaction of the Federal Reserve Bank."[92]

In order to discuss the opportunity of a bailout we may consider the views of some authors who studied the risks correlated to the decision whether to save a financial institution or not.It has been suggested (AYOTTE, SKEEL)[93] that this decision always carries two types of risks: the dissipation of value of firm's assets (*firm-specific risks*), and the spillover effects of bankruptcy, which consist of the loss of confidence in the market (*systemic risk*).The authors are of the opinion that bankruptcy under Chapter 11 does not exacerbate firm-specific risks, rather it is a good solution for the firm itself for different reasons. First off, they say that some acquisitions are facilitated by the law inside bankruptcy, whereas their process would not be very smooth outside bankruptcy. The example taken to support this view is the case of Barclays, which was willing to

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[88]see: Grading Ben Bernanke's time at the Fed, https://www.youtube.com/watch?v=cUCMsR3GvkY&feature=youtu.be&t=1m52s

[89]The amount was reduced to $475 billion by the Dodd-Frank Act

[90]Fed Act http://www.federalreserve.gov/aboutthefed/section13.htm

[91]Stewart, J., Eavis, P. (2014) Revisiting the Lehman Brothers Bailout That Never Was.*The New York Times.*[Online]29 September. Available at: http://www.nytimes.com/2014/09/30/business/revisiting-the-lehman-brothers-bailout-that-never-was.html?_r=0 . [Accessed: 10 July 2016].

[92]see *supra* note 24

[93]Ayotte, K. & Skill, D. (2010) Bankruptcy or Bailouts? *The Journal of Corporation Law.* 35 (3). p.469-498.

purchase the most valid assets of Lehman only after the filing[94]; secondly they challenge the opinion according to which the sale of assets is inefficient and costly, holding that the time pressure makes buyer materialize and take decisions more quickly.

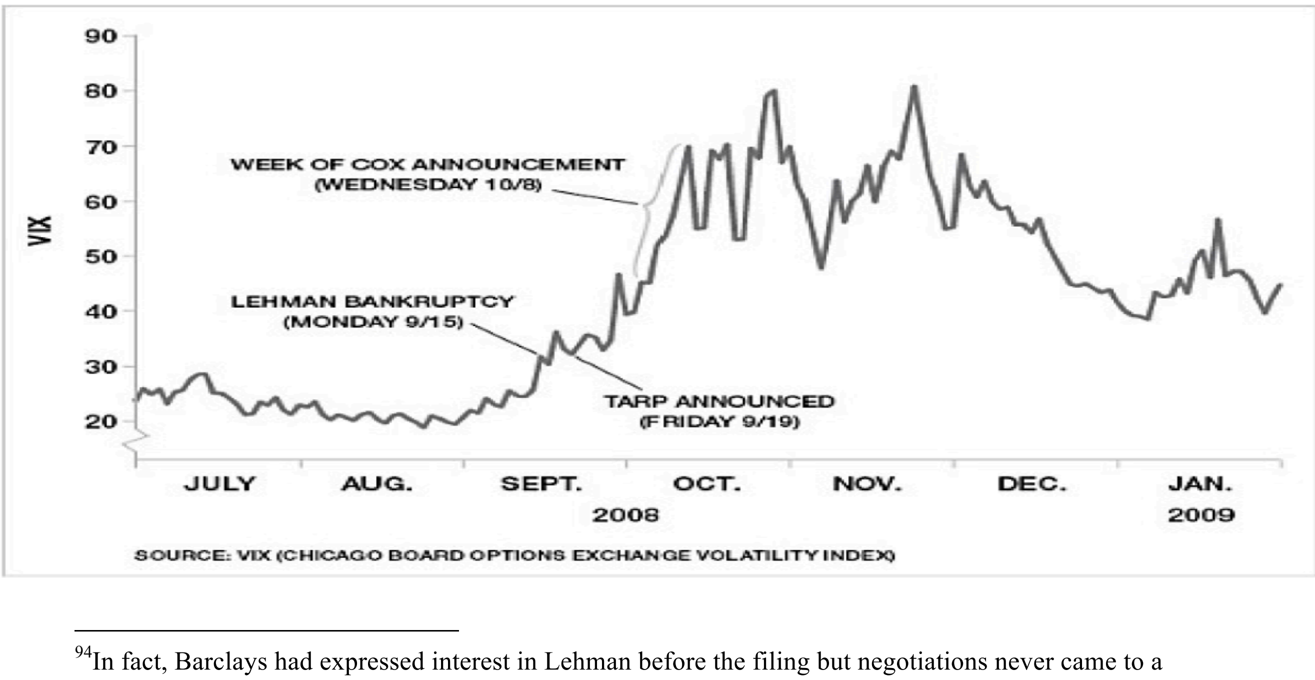
As far as the systemic risk is concerned, AYOTTE & SKEEL believe that this is a consequence of the lack of confidence in the market but it is not necessarily triggered by bankruptcy, as “It is entirely possible, for instance, that Lehman’s bankruptcy had severe effects on the financial system simply because people believed that it would”[95]

We might be great supporters of the mantra “Things will happen if you believe they will” but as a matter of fact, when a large corporation invokes Chapter 11 protection, systemic effects are tangible.

The first consequence we may examine is the change in VIX. The VIX (Chigago Board Options Exchange Volatility Index) measures the expected volatility in the market in a 30-days range[96] and it is usually referred to as the “investor fear gauge”.

In the graph below we may observe how the VIX changed when Lehman filed forbankruptcy.[97]

FIGURE 6-5: VIX Following the Lehman Brothers Bankruptcy



[94]In fact, Barclays had expressed interest in Lehman before the filing but negotiations never came to a conclusion before Lehman filed for Chapter 11 protection. See *supra* note 26.

[95]See *supra* note 26.

[96]For further information see: http://www.investopedia.com/terms/v/vix.asp?ad=dirN&qo=serpSearchTopBox&qsrc=1&o=40186

[97]Conard, E. (2012) *Unintended Consequences. Why everything you’ve been told about the economy is wrong.* U.S.A: Portfolio/Penguin

Following the events of September 15 the VIX spiked, and decreased only some days later, when TARP was announced to restore trust in investors. The sharp increase in the volatility indicates that the systemic risk is high and financial stability is at stake when a large financial institution, interconnected with others and preminent in the market is left to fail.

2.7.1 Too Big To Fail

Systemic risk is tightly connected to the "Too Big To Fail" concept. This intriguing expression has, in reality, a very unpoetic meaning. An institution is considered Too Big To Fail when the effects of its collapse are catastrophic, not only for the institution itself but at a macroeconomic level.

Levitine (2011) argues that when a firm is Too Big To Fail, three major consequences may occur[98]. First, there is a domino effect. The domino effect occurs when the failure of one firm leads to the failure of other firms which, as counterparties, relied on the failed firm's payments. Lehman Brothers for example, provided credit to other banks that collapsed when Lehman sunk. The second effect is informational contagion. When a loss of confidence takes place, it tends to be very generalized and erodes in similar firms. After Lehman collapsed, Merril Lynch was forced to sell itself to Bank of America because there were anticipated runs generated by fear. Lastly, systemic risk brings common shock, meaning that there is an overreaction that, in fact, causes more harm.

The impact of Lehman Brothers bankruptcy was massive in all these risk-related components, it did belong to the group of those which were "Too Big To Fail". Then why was it left to crumble, along with its 25.000 employees and the hopes of all those who were not ready to bear the consequences that its collapse would have led to?

The answer sounds banal but it's spelled "moral hazard". We have previously stated that moral hazard is the concern that someone who is protected against the consequences of a risk has less incentive to take precautions against the risk. In the first weeks of September 2008 the mortgage finance giant Fannie Mae and Freddie Mac were bailed out by the Treasury. But the same Mr. Paulson, Secretary of the Treasury,

[98]Levitin, A. (2011) In Defense of Bailouts. *The Georgetown Law Journal*. 99 (435). p. 437-514.

when interviewed on his decision not to bail out Lehman said he “had no authority to commit public money in that way”[99].

Therefore Lehman seems to have been used to give an example to all financial firms who were going blind on their investment decisions. What has not been assessed is whether its collapse was the only viable solution.

2.8 Proposed alternative solutions

In order to examine whether allowing Lehman’s bankruptcy was the sole way-out we might want to consider the consequences of a bail-out and, more ambitiously, how Lehman’s resolution would have been managed if the Dodd-Frank Act, especially Title II and the OLA mechanism, had been enacted prior to its failure. As we know[100] access to OLA is subject to the satisfaction of certain conditions set out in §203 ensuring that the company is a financial company, it is in default or danger of default and its failure under other applicable law would have serious adverse effects on the financial stability of the United States.

The first step for determining whether Lehman could have undergone OLA is to prove that it would have met the conditions. In fact Lehman Brothers was a financial company in the terms of §201(11)(B)(i) of the Dodd-Frank, as it was a bank financial company, or, more precisely a global financial services firm which was involved in investment banking, broking in debt and equity, trading on its own account, research, private equity, investment management and private banking.[101]

At the time of its bankruptcy Lehman had more than 100,000 creditors and more than $150 billion in outstanding bond debt. Its total debts amounted to $613 billion against total assets of $639 billion[102] and the only possibilities it theoretically had were filing for bankruptcy or accessing a bail-out. In fact, it sought bankruptcy protection under Chapter 11.Hence, the requirement set forth in §203(4) concerning the default or danger of default is satisfied as it demands that: (A) a case has been, or likely will promptly be, commenced with respect to the financial company under theBankruptcy Code;(B) the

[99] See *supra* note 24.
[100]
[101]See: Investment Banks Guide at: http://www.investmentbanksguide.com/lehman+brothers/.
[102]Data accessed via MarketWatch. Available at: http://www.marketwatch.com/story/lehman-folds-with-record-613-billion-debt.

financial company has incurred, or is likelyto incur, losses that will deplete all or substantially allof its capital, and there is no reasonable prospect for thecompany to avoid such depletion;(C) the assets of the financial company are, or arelikely to be, less than its obligations to creditors and others;or(D) the financial company is, or is likely to be, unableto pay its obligations in the normal course of business. The last requirement – the one concerning the potential threat to the financial stability of the United States- is more than met, given the spike in the VIX, as we have seen before, recalling that the VIX gauges the prevision of instability in the market.

Given that all circumstances were fulfilled, if the Dodd-Frank had already been law the FDIC might have proceeded in taking over Lehman for an Orderly Liquidation Authority. The FDIC would have needed to start with due diligence. For Lehman, in the absence of an early private sector solution, the FDIC would have had the necessity to establish an on-site presence to begin duediligence and to plan for a potential Title II resolution Lehman was not the only firm in possible trouble and the FDIC would likely have had a heightened presencein other subject firms at the time. Thus, the marketwould not necessarily have taken the FDIC's heightenedpresence as a signal that a failure was imminent as the market already was aware of Lehman's problems. In thefailure of Lehman it is noteworthy that senior management gave no credence to the possibility of failure until the verylast moment. There was apparently a belief, followingthe government's actions in respect of other institutions,that the government, despite it claimed thecontrary, would step in and provide financial assistanceand Lehman would be rescued. If Title II of the Dodd-Frank Act had been in effect, the framework would have been extremely altered. Lehman's senior managementwould have understood clearly that the governmentcould not extend financialassistance outside of a resolution because of the clearrequirements in the Dodd-Frank Act that losses are tobe borne by equity holders and unsecured creditors, and management responsible for the failure is not to be retained. Therefore if the Dodd-Frank had been enactet at Lehman they would have known that they were not *too big to fail*anymore and that the alternative to a sale of thecompany or a substantial capital raising would be abankruptcy under the Bankruptcy Code or a resolution underTitle II with no expectation of any return to shareholders.

Regulators could have set a deadline to sell to company or raise capital. This would have clearlyfocused Lehman's Board of Directors on the urgency ofthe matter and encouraged the Board to accept the bestnon-government offer it received even if a dilution of capital would have followed; virtually any private sale would yield abetter return for shareholders than the proceeds shareholders would receive in an FDIC receivership,as equity holders have the lowest priority claimsin a receivership.Lehman's senior management and Board of Directors may have been more willing to recommend offers thatwere below the then-current market price if they knew with certainty that extraordinarygovernment assistance wereunavailable to the companyand that Lehman would be put into receivership.[103]

The preferred solution under the Dodd-Frank Act is fora troubled financial company to find an investoror to recapitalize without direct government involvementor the FDIC being appointed receiver. This may be inferred by section 203(a)(2)(E), in which it is prescribed that the recommendation that the FDIC and the Board of Governors should deliver to the Secretary must contain among others "an evaluation of the likelihood of a private sectoralternative to prevent the default of the financial company"[104], and by section 203(b)(3) requiring that the Secretary take the action only when "no viable private sector alternative is available to preventthe default of the financial company"[105].

Since the OLA is last resort, the FDIC will need to gather as much information as possible about a systemically important financial institution in advance of any Title II resolution. In the case of Lehman, the FDIC could have already been on-site at Lehman and exercise its resolution and monitoring activities and it would have determined, jointly with other supervisors, thecondition of the company for the purposes of ordering corrective actions to avoid failure, and it otherwisewould have prepared for a Title II orderly resolution.

Had the Dodd-Frank Act been enacted sufficiently far in advance of Lehman's failure, surely much more supervisory informationwould have been available. As a matter of fact, being Lehman Brothers a SIFI, it would have been subject to §165(d) of the Act

[103]*In fact, it was reported that a KDB on August 31 was willing to pay $6.40 per share when Lehman's stock was trading at $17.50. This was exactly 15 days before its bankruptcy*. FDIC. (2011) *The Orderly Liquidation Of Lehman Brothers Holdings Under The Dodd-Frank Act.* [Online]. Available at: https://www.fdic.gov/regulations/reform/lehman.html. [Accessed: 15 October, 2016].

[104]Dodd-Frank Act (2010).

[105]Id.

requiring the submission of a resolution plan or “living will” containing relevant information about the company for a smoother resolution process[106]. By March 2008, Lehman had recognized that itscommercial real estate related holdings were a majorimpediment to finding a merger partner.

During the week leading up to Lehman’s bankruptcy filing, the private potential aquirers, namely Bank of America and Barclay’s identified a great deal of billion dollars in suspect residential real estate related assetsand private equity assets that they would not purchase in an acquisition. In the FDIC’s resolution process, the FDIC’sstructuring team as well as potential bidders wouldhave had sufficient time to discern problem asset pools. While Lehman was seekingan investor pre-failure, the FDIC might have identified the best-working bid structure for Lehman and besides, it could have exercised the authority conferred by §210(h) of the Act to establish a bridge financial company for the purpose of transfering problem assets.

We have affirmed above that perhaps, if the Dodd-Frank Act had been implemented, at Lehman they would have sought to find a private buyer, given that no public rescue would have been available and a private solution was less burdensome than being put into receivership. Nevertheless if Lehman were not able to sell itself the FDIC would have to define a convenient bid structure and invite bidders. To that end two realistic options have been suggested feasible[107].

Option A: whole financial company purchase and assumption with partial loss share (loss-sharing P&A). Under this option, the assets and operations of Lehman are transferred to the acquirer with no government control. Due to the problem assets, however, it may be necessary for the receivership estate to offer a potential acquirer protection from loss in respect of that identified pool of problem assets. By means of this transaction the acquirer and the FDIC would share losses. This type of operations are necessary to obtain better bids from the acquirer, they proved particularly effective and were used several times by FDIC to resolve failing banks.

Option B: modified purchase and assumption without loss share (modified P&A). This

[106]The Resolution Plan is designed for a resolution under the Bankruptcy Code, nonetheless it would contain essential elements for resolution under OLA.

[107] Supra *note* 36.

transaction is similar to a good bank-bad bank resolution strategy because it transfers to the acquirer the majority of assets and operations of Lehman except the pools of problem assets, which could be retained and dealt with at a later date.

The parties interested in one of these two options would have submitted bids after conducting due diligence. At this point the FDIC would have to abide by the prescriptions of §210(a)(9)(E) designed to guide the Corporation through the disposition of assets of the failing company, which requires that its powers as a receiver are exercised in a manner that maximises the net present value return from the sale of assets, minimizes the amount of any losses, mitigates potential adverse effects to the stability of the financial system and ensures fair competition and equal treatment of the offerors. In other words, the FDIC after receiving submission of bids would have to evaluate them according to the guidelines offered by the Dodd-Frank Act in order to maximise the return from the disposition of assets and would have to select the winning bid.

2.8.1 Destiny of Financial Contracts of the Failing Company

We have assumed that the FDIC has selected the best offeror; this could have paid the acquired assets through a combination of cash, liabilities and notes. Since we have held that one of the biggest losses brought by the bankruptcy of Lehman Bothers was the run on its derivative transactions, which are subject to early termination rights due to their exemptions from the automatic stay, we might wonder what would have been the fate of Lehman's financial contracts in a P&A deal if the bank had been resolved under OLA. Lehman's derivative trading was conducted almostexclusively in its broker-dealer, LBI, and in LBI'ssubsidiaries. As a result, the acquisition by the acquiror, selected by the FDIC, of thebroker-dealer group would have transferred the derivativesoperations, together with the related collateral, to the same acquiror in its entirety as an ongoing operation. At themoment of failure, he would have assumed anyparent guarantee by Lehman outstanding in respect ofthe subsidiaries' qualified financial contracts. This action should have substantially eliminated anycommercial basis for the subsidiaries' counterparties toengage in termination and close-out netting of qualifiedfinancial contracts based upon the insolvency of theparent guarantor. This would have removed any financialincentive to do so as well, as a financially secureacquirer would have assumed the obligations andprovided guarantees to the same extent as its predecessor.[108]

2.8.2 Bailout

After praising the protection of creditors and the orderly procedures guaranteed by the Bankruptcy Code we might attempt to give an opinion on whether, in the circumstances in which Lehman laid, a prompt access to a very exceptional bailout would have dampened the consequences that as a matter of fact took place.

First of all we should clarifywhat we mean by bailout. The proper bailout is the taxpayer-funded bailout, which can be defined as aninjection of public money into an otherwise insolvent firm that imposes at leastsome losses on parties other than the non-public shareholders and creditors ofthe firm.[109] The beneficiaries of the bailout are creditors and shareholders but in reality are also managers and employees, who would lose their jobs in case of a liquidation or reorganization. Nevertheless it has been suggested that the taxpayer-funded bailout is not the only form of public rescue existing. In fact, the traditional lender-of-last-resort function of a central bank is to lend freely to solvent butilliquidfirms during a financial panic on a fully secured basis and at penaltyrates. Lender-of-last-resort facilities thus provide firms with an emergencysource of credit in order to turn assets that have temporarily become illiquid into cash.[110]Thus, the discount window lending of the Federal Reserve qualifies as a lender-of-last-resort facility.[111]

Bailouts are commonly perceived as unfair solutions in respect of the members of the society who are called to bear the costs of the mismanagements occurring in Wall Street but perhaps, in the case of a large SIFI like Lehman Brothers,a bailout would have been less detrimental for the society than the bankruptcy thatcame about instead. In point of fact a bailout is the *lesser of two evils*[112] when the social costs of it are less than those of the next best alternative. In order to sustain this argument we might use an example. For the purpose of this example we will assume that the alternative to the bailout is fire-sale

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[108]Supra note 36.
[109]Are bailouts inevitable?
[110]Bagehot, W. (1873) *Lombard Street: A description of the Money Market*. Third edition. London: Henry S. King.
[111]For more information see: https://www.federalreserve.gov/newsevents/reform_discount_window.htm.
[112]Recalling the words of Sheila Bair, Chairman of the FED.

liquidation. Let’s assume that a particular SIFIbecomes insolvent during a financial panic. Assume further that the SIFI has $1trillion in liabilities and a going-concern value, before liabilities, of $950billion. This gross going-concern value can only be realized if the firm isimmediately recapitalized with $150 billion in return for all of the firm'scommon equity, leaving the firm with a net firm value of $100 billion. The cost of recapitalizing this firm would be $50 billion: the gross cost of $150billion, less the $100 billion value of the new common equity issued to the taxpayers. Furthermore, after this recapitalization, the firm will need atemporary source of secured funding, until it can regain its position and access to general credit markets. Conversely, if the firm's assets are immediately liquidated in a fire sale atthe bottom of the panic-affected market, the assets may generate very little amount but by contrast it would generate a large “going concern surplus”, meaning by that thedifference between its gross going-concern value and its liquidation value and therefore representing a loss. Moreover, much of the potential loss represented by this goingconcernsurplus is a "deadweight" loss in the social value of the assets, ratherthan a "mere" transfer of wealth from the firm's unlucky creditors to the "lucky" and potentially more prudent purchasers ofthe assets at the fire-sale prices[113]. Such a dramatically large going-concernsurplus may emerge very suddenly during a financial panic, because on the one hand there is a lack of trust and pessimism in the marketabout the value of aSIFI's assets and its future earnings, and on the other hand every financial institutionfearinga cascade of withdrawals would sell its assets at any discounted price as long as this guarantees its survival.[114] Given that our aim is to compare the costs of the two alternatives and suggest which one is more favorable we might say that under these circumstances, the social cost of a taxpayer-funded bailout would include the following: the sum of the net cost of recapitalizing the insolvent institution; the cost of providing it with a temporary source of secured funding; and the increased moral hazard created by the bailout. Nonetheless, this cost might be offset by any contribution collected from the firm's bailed-out creditors, or by any proceeds, from the eventual sale of the equity received in exchange for the recapitalization in excess of the equity's initial value. The social cost of the fire-sale liquidation, by contrast, would be the portion of the going-concern surplus that is a

[113]The theory of the transfer of wealth instead of loss of value in a firesale liquidation has been sustained by

[114]See supra note 45.

deadweight loss in the social value of the assets, plus the increased risk of an acute destabilization or collapse of the financial system, with subsequent long-term harm to the wider economy and society. This approximate evaluation suggests that, in the majority of cases a bailout would be less costly to society than a fire-sale liquidation of the SIFI. Even thought for the sake of simplicity we have assumed that the costly alternative to a bailout is liquidation, the same principles apply in the case of Bankruptcy under Chapter 11, hence reorganization, which was the case of Lehman Brothers. In the case of Lehman, in fact, there is one more variable to consider: due to the financial panic there was a run on the bank even before any type of sale could occur. The run consisted in the premature closeouts on the financial contracts held by Lehman triggered and allowed by the Bankruptcy Code in case of filing of a petition, causing a loss of Lehman's worth and a distruction of value of the proceeds that could have been distributed among creditors in a reorganization.

CHAPTER 3

The Need For A Discipline Effectively Dealing With Systemically Important Institutions in Distress: United States and Europe.

Before the global financial crisis that hit the industrialized world in 2008, financial institutions, even those considered pillars for markets stability, were subject to inappropriate rules in case of adversities. In particular, in the United States, when a SIFI reached its ultimate stage of financial suffering she had before her few limited alternatives, namely market solutions, public rescue (or bailout) or filing for bankruptcy protection. Market "rescues" happen when a market solution is used to save a market player. A collapsing institution may be saved from losses through, for example, a merger with a healthier one. This was the case with Bank of America's acquisition of Merril Lynch on September 14, 2008 for $50 billion. In fact, it was said that if Bank of America had not acquired Merrill, it is likely the investment bank would have collapsed like Lehman Brothers under the force of market skepticism[115]. Bailouts take place when governments inject institutions with public money to recapitalize them and help them continue performing their activities. Governments generally favored bailouts in order to prevent the collapse of the institution or the systemic effects that may be triggered with the filing for bankruptcy protection[116]. A company will generally file for bankruptcy protection when no other solutions are available. In this case a petition may be filed either to liquidate the failing business –therefore invoking the rules of Chapter 7 of the Bankruptcy Code- or to reorganize the business, when it is more valuable as a going concern, and to allow the company to "start from the scratch"[117]. Companies' reorganization is regulated under Chapter 11 of the Bankruptcy Code. When Lehman Brothers in 2008 was denied other institutions' support and governmental aid, she had no other possibility than resorting to bankruptcy and entering into reorganization

[115] Bank of America-Merrill Lynch: A $50 Billion Deal From Hell. (2009) *The Wall Street Journal*. January 22, 2009. Available from: http://blogs.wsj.com/deals/2009/01/22/bank-of-america-merrill-lynch-a-50-billion-deal-from-hell/. [Accessed: September 20, 2016].

[116] For example, on September 16, 2008 the federal government gave the American International Group (NYSE:AIG) - a bailout of $85 billion. In exchange, the U.S. government received nearly 80% of the firm's equity.

[117] I decided not to use the term "fresh start" because, as we have acknowledge in Chapter 1, corporations are not given a fresh start and they do not need one.

proceedings. Lehman's bankruptcy weakened the market and, due to the domino effect, caused a systemic crisis. From that very moment onwards awareness among regulators began to rise that perhaps institutions, which have a pivotal role within the market, are characterized by different structures than other corporations and general bankruptcy or insolvency rules may not be adequate to cope with them.

In the United States the main reaction to an alleged inadequate system was the enactment of the Dodd-Frank Act in 2010, which aimed to fill the gaps of the Bankruptcy Code for systemically important institutions, while Europe, a few years later emanated the *Bank Recovery and Resolution Directive*, in order to address the discordance of procedures among Member States.

3.1 Towards a common global discipline for Sifis' resolution

The new two regulations are based on the same principles and they both intend to preserve public money while protecting the defaulting firm's operations that are critical to the market. The reason of the similarities is that both the American and the European legislator draw on the guidelines laid down by the Financial Stability Board in the *Key Attributes of Effective Resolution Regimes for Financial Institutions* ("Key Attributes"). The Key Attributes constitute a set of policies aiming to address the Too-Big-To-Fail problem. G20 Leaders at the Cannes Summit endorsed the implementation of these measures in 2011 as new international standards for resolution regimes that allow authorities to resolve financial institutions in an orderly manner without taxpayer exposure to loss from solvency support, while maintaining continuity of their vital economic functions.[118]

According to the Key Attributes, resolution regimes of all jurisdictions should have twelve essential features. These relate to (1) Scope; (2) Resolution authority; (3) Resolution powers; (4) Set-off, netting, collateralisation, segregation of client assets; (5) Safeguards; (6) Funding of firms in resolution; (7) Legal framework conditions for cross-border cooperation; (8) Crisis Management Groups; (9) Institution-specific cross-border cooperation agreements; (10) Resolvability assessments; (11) Recovery and resolution planning; (12) Access to information and information sharing. The Key

[118] See: http://www.fsb.org/what-we-do/policy-development/effective-resolution-regimes-and-policies/key-attributes-of-effective-resolution-regimes-for-financial-institutions/

Attributes also contain Annexes to guide on the interpretation and implementation of the standards set out.

Scope

The *scope* refers to the institutions subject to the resolution regime designated in the Key Attributes. The regime should extend to the financial institutions (referred to as "firms" in the Document) that are systemically critical.

These include: (i) holding companies of a firm; (ii) non-regulated operational entities within a financial group or conglomerate that are significant to the business of the group or conglomerate; (iii) and branches of foreign firms.[119]

Resolution Authority

Each jurisdiction should have a designated administrative authority ("Resolution Authority" or "Authority") that ensures the correct application of the regime to the firms within the scope. It is required that the Resolution Authority under each jurisdiction has the powers to pursue financial stability and ensure continuity of systemically important financial services, protect depositors where applicable, avoid unnecessary destruction of value while seeking to minimise the overall costs of resolution and losses to creditors, duly consider the potential impact of its resolution actions on financial stability in other jurisdictions.[120]

In the American jurisdiction the Resolution Authority is designated in Title II of the Dodd-Frank Act, namely the FDIC, which has the power of resolving a financial institution entering into OLA.

Resolution Powers

Resolution powers that may be exercised by the Authority include the powers to timely enter into resolution, before the firm is balance-sheet insolvent, and the specific powers to use certain tools in order to achieve an efficient resolution. These tools encompass:

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[119] Key Attributes of Effective Resolution Regimes for Financial Institutions (2011). Financial Stability Board. Available from: http://www.fsb.org/what-we-do/policy-development/effective-resolution-regimes-and-policies/key-attributes-of-effective-resolution-regimes-for-financial-institutions/#1scope

[120] Id.

transfer of assets and liabilities (resolution authorities should have the power to transfer selected assets and liabilities of the failed firm to a third party institution or to a newly established bridge institution); creation of a Bridge Institution to ensure the maintenance of critical functions; bail-in within resolution, correlated with write-down and conversion powers. In Dodd-Frank Title II requires that the losses of any financial company placed into receivership will not be borne by taxpayers, but by common and preferred stockholders, debt holders, and other unsecured creditors.

Set-off, netting, collateralisation, segregation of client assets

Entry into resolution should not trigger statutory or contractual set-off rights, or constitute an event that entitles any counterparty of the firm in resolution to exercise early termination rights for the only reason of the entry into resolution. Should early termination rights nevertheless be exercisable, the resolutionauthority should have the power to stay temporarily such rights where they arise by reason only of entry into resolution or in connection with the exercise of any resolution powers.

Safeguards

The concept of safeguards consists in the respect of some baseline principles, similar to the automatic stay and the absolute priority rule in American bankruptcy. In the Key Attributes these baseline rules are respect of creditor hierarchy and "no creditors worse off" principle. Hierarchy of claims shall be respected in the exercise of resolution powers but the general treatment of equal treatment of creditors may be departed if the departure is validly motivated. "No creditors worse off" should be read as "no creditors worse off *than liquidation*", implying that in the resolution procedure creditors should not collect less than they would have collected if the firm had been liquidated. In others words, creditors of a firm that has undergone resolution should obtain at least what they would have obtained in liquidation.

Funding of firms in resolution

One objective of imposing resolution procedures is to minimize moral hazard. In order to do so regulations should limit as much as possible public funds and therefore avoid bailout as a means of resolving institutions. For this reason the Key Attributes require jurisdictions to put in place privately-financed deposit insurance or resolution funds, or a funding mechanism with ex post recovery from the industry of the costs of providing temporary financing to facilitate the resolution of the firm. In the Dodd Frank this requirement is implemented by providing in section 204(d) that the FDIC as a receiver in charge of resolving the firm may make available funds for the orderly liquidation ("Orderly Liquidation Fund" or "OLF") which shall have a priority of claims.[121]

Legal framework conditions for cross-border cooperation

According to the Key Attributes the mandate of a national Resolution Authority should encourage cooperation with authorities of other jurisdictions and it should not be constructed in a way that allows automatic effects to arise from the exercise of powers by an Authority in a different jurisdiction. The Key Attributes specifically require that "*(l)egislation and regulations in jurisdictions should not contain provisions that trigger automatic action in that jurisdiction as a result of official intervention or the initiation of resolution or insolvency proceedings in another jurisdiction, while reserving the right of discretionary national action if necessary to achieve domestic stability in the absence of effective international cooperation and information sharing*."[122]

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[121] Section 204(d) of the Dodd-Frank Act says: "*Upon its appointment as receiver for a covered financial company, and thereafter as the Corporation may, in its discretion, determine to be necessary or appropriate, the Corporation may make available to the receivership, subject to the conditions set forth in section 206 and subject to the plan described in section 210(n)(9), funds for the orderly liquidation of the covered financial company. All funds providedby the Corporation under this subsection shall have a priority of claims under subparagraph (A) or (B) of section 210(b)(1), as applicable, including funds used for—(1) making loans to, or purchasing any debt obligation of, the covered financial company or any covered subsidiary; (2) purchasing or guaranteeing against loss the assets of the covered financial company or any covered subsidiary, directly or through an entity established by the Corporation for such purpose; (3) assuming or guaranteeing the obligations of the covered financial company or any covered subsidiary to 1 or more third parties; (4) taking a lien on any or all assets of the covered financial company or any covered subsidiary, including a first priority lien on all unencumbered assets of the covered financial company or any covered subsidiary to secure repayment of any transactions conducted under this subsection; (5) selling or transferring all, or any part, of such acquired assets, liabilities, or obligations of the covered financial company or any covered subsidiary; and (6) making payments pursuant to subsections (b)(4), (d)(4), and (h)(5)(E) of section 210.*"

[122] *Supra* note 35. Key Attributes, n.7.

Crisis Management Groups (CMGs)

Home and key host authorities of all G-SIFIs should be prepared to manage the resolution of a cross-border financial crisis affecting the firm. CMGs should include the supervisory authorities, central banks, resolution authorities, finance ministries and the public authorities responsible for guarantee schemes of jurisdictions that are home or host to entities of the group that are material to its resolution, and should cooperate closely with authorities in other jurisdictions where firms have a systemic presence.

Institution-specific cross-border cooperation agreements

For all G-SIFIs there should be cooperation agreements, the minimum content of which is set out in Annex I of the Key Attributes, for the coordination of the operations that need to be undertaken by home and relevant host authorities involved in the planning and crisis resolution stages.

Resolvability assessments

Resolution Authorities may not put a firm into resolution using discretionary criteria, they rather should evaluate whether a firm is resolvable and hence what is the impact of the firm's failure on the economy. I-Annex 3 of the Key Attributes provides guidance for Authorities that have to conduct this type of assessment.

In the Dodd-Frank[123] the procedure is not defined resolvability assessment but serves the same purpose. In fact, in the United States, in order to appoint the OLA and to orderly liquidate or "resolve" a firm, different authorities are involved. Pursuant to section 202(a)(1)(A) of the Dodd-Frank, the OLA commences[124] with a determination

[123]Unlikely, as we will further discuss, the European Directive 2014/59/UE specifically refers to it as "assessment of resolvability".

[124] Section 202(a)(1) *Dodd-Frank Act*. For the application of the OLA regime, and therefore the appointment of the FDIC as a receiver there is a specific procedure to follow. The Secretary of the Fed shall determine whether the financial company is a covered one and notify the appointment of the FDIC ("the Corporation") as a receiver to the financial company and to the Corporation. The board of the company may acquiesce to the appointment or reject it. In the former case the Corporation is appointed, in the latter the Secretary shall require an order of appointment to the District Court for the District of Columbia, which may make its decision whether to emanate the order or not.

made by the Secretary of the Federal Reserve that the financial company is a covered company[125]

This determination is a resolvability assessment on account of the fact that it shall culminate into a written recommendation stating, among others, that: the financial company is in default or in danger ofdefault;the failure of the financial company and its resolutionunder otherwise applicable Federal or State law would haveserious adverse effects on financial stability in the UnitedStates;no viable private sector alternative is available to preventthe default of the financial company;any effect on the claims or interests of creditors, counterparties,and shareholders of the financial company and othermarket participants as a result of actions to be taken underthis title is appropriate; any action under section 204 (application of OLA) would avoid or mitigate such adverse effects.

Recovery and resolution planning

Jurisdictions should require that institutions whose failure might have a systemic impact plan their fate in advance through Recovery and Resolution plans. The minimum elements of these plans are set out in I-Annex 4 of the Key Attributes. Recovery plans serve the purpose of allowing the institution to quickly identify possibilities and tools for restoring its financial strength, for the reason that this identification might be more difficult to make when the firm is under severe stress.

Resolution plans are intended to facilitate the use of resolution powers to protect systemically important functions, with the aim of making the resolution of any firm feasible without severe disruption and without exposing taxpayers to loss. It should include a resolution strategy agreed by top officials and an operational plan for its implementation.[126] In American jurisdiction Resolution plans are commonly known as “living wills” and are required under Section 165(d) of the Dodd-Frank Act for bank holding companies with total consolidated assets of $50 billion or more and nonbank financial companies designated by the Financial Stability Oversight Council (FSOC). Resolution plans must be submitted to the Federal Reserve and the Federal Deposit

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[125] A covered financial company under the Dodd-Frank is a financial company for which the determination under section 203(b) of the Acthas been made.

[126] *Supra* note 35. Key Attributes, n.11.

Insurance Corporation for supervision and they must describe the company's strategy for rapid and orderly resolution in the event of material financial distress or failure of the company.[127]

The need for Recovery plans is reminded for the first time in the Supervision and Regulation Letter of the Federal Reserve SR 12-17[128] where the Fed stresses the importance for robust recovery planning in order to enhance the resilience of a firm and preserve its functions in case of weaknesses. Nevertheless, the guidelines for recovery planning in SR 12-17 were quite dim and it was only specified that the guidance of the Fed did not apply to banking organizations with consolidated assets for $10 billion or less. The vagueness was to a certain degree compensated with SR 14-8, where stringent and more precise requirements for resolution plans are outlined for the eight US Global systemically important banks (G-SIBs)[129]

Access to information and information sharing

The last of the twelve features that regulations should encompass relates to both access to information and sharing of information. Authorities should be able to access firm-specific information and recovery and resolution planning even in normal times (when a crisis is not in place). Supervision and Resolution Authorities from different jurisdictions should not be hindered in the transmission of information necessary for their cooperation.

3.2 Bank's insolvency in Europe. A spectre lingering in Europe

The financial crisis that has allegedly generated in the United States by the Lehman Brothers collapse did not take long to spread all over the rest of the world and especially Europe. Policy makers and the European Parliament have constantly pondered what measures to take to keep the systemic damages of banks' collapses within bounds, as bailouts led by the Governments are in contrast with EU competition law, which restrains State aids. The discipline that would address the problem needed to find a balance between keeping the bank -or part of it- running and alive and avoiding public

[127] Section 165(d) Dodd-Frank Act.
[128] Consolidated Supervision Framework for Large Financial Institutions (2012) *Supervision and Regulation Letters* SR1 12-17/CA 12-14. December 12, 2012. Available at: https://www.federalreserve.gov/bankinforeg/srletters/sr1217.htm#_ftnref5.
[129] Id. SR 14-8. Available at: https://www.federalreserve.gov/bankinforeg/srletters/sr1408.pdf.

financing. The answer to the question " How can you rescue a moderately big financial institution without involving the State and therefore taxpayers' money? " was straightforward for the European parliament and Council and it consisted in substituting the bail in to the well-known bail out.

It has been said that the bail in is a spectre lingering in Europe and it was brought in by Directive 2014/59/UE of Parliament and EU Council of May 15, 2014. The Directive regulates the resolution of banks and investment firms and it was named *Bank Recovery and Resolution Directive* (hereinafter *BRRD*). All European countries have learnt the hard way that when a bank is near to a breakdown in the absence of a market solution, such as a merger or acquisition by other institutions, the only alternative to liquidation is a public rescuing.

This solution has proven no more viable. As a fact, when public resources are used for banks' bailouts the burden placed on citizens is heavy, because they pay twice, with costs of a taxpayer bailout followed by recession and spending cuts. What is also not compatible with public rescuing is EU Competition Law (art. 101 TFEU). The bail out distorts competition in the market and is an inducement to moral hazard. Banks whose governance disrespected the rules of prudent management are helped and allowed to stay in the market in an advantage position compared to other competitors, which have to face the risks related to their activities with no external assistance.

In the Communication of July 30th, 2013 concerning State aid and financial support to banks hit by financial crisis, the European Commission set forth the principle according to which State aids must be limited to special conditions and used as a measure of last resort in order to restrain moral hazard.[130]

The circumstances that brought the EU Parliament and Council to emanate the *Bank Recovery and Resolution Directive* are stated in the text of the same Directive, where it is pointed out that "*The financial crisis has shown that there is a significant lack of adequate tools at Union level to deal effectively with unsound or failing credit institutions and investment firms ('institutions'). Such tools are needed, in particular, to prevent insolvency or, when insolvency occurs, to minimise negative repercussions by preserving the systemically important functions of the institution concerned. During the*

[130]BRRD, Bail in, risoluzione della banca in dissesto,condivisione concorsuale delle perdite (2016). *Contratto e Impresa.* 3/2016

crisis, those challenges were a major factor that forced Member States to save institutions using taxpayers' money. The objective of a credible recovery and resolution framework is to obviate the need for such action to the greatest extent possible."[131]

The absence of tools for dampening the effects of collapsing institutions has caught authorities unprepared to make swift decisions and minimise systemic risk. The Directive moves its steps from the recognition of the interconnectedness of financial markets at a Union level. It is, in fact, aknowledged that "*Union financial markets are highly integrated and interconnected with many institutions operating extensively beyond national borders. The failure of a cross-border institution is likely to affect the stability of financial markets in the different Member States in which it operates. The inability of Member States to seize control of a failing institution and resolve it in a way that effectively prevents broader systemic damage can undermine Member States' mutual trust and the credibility of the internal market in the field of financial services*."[132]

The awareness of effects extending to the entire financial system is a step towards the harmonization of resolution procedures.

3.2.1 Purposes of BRRD

The purposesof the Bank Recovery Resolution Directive, as stated, are to harmonize the procedures for resolving institutions, protect financial stability and minimize moral hazard.

Member States from time to time have applied to systemically important institutions the same procedures they apply to insolvent enterprises but the Directive recognizes that "*the financial crisis has exposed the fact that general corporate insolvency procedures may not always be appropriate for institutions as they may not always ensure sufficient speed of intervention, the continuation of the critical functions of institutions and the preservation of financial stability*."[133]

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[131]Directive 2014/59/EU
[132]Id.
[133]Id.

Therefore the objective of the Directive is to address the problem introducing a regime to provide authorities with a set of tools that allows them to intervene quickly in an unsound or failing institution

so as to ensure the continuity of the institution's critical functions, while minimising the impact of an institution's failure on the economy and financial system. The new regime, though, does not just call for a swift intervention but also "*[...]should ensure that shareholders bear losses first and that creditors bear losses after shareholders, provided that no creditor incurs greater losses than it would have incurred if the institution had been wound up under normal insolvency proceedings in accordance with the no creditor worse off principle as specified in this Directive. New powers should enable authorities to [...]apportion losses in a manner that is fair and predictable. Those objectives should help avoid destabilising financial markets and minimise the costs for taxpayers*."[134]

Harmonization of resolution procedures for institutions

The main objective of the Directive is to provide Member States with a common discipline for tackling the insolvency of an institution posing systemic risk throughout the Union.

Even though some Member States have already enacted changes in national legislation in order to resolve failing institutions, the absence of common minimum rules, powers and processes might hinder cooperation between national authorities when dealing with failing cross-border institutions and threaten the smoothness of operations. It is especially recognized in the Directive the importance for national authorities to be granted the same ability to resolve insolvent institutions.[135]

Covered institutions

The institutions whose resolutions the *BRRD* aims to harmonize are indicated in Recital 11 of the Directive, which specifies that "*the resolution regime should apply to institutions subject to the prudential requirements laid down in Regulation (EU) No 575/2013 of the European Parliament and of the Council and Directive 2013/36/EU of*

[134] Id.
[135] Id.

the European Parliament and of the Council. The regime should also apply to financial holding companies, mixed financial holding companies provided for in Directive 2002/87/EC of the European Parliament and of the Council, mixed-activity holding companies and financial institutions, when the latter are subsidiaries of an institution or of a financial holding company, a mixed financial holding company or a mixed-activity holding company and are covered by the supervision of the parent undertaking on a consolidated basis." [136] Generally speaking, these institutions are mostly investment, credit and financial institutions, whether single entities or parts of a group and the Directive acknowledges them as systemically important.[137]

Notwithstanding the inclusion of these institutions in the catalogue of institutions covered by the Directive, Recital 14 of the Directive specifies that not all institutions are the same and authorities should consider several factors when applying the regime. In particular, they "*should take into account the nature of an institution's business, shareholding structure, legal form, risk profile, size, legal status and interconnectedness to other institutions or to the financial system in general, the scope and complexity of its activities, whether it is a member of an institutional protection scheme or other cooperative mutual solidarity systems, whether it exercises any investment services or activities and whether its failure and subsequent winding up under normal insolvency proceedings would be likely to have a significant negative effect on financial markets, on other institutions, on funding conditions, or on the wider economy in the context of recovery and resolution plans and when using the different powers and tools at their disposal, making sure that the regime is applied in an appropriate and proportionate way and that the administrative burden relating to the recovery and resolution plan preparation obligations is minimised*."

It is of significant importance that institutions prepare and update recovery plans that set out measures to be taken for the restoration of their financial position following a significant deterioration. Such plans should be detailed and realistic, besides applicable in a range of robust and severe scenarios. The requirement to prepare a recovery plan should, however, reflect the systemic importance of the institution or the group and its interconnectedness. Accordingly, the required content should take into account the nature of the institution's sources of funding. Moreover, institutions should be required

[136]Id. Recital 11.
[137]With the meaning offered in Chapter 1.

to submit their plans to competent authorities for a complete assessment, including whether the plans are comprehensive and could feasibly restore an institution's viability, in a timely manner, even in periods of severe financial stress.

Recital 18 of the Directive states: "*In the resolution of institutions or groups operating across the Union, the decisions taken should also aim to preserve financial stability and minimise economic and social effects in the Member States where the institution or group operates.*"

The objective of protecting financial stability as set forth in Recital 18 specifically refers to institutions operating cross-border but the real focus is on economic and social effects, which justify the special treatment afforded by the Directive to systemically important institutions and constitute the reason why these need to be dealt with instruments which are different than the ones used for insolvent enterprises.

In fact, as far as economic effects are concerned, we may start from the assumption that an advanced economy should maintain the capacity of the banking sector and of the intermediary sector as a channel credit, in order to support the real economy. In the case of a common shock, individual intermediaries shrink their assets in order to preserve the capital ratio. Thus, they reduce the credit availability in the economy, triggering an unstable spiral of balance sheet shrinkage which weakens the economy.[138] This weakness may turn very easily into recession, which takes place when production slows down and unemployment increases. In recession the GDP plummets as a result of inefficiencies in the production. The overall economy is at stake as lower production entails a halt in economy's growth.

Social effects are somehow intertwined with economic effects, as by them we mean mainly the lack of confidence in the economy. Investments are drastically reduced, because the expectations on the future demand are bad and small firms start to fire their employees as a result of negative forecasts on the ensuing periods. The level of unemployment therefore rises and the stability and wealth of families and individuals are jeopardized.

[138] Ionescu, C. (2014) Stress Testing and Financial Instability. Economics, Management, and Financial Markets. 9(1) pp. 466–474.

Minimization of Moral Hazard

Moral hazard has been considered a big component of colossal banking failures, as Ben Bernanke stated in a recent interview "*the moral hazard is that if you bail out firms that they will imagine that they will always be bailed out and they won't have any incentive to be cautious or take risks*"[139].

The *BRRD* attempts to fight moral hazard encouraging national authorities to be prompt on the resolution of failing institutions and providing them with specific tools devised for that specific purpose. Recital 45 requires that "*In order to avoid moral hazard, any failing institution should be able to exit the market, irrespective of its size and interconnectedness, without causing systemic disruption*."[140]

Therefore, authorities shall resolve an institution when it is likely to fail, notwithstanding its systemic importance, because if this feature will be adduced to justify the permanence on the market of the institution, moral hazard will increase as the institution will have no incentive to be cautious when engaging in perilous activities.

With this provision the Directive is not overlooking systemic risk, rather it is attempting to find a balance between fighting against the Too-Big-To-Fail concept and minimizing the effects on financial stability of the resolution of a SIFI.

This balance, in the Directive, lies in the resolution regime. Normal insolvency proceedings might not be adequate to address a SIFI failure, they "*might jeopardise financial stability, interrupt the provision of critical functions, and affect the protection of depositors*."[141] In this case resolution might better do the public interest by ensuring the continuity of critical functions, protecting client funds and assets and avoiding that these institution rely on extraordinary public financing for their rescue.

3.3 Preparation Measures. The Plans.

As mentioned, the Directive aims, among other things, to ensure that the administrative process linked to the resolution of an institution works out smoothly, hence to help authorities take decisions quickly should they be required to take control of a distressed

[139]Washington Post (2015) *Ben Bernanke on Why He Was Right About The Economy*. [Online] Available from: https://www.washingtonpost.com/news/wonk/wp/2015/10/14/ben-bernanke-on-why-he-was-right-about-the-economy/. [Accessed: September 10th, 2016].
[140]Recital 45, *BRRD*.
[141]Id.

institution. For this reason, the Directive establishes two types of planning that major institutions must carry out; these planning activities are regulated in Sections 2 and following of the *BRRD*, among which are *Recovery planning* and *Resolution planning*.

3.3.1 Recovery Plans

Every systemically important institution must draw up and maintain a recovery plan, which indicates the actions that shall be performed in order to restore their financial position in case of deterioration of their financial situation.[142]The drawing up of recovery plans shall follow the standards set by the European Banking Authority and they shall be, with the aid of authorities, updated at least annually and after every change of structure of the institution which may have effects on the recovery plan. The purpose of these plans is to induce the institution to be adequately prepared in the occurrance of a crisis, in order to mantain liquidity and continuity of essential functions. A recovery plan is in substance, a guide to the recovery of a distressed institution. In this phase the firm has not yet met the conditions for resolution or entered the resolution regime. There should be a reasonable prospect of recovery if appropriate recovery measures are taken.

The recovery may be achieved through the use of a wide range of measures, which should include actions to strengthen the capital situation, for example, recapitalisations after extraordinary losses, capital conservation measures such as suspension of dividends and payments of variable remuneration;sales of subsidiaries and spin-off of business units;voluntary restructuring of liabilities through debt-to-equity conversion; measures to secure sufficient funding while ensuring sufficient diversification of funding sources and adequate availability of collateral; possible transfers of liquidity and assets within the group.[143]

3.3.2 Resolution Plans

The same scope of orderly managing the crisis is served by resolution plans, though these tools have different outcomes. As a matter of fact, while recovery plans aim to aid

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[142]Article 5, *BRRD*.

[143]Financial Stability Board.*Key Attributes of Effective Resolution Regimes for Financial Institutions.* Annex 4(3).

the institution *overcoming* the crisis more easily, resolution plans aim to put in place a set of mechanisms whose ultimate purpose is not to rescue the collapsing institution and save its value as a going concern, but to prevent a systemic crisis and hence, the collapse of the entire system.

Resolution plans shall be drawn up by resolution authorities[144] and it must take in consideration main relevant scenarios when setting up measures to adopt, for example the idiosyncrasy of the failure. Even though the resolution instruments contained in the resolution plan are crucial to the prevention of systemic risk, the Directive imposes several restrictions on the content of the plan, which shall not assume any extraordinary public financial support besides the use of the financing arrangements, any central bank emergency liquidity assistance orany central bank liquidity assistance provided under non-standard collateralisation, tenor and interest rate terms.[145]

The institution may be required to assist the resolution authority in the drafting of the resolution plan and this one, as well as the recovery plan, should be updated at least every year and after any significant change in the institution which may have effects on the resolution measures.

Resolvability Assessment

The drafting of the resolution plan presupposes an assessment, made by resolution authorities, intended to make sure that the institution is *resolvable.* The resolvability assessment is, therefore, simultaneous with the drawing up of the plan. In conformity with the Directive an institution is deemed to be resolvable "*if it is feasible and credible for the resolution authority to either liquidate it under normal insolvency proceedings or to resolve it by applying the different resolution tools and powers to the institution while avoiding to the maximum extent possible any significant adverse effect on the financial system, including in circumstances of broader financial instability or system-wide events, of the Member State in which the institution is established, or other Member States or the Union and with a view to ensuring the continuity of critical functions carried out by the institution*."[146] In other words, it is authorities duty to

[144]Article 10, *BRRD*.
[145]Article 10(3) *BRRD*.
[146]Article 15(1) *BRRD*.

consider the effects that the resolution of the suffering institution would cause to the financial system and to choose the resolution tools, among those allowed by the Directive, which better suit the specific needs.

3.4 Resolution Tools under BRRD

European Parliament and Commission provided designated national authorities with a set of conspicuous tools for the resolution of institutions. These tools aim to allow the reorganization or exit from the market of the institution while dampening the bad consequences that exit might imply.

From the analysis of the Directive two major principles emerge given the tools offered for the resolution. One principle is the "*no creditors worse off*" principle, according to which no creditor shall incur greater losses than he would have incurred if normal insolvency proceedings had been used to wind up the institution. Compliance with the "no creditors worse off" principle requires, generally, a valuation of the treatment that shareholders and creditors would have received if the resolution regime had not been applied and instead the institution had been wound up under insolvency proceedings. Furthermore, in order to render this principle effective, the valuation shall be also done *ex post* in order to make sure that the resolution under *BRRD* actually made creditors, if not better off, at least not worse off. To be more precise, in Recital 51 is stated, "*in addition, where required under this Directive, an ex-post comparison between the treatment that shareholders and creditors have actually been afforded and the treatment they would have received under normal insolvency proceedings should be carried out after resolution tools have been applied. If it is determined that shareholders and creditors have received, in payment of, or compensation for, their claims, the equivalent of less than the amount that they would have received under normal insolvency proceedings, they should be entitled to the payment of the difference where required under this Directive.*"[147]

When creditors or shareholders believe they have received less than they would have received if the resolution regime had not been applied, they may challenge the comparison separately from the resolution decision and Member States are entitled to decide freely on the procedure as to how to pay the difference of treatment. That

[147] Recital 51, *BRRD*.

difference, if any, should be paid by the financial arrangements established in accordance with the Directive.

The other emerging principle is the "*burden sharing*" principle. This principle derives from lessons learnt from the financial crisis. EU Commission recognized crucial that State aid discipline is not set-aside even during a crisis and the bail-out tool is not used. Therefore the bank and its capital holders should contribute to the restructuring as much as possible with their own resources. State support should be granted on terms which represent an adequate burden-sharing by those who invested in the bank.Since the start of the crisis, when examining the compatibility of aid to banks the Commission has required at least a minimum degree of burden-sharing relative to the amount of aid received by those banks, in particular by absorbing losses with available capital and by paying an adequate remuneration for State interventions.[148]

3.4.1 Sale of Business or Shares and Creation of Bridge Institution

Liquidation of a systemically important institution as a whole may determine a great loss of value besides triggering systemic risk, thus resolution should aim to keep the failing institution capable of performing its activities when possible. For this reason the resolution tools include the possibility for national authorities to transfer the systemically important services or viable business of an institution to a sound entity such as a private sector purchaser or bridge institution and liquidate within an appropriate time frame the residual part of the institution. Notwithstanding the protection granted by the Directive to creditors and shareholders, it is provided that the sale of business or shares should enable authorities to make a sale without the consent of shareholders[149] and it is recognized in recital 13 that "*the use of resolution tools and powers provided for in this Directive may disrupt the rights of shareholders and creditors. In particular, the power of the authorities to transfer the shares or all or part of the assets of an institution to a private purchaser without the consent of shareholders affects the property rights of shareholders. In addition, the power to decide which liabilities to transfer out of a failing institution based upon the objectives of ensuring the continuity of services and avoiding adverse effects on financial stability may affect*

[148] Banking Communication 2013/C 216/01.

[149] Recital 61, *BRRD*.

the equal treatment of creditors."[150] Consequently, there must be a public interest which justifies the use of this resolution tool and the interference with rights of shareholders and creditors should be compatible with the Charter of Fundamental Rights of the European Union.

The sale process should be open, transparent and non-discriminatory and should aim to maximize sale price.

Authorities may use the bridge institution tool in order to maintain critical functions. As set out in Article 40(2) of the Directive "*The bridge institution shall be a legal person that meets all of the following requirements:*

(a) it is wholly or partially owned by one or more public authorities which may include the resolution authority or the resolution financing arrangement and is controlled by the resolution authority;

(b) it is created for the purpose of receiving and holding some or all of the shares or other instruments of ownership issued by an institution under resolution or some or all of the assets, rights and liabilities of one or more institutions under resolution with a view to maintaining access to critical functions and selling the institution or entity [..]".[151]

3.4.2 Asset Separation Tool

The asset separation tool has the purpose of separating good assets from bad assets of a distressed or failing institution. In particular, BRRD requires that Member States with the law implementing the Directive grant authorities the power to transfer assets, rights or liabilities of an institution under resolution or a bridge institution to assets management vehicles.

For the sake of speed of action the transfer may take place without obtaining the consent of the shareholders and without complying with any requirements under company or securities law.

The assets management vehicle should be wholly or partially owned by public authorities and needs to maximize, as far as possible, the value of assets received.

[150]Recital 13 *BRRD*.
[151]Article 40(2) *BRRD*.

Nevertheless the power to transfer assets is subject to strict conditions set forth in Article 42(5) of the Directive, where is requested that "*Resolution authorities may exercise the power [..] to transfer assets, rights or liabilities only if: (a) the situation of the particular market for those assets is of such a nature that the liquidation of those assets under normal insolvency proceedings could have an adverse effect on one or more financial markets.*
(b) such a transfer is necessary to ensure the proper functioning of the institution under resolution or bridge institution; or
(c) such a transfer is necessary to maximise liquidation proceeds."[152]

3.4.3 The Bail-in Tool

The Bail-in tool is the most discussed and innovative resolution tool introduced by the Directive and it was created as an alternative to the widely used bail-out. As we know, the bail-out is a measure taken by governments to rescue financial firms which have been recklessly operated in the financial markets and involve using public money to cover the big losses on financial firms' balance sheets with the purpose of avoiding the systemic risk connected with the failure of the firm. The bail-out has been described as a wrong way to ask for taxpayers' money to "*foot the bill for Wall Street mistakes*"[153].
Hence, on the one hand the bail-in works as an "anti-moral hazard" device, because if shareholders and creditors know from the beginning that no public rescue will take place and they will have to bear the losses of the institution themselves, they will be more cautious and will monitor the health of the institution during its normal course of business.
On the other hand the bail-in aims to preserve taxpayers' money from bearing costs of a failing institution.
Unlike liquidation, whereby assets are sold in order to deploy the proceeds among creditors and therefore the institution is helped to exit the market, the bail-in has as its goal to recapitalize the firm and allow it to continue operating as a going-concern. The bail in applies to up to 8% of liabilities. When losses affect the minimum capital base, common equity tier 1 items are reduced in proportion to the losses, and additional tier 1,

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[152]Article 42(5) *BRRD*.
[153]President Obama's statement.

tier 2 instruments and certain other liabilities (senior debt) are converted into capital. An independent valuation of the assets and liabilities of the institution shall therefore be undertaken before taking resolution action or exercisingthe power to write down or convert relevant capital instruments. This valuation shall "*not assume any potential future provision of extraordinary public financial support or central bank emergency liquidity assistance or any central bank liquidity assistance provided under non standard collateralization*"[154].

A bail in requires that banks' balance sheets have sufficient liabilities that can be bailed in, in a progressive and hierarchical manner. The bail in can apply to all liabilities, with the exception of covered deposits, covered bonds and other collateralized instruments, short-term liabilities, and liabilities related to fiduciary functions on the bank. In most cases, when this tool is applied management of the firm is replaced and the restructuring of the institution is carried out according to a business-restructuring plan.

The requirement to substitute the management is based on the assumption that the old management did not operate correctly, or at least efficiently, and was the cause that led the institution to default in the first place.[155] Therefore, according to the Directive, in order to effectively take a second chance on the institution it is appropriate to have its management replaced.

Bail in and Priority Matters

Recital 77 of the Directive says: "*Except where otherwise specified in this Directive, resolution authorities should apply the bail-in tool in a way that respects the pari passu treatment of creditors and the statutory ranking of claims under the applicable insolvency law. Losses should first be absorbed by regulatory capital instruments and should be allocated to shareholders either through the cancellation or transfer of shares or through severe dilution. Where those instruments are not sufficient, subordinated debt should be converted or written down. Senior liabilities should be*

[154]Article 37(5) *BRRD*.

[155]There is large debate among Academics on whether corporate governance plays an incisive role in banks' default. An affirmative response is given by LANG & JAGTIANI, who say that senior managers and the board of directors, when the housing bubble was inflating were not capable of recognizing risk exposures. Lang, W. & Jagtiani, J. (2010) The Mortgage and Financial Crises: The Role of Credit Risk Management and Corporate Governance. *Atlantic Economic Journal.* P.123-144.

converted or written down if the subordinate classes have been converted or written down entirely."

It is interesting to analyze how the bail in tool combines with creditors classes, as we acknowledged that even though shareholders bear losses first the second step through recapitalization of the firm is to rely on credits.

First capital instruments will uphold the losses and shareholders will see their shares cancelled or diluted, afterwards, if this measure is not sufficient loss absorption will involve credit issuers. Even though in order to ensure the effectiveness of the bail in tool this should be applied to as wide a range of unsecured liabilities as possible – therefore leaving out secured or collateralized liabilities- some types of unsecured liabilities should be exempted from the reach of the bail in. In fact,as the protection of covered depositors is one of the most important objectives of resolution, covered deposits should not be subject to the exercise of the bail-in tool. The deposit guarantee scheme should, however, absorb losses to the extent of the net losses that it would have had to suffer after compensating depositors in normal insolvency proceedings. In general, the bail in should not apply to covered deposits in order to protect covered deposits' holders, it should not apply to certain liabilities to employees of the failing institution or to commercial claims that relate to goods and services critical to the daily functioning of the institutionin order to ensure continuity of critical functions and it should not apply to the failing institution's liabilities to a pension scheme to honor pension entitlements and pension amounts owed or owing to pension trusts and pension trustees.[156]

The Directive, in Article 44(3) provides that in some cases, certain liabilities may be exempted from the write-down or conversion powers. This exemption should be justified by exceptional circumstances, listed in the Article. To be more specific, the aforementioned circumstances include:

"(a) it is not possible to bail-in that liability within a reasonable time notwithstanding the good faith efforts of the resolution authority;

(b) the exclusion is strictly necessary and is proportionate to achieve the continuity of critical functions and core business lines in a manner that maintains the ability of the institution under resolution to continue key operations, services and transactions;

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[156]Recital 70 *BRRD*.

(c) the exclusion is strictly necessary and proportionate to avoid giving rise to widespread contagion, in particular as regards eligible deposits held by natural persons and micro, small and medium sized enterprises, which would severely disrupt the functioning of financial markets, including of financial market infrastructures, in a manner that could cause a serious disturbance to the economy of a Member State or of the Union; or

(d) the application of the bail-in tool to those liabilities would cause a destruction in value such that the losses borne by other creditors would be higher than if those liabilities were excluded from bail-in."[157]

The tools with which authorities are provided under the BRRD have as their main objective the increase of speed of action and the minimization of systemic risk. Sometimes these two are somehow related. If authorities do not act promptly the distress of the institution may have a contagion effect towards other institutions and bring fear within the market, which may disrupt the functioning of the market itself.

3.5 Financial Contracts and Derivatives

Under the BRRD derivatives have a peculiar treatment. Liabilities arising from derivatives may be written down or converted as other unsecured liabilities. Nevertheless the conversion powers shall be exercised by authorities only upon or after closing out the derivatives, for this purpose authorities shall be empowered to terminate and close out any derivative contract when the institution enters into resolution.[158]

When authorities exercise their power to terminate derivatives and these transactions are subject to a netting agreement, the resolution authority or an independent valuer shall determine the liability arising from those transactions on a net basis, pursuant to the terms of the agreement. Article 49(4) of the Directive provides that

"*Resolution authorities shall determine the value of liabilities arising from derivatives in accordance with the following:*

(a) appropriate methodologies for determining the value of classes of derivatives, including transactions that are subject to netting agreements;

[157] Article 44(3) *BRRD*.
[158] Article 49(2) *BRRD*.

(b) principles for establishing the relevant point in time at which the value of a derivative position should be established; and

(c) appropriate methodologies for comparing the destruction in value that would arise from the close out and bail-in of derivatives with the amount of losses that would be borne by derivatives in a bail-in."[159]

3.5.1 Attempts made by the regulations to address the financial contracts problem

We have previously stated that complex financial institutions treat complex financial transactions by means of financial contracts and derivatives. Even though are considered "weapons of mass destruction"[160] derivatives represent a big number on financial institutions' balance sheets and hence they deserve a punctual regulation.

The U.S Bankruptcy Code exempts derivative contracts from the automatic stay, which is one of the crucial devices for reorganization purposes, as it prevents creditors to attack the property of the estate and impede the debtor to reorganize its business effectively. We have explained earlier that the exemptions of financial contracts from the automatic stay is considered necessary not to "drain liquidity" from the market[161] but we have also demonstrated that the exercise of termination rights upon failure of an institution may be itself an event that triggers systemic risk[162]. American legislation before and European legislation following, attempted to take legislative measures meant to regulate the treatment of financial contracts, and a special focus should be put on clearing organizations, or "clearing houses". In order to evaluate the innovation of these entities it is necessary to point out very briefly the legal framework for derivatives in the United States before the Dodd-Frank Act.

The first comprehensive federal government regulations on commodities futures[163] were established in the Commodities Exchange Act of 1936, but the real evolution in the regulations took place when the Commodity Futures Trading Commission ("CFTC" or

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[159]Article 49(4) *BRRD*.

[160]Warren Buffet's interview Financial Times.

[161]See §1.3.2

[162]Id.

[163] A future is one type of derivative contract. It is a standardized contract whereby the parties initially agree to buy and sell an asset for a price agreed upon today with delivery and payment occurring at a future date, the *delivery date*.

“the Commission”) was created, after the Congress passed the Commodity Futures Trading Commission Act in 1974. The CFTC has jurisdiction over futures and futures exchanges. More specifically, it has regulatory jurisdiction over “agreements [..] and transactions involving contracts of sale of a commodity for future delivery traded or executed on an exchange”. In order to determine whether CFTC has jurisdiction over a transaction the element to look at is whether actual delivery of the underlying asset is contemplated.[164]

The Commodity Exchange Act also deals with swaps[165]. Nevertheless, before the Dodd-Frankthe CFTC had exempted swap agreement from any regulations with the sole warning that parties to the swap should be “eligible swap participants”, which substantially ended up being only large institutions. As a matter of fact swaps are classified as an OTC financial instrument and, previously, most swap transactions were conducted on the OTC market and were not cleared by a central party in any way[166]

The “powers” or jurisdictional mandate of the CFTC are supplemented in Section 722 of the Dodd-Frank, where the Commission is allowed to regulate swaps and swap execution facilities, while Section 712[167] reviews the changes in the mandate, not only of the CFTC but also of the Securities and Exchange Commission (SEC). Both the CFTC and the SEC are meant to coordinate and consult in creating and implementing new rules across their respective jurisdictions. The CFTC has (expanded) authority to promulgate rules regarding oversight of financial instruments including swap, swap dealers and participants, swap repositories and derivatives clearing organizations (“DCOs”), while the SEC’s expanded authority now includes security-based swaps. In the scheme formulated by the Dodd-Frank Act a DCO is extremely important, because all swaps must be cleared by a clearing organization. An objective of Title VII of the Dodd-Frank Act is to create a structure and incentives to expand pre- and post-execution transparency for swaps and security-based swaps and contain the consequences of the failure of a party with a massive swaps position.

A DCO is defined as an organization that allows the party to a transaction to substitute the credit of the DCO for the credit of the parties, provides settlement or netting of

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[164]Cadmus. E.H. (2012). An Altered Derivatives Marketplace: Clearing Swaps Under Dodd-Frank. *Fordham Journal of Corporate and Financial Law.* Vol. XVII. P.190-226.

[165] A swap is a derivative contract whereby parties exchange (swap) cash flows at a specified date.

[166] See *supra* note 50.

[167]the Dodd-Frank Act § 712.

obligations, or otherwise arranges for services that transfer the risk arising out of the transaction[168]. For the sake of simplicity we may define a clearing organization as a central counterparty, hence the buyer of every seller and the seller of every buyer on the swap market.

Nevertheless the need for a central counterparty for OTC derivatives was not an American discovery, in fact, in the G20 of 2009 leaders agreed that, by the end of 2012, all standardized OTC derivatives should be cleared through a so-called clearinghouse and reported to trade repositories. What the US legislation did with Dodd-Frank in 2010, namely requiring central clearing of derivatives, was done by EU legislation two years later with the enactment of the European Market Infrastructure Regulation (EMIR)[169]. The EU Parliament and Council acknowledge that "*[OTC derivative contracts] lack transparency as they are privately negotiated contracts and any information concerning them is usually only available to the contracting parties. They create a complex web of interdependence which can make it difficult to identify the nature and level of risks involved. The financial crisis has demonstrated that such characteristics increase uncertainty in times of market stress and, accordingly, pose risks to financial stability*."[170] Therefore they aim to mitigate those risks and increase transparency by imposing mandatory clearing of swaps through a central counterparty.

3.5.2 Unresolved Matters: Clearinghouses like Sifis.

Central clearing of transaction generally happens through novation and involves the creation of two new perfectly offsetting contracts and improvement of liquidity in the market. The clearinghouse assumes the risk of default of its clearing members, thus eliminating the counterparty's risk. Under this mechanism the clearinghouse assumes the credit risk of the transactions it clears but it bears a very high default risk in case of its own failure. This is the reason which made authors (HENKEL, 2013) state that the central counterparty is effectively a systemically important financial institution which

[168] 7 U.S.C. § 1(a)(15).
[169] Council Regulation 648/2012. Available at: http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32012R0648.
[170] Id. at (4).

might threaten financial stability should it collapse[171]. A clearinghouse failure may lead to a temporary breakdown inside the market. The system through which positions are established, set off, closed out would be disrupted. The mitigation of this risk relies on some reinforcing mechanisms present in both American and European regulations. In Dodd-Frank it is required that the clearing organization have adequate financial resources to "discharge each responsibility of the derivatives clearing organization" and a minimum amount of financial resources which should be consistent enough to cover the default of the member creating the largest financial exposure[172]. Under EMIR takes place a mechanism known as a "default waterfall". The first line of defense may be a restriction of membership: central counterparties may set their own membership criteria based on creditworthiness and operational capability. Another line of defense may include the imposition of collateral requirement. If the posted collateral is not sufficient to offset any losses, the central counterparty may access default funds set up for this purpose by the defaulting member. The very last resort for offsetting losses may be the central counterparty's own capital.[173]

Several times we have affirmed that safe harbors might be a dangerous device and this feature is maintained even when they involve clearinghouses. Under EMIR, if a clearing member becomes insolvent and files forbankruptcy, the positions of the insolvent clearing member's clients held inclient accounts may be transferred directly to another non-defaulting clearingmember. Clients are institutions having a contractual relationship witha member of a central counterparty, allowing them to clear required transactionsthrough the clearinghouse without being a clearing member. The transfer from theaccount of the insolvent member to a so-called back-up clearing member iscalled porting. Porting is part of the default procedure of central counterparties requiringstrict segregation of clients' funds and prohibiting the pooling of client fundsor distribution. Nevertheless, porting may also be described as a safe harbor for clientsof insolvent clearing members. While client positions may be comparable todeposits in bank accounts, the sanction of pooling effectively treats clients ofan insolvent clearing member as creditors in a preferential manner comparedto other creditors of the clearing

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[171]Henkel, C. (2013). Harmonizing European Union Bank Resolution: Central Clearing of OTC Derivative Contracts Mantaining the Status Quo of Safe Harbors. *Transnational Law and Contemporary Problems.* Vol. 22 n.81. P.82-113.
[172]Dodd-Frank Act §725(B)(ii).
[173]*Supra* note 57.

member. Clients ofclearing members are sophisticated market participants that might have potentially become clearing members themselves. As such, they should also be obligated topractice proper risk management, which is not encouraged through porting.Creating safe harbors for clients of clearing members may therefore diminishthe overall benefit of clearing OTC derivatives through a system of central counterparties.[174] Even though not carried out through specific provisions, an expansion of safe harbors occurs in european legislation running counter to its goals.

Conclusions

It is useful to remark the reason for which all legislations have adopted insolvency regulations: without any types of rules on insolvency, any claimant over the remainders of the common pool might drain the pool to satisfy their own interests and leave nothing for those who exercise their entitlements less swiftly. Nevertheless, insolvency law serves various others purposes within a legal system, or more generally, a social system. In particular, the fact that a troubled business or a distressed institution might be forced to terminate their activities, liquidate and eventually cease to exist, is a powerful instrument against moral hazard. Moral hazard occurs when unconscious and risky activities are undertaken due to the certainty of a public rescue.

As we have seen, insolvency procedures vary from Continent to Continent and from State to State. The literature in the fields of law and economics has traditionallydistinguished the American soft approach to bankruptcy fromthe tough one of European legislators. Recently, this dichotomy hasbeen put at stake by a process of convergence due to the adoption,in major European countries, of bankruptcy codes inspired byAmerican Chapter 11. Cornerstone for the harmonization process has especially been a recent draft directive published by the EU Commission on insolvency, restructuring and second chance[175]. This draft ("The Proposals") is not yet law but its ultimate objective is, in fact, the harmonization of insolvency rules within the European borders. The Proposals have as a source the acknowledgement that insolvency matters

[174]Id.

[175]Proposal for a directive of the European Parliament and the Council on preventive restructuring frameworks, second chance and measures to increase the efficiency of restructuring, insolvency and discharge procedures and amending Directive 2012/30/EU. Published on 22 November 2016.

have an enormous impact on the European markets. They are a deterrent for cross-border expansion and investments. Many investors mention uncertainty over insolvency rules or the risk of lengthy or complex insolvency procedures in another country as a main reason for not investing or not entering into a business relationship outside their own country. A higher degree of harmonization in insolvency law is thus essential for a well-functioning single market and for a true Capital Markets Union. The Proposals are divided in three main parts: a preventive restructuring framework; a second chance for entrepreneurs; and measures to raise the efficiency of restructuring, insolvency and second chance more generally. The most significant part to the end of harmonization is the preventive restructuring framework, where are provided common core elements for each State. It has been commented by many that the core elements set forth by The Proposals might draw the European framework on insolvency close to American Chapter 11. In point of fact, various essentials of Chapter 11 Bankruptcy are proposed, including the debtor-in-possession model, the automatic stay of individual enforcement actions and the judicial cram-down of the restructuring plan. According to The Proposals, Member States shall ensure that debtors accessing preventive restructuring procedures remain at least partially in control of their assets and the day-to- day operation of the business. Furthermore, Member States shall ensure that debtors who are negotiating a restructuring plan with their creditors may benefit from a stay of individual enforcement actions to the extent such a stay is necessary to support the negotiations of a restructuring plan. The stay may be ordered in respect of all types of creditors, including secured and preferential creditors. It is noteworthy that these features, which constitute the most distinctive traits of American Chapter 11 and, therefore, in American legislation their effectiveness is triggered by the filing of a bankruptcy petition, are reproduced in The Proposals as provisions which are meant to come into effect before the occurrence of failure, in the implementation of the preventive restructuring measures. It seems that the process of convergence between American and European Insolvency law is reaching an advanced stage with the acknowledgement of the points of major strength of the American Bankruptcy system, i.e. the automatic stay of §362[176].

[176]§362 U.S. Bankruptcy Code.

Undoubtedly harmonization represents the only possible way for an effective discipline to deal with insolvency matters at European level.
The elimination of divergences between Member States has always represented the ideal solution to many of the problems afflicting the Union and the achievement of this goal through the adoption of core elements derived from the efficient modules of the American legislation is a process that has just started and is not likely to cease any time soon.

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