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Testimony of Professor Lubben before U.S. House Financial Services Subcommittee on Financial Institutions and Consumer Credit regarding Orderly Liquidation Authority and Too Big to Fail

Washington, D.C. -- June 14, 2011

Chair Capito and Distinguished Members of this Subcommittee:

I am the Daniel J. Moore Professor of Law at Seton Hall University School of Law in Newark, N.J. I have been at Seton Hall since entering academia in 2002, and I teach Bankruptcy, Business Associations, Corporate Finance, and Financial Institutions at the Law School. I also comment on debt and financial distress for the New York Times' *Dealbook* blog, and write about corporate bankruptcy for *Credit Slips*.

Before entering academia, I was an associate for several years with the law firm of Skadden, Arps, Slate, Meagher & Flom in New York and Los Angeles, where I specialized in corporate reorganization.

I was asked by Committee staff to address the broad topic of the Dodd-Frank Act's Orderly Liquidation Authority (OLA) and the specific issue of whether Dodd-Frank had ended "too big to fail."

Taking the last issue first, the notion of ending too big to fail is subject to many definitions. If we mean that we could now liquidate, in a chapter 7-bankruptcy sense, a large financial institution without severe disruption to the financial markets, then Dodd-Frank clearly fails the test

While Dodd-Frank OLA provides for the ultimate liquidation of a financial institution, it does so in a fashion that is closer to a liquidation under chapter 11 of the Bankruptcy Code. Moreover, the orderly liquidation of financial institutions under OLA is primarily achieved by virtue of the FDIC's ability to provide ongoing liquidity to the financial institution, which many would consider a form of bailout of the financial institution's counterparties.

In short, Dodd-Frank does not end too big to fail if by that term we mean it is possible for a large financial institution to fail without government assistance and not thereby dislocate the financial markets. On the other hand, one might question whether such a goal is politically feasible or realistic, given the significant changes it would require to our financial system as it currently exists.

Turning to the broader issue of Dodd-Frank's Orderly Liquidation Authority, while I think that OLA improves in some respects on chapter 11, OLA created unneeded uncertainty with regard to the resolution of financial institutions and missed the opportunity to integrate the OLA process into the broader structure of insolvency law.

Before beginning this discussion, I should note that much of the functioning of OLA depends on regulators' actions before the onset of financial distress. For example, enforcement of the "living wills" provisions of Dodd-Frank in a way that produces realistic, and up-to-date plans for resolution of the financial institution will make all the difference when it comes time to actually use OLA.

Likewise, it will be vital that regulators use their power to demand rationalization of corporate structures if OLA is going to have any chance of success. Robust capital and collateral requirements, with minimal loopholes, obviously help avoid the need for OLA and the effects of financial distress when it does occur.

With regard to the things Dodd-Frank OLA gets right, I think they can be summarized in two words: speed and financing. OLA speeds up the already quick chapter 11 timeline – seen in cases like Lehman, GM, and Chrysler – to allow the sale of the financial institution on the very first day of the case. Quick formulation and implementation of resolution plans is key if financial distress is to be contained.

Similarly, because financial institutions depend on each other to a degree that Ford does not depend on Chrysler, it is extremely important that a distressed financial institution publicly demonstrate its ability to perform on its obligations on day one of any insolvency proceeding. Moreover, liquidity buys the financial institution time, which it needs for its asset values to stabilize.

This vital liquidity might be provided by private DIP lenders, but at the very least one would want to have a government "backstop" in cases where the lending market entirely shuts down – such as occurred immediately after the Lehman collapse.

Moreover, private DIP financing for a financial institution of any significant size would likely be beyond the market's ability to provide, even in good times. And it is unlikely that many financial intuitions will fail in good times.

Thus, I think it is very commendable that Dodd-Frank OLA provides for FDIC financing of the financial institution pending resolution. This provision will ensure that the financial institution's distress does not spread to its counterparties.

On the other hand, the failure to specify when OLA will apply has created unnecessary confusion. Instead of replacing chapter 11, OLA simply supplants chapter 11 when regulators decide it should. Thus, most financial holding companies remain subject to chapter 11, except for when they are subject to OLA.

The confusion in this regard has been exacerbated by the FDIC's recent decision to denigrate chapter 11 while promoting its hypothetical resolution of Lehman under OLA. This suggests that FDIC does not see chapter 11 as a workable solution for financial institutions, while chapter 11 nonetheless remains the default options for such institutions.

It would have been preferable to apply OLA to a set of financial institutions in all situations, removing the need to guess what a particular Treasury Secretary might do with regard to any particular institution.

Similarly, OLA would better function if it applied to the whole of the financial institution. As it stands now, broker-dealers are partially within OLA and partially within their normal SIPA resolution procedures, while banks and insurance companies are entirely outside of OLA. The only piece of the enterprise that is entirely within OLA is the holding company and its unregulated subsidiaries, but even then they are subject to the previously mentioned confusion about when OLA applies.

The enactment of Dodd-Frank provided an opportunity to create a single forum for resolution of distressed financial intuitions, and it is unfortunate that this opportunity was not realized.

I think there is also real concern about the FDIC's ability to adequately staff the resolution proceedings if several financial institutions encounter distress in quick succession. For example, if OLA had been in effect in the past crisis, FDIC would have had to address Wachovia, Merrill, Lehman, AIG, Citibank, Washington Mutual, and perhaps others almost simultaneously.

It might have been better to adopt something like the chapter 11 model, which relies on private professionals to handle the bulk of the work. Moreover, such an approach ensures that the cost of resolution is internal to the financial institution and thus incurred by its shareholders and junior creditors.

While FDIC asserts that this will be so under OLA, it is not clear that administration of OLA proceedings will not be at least partially subsidized (for example, does FDIC intend to charge overhead to the financial intuitions it resolves?). And in any event, there remains the larger question of FDIC's ability to staff multiple simultaneous resolutions, especially if such resolutions occur during a broader banking crisis that would implicate FDIC's other responsibilities.

Finally, OLA might be better off if it did not rely so much on the bank receiver model, with all the opacity that such a system entails. Without a doubt resolution necessitates pre-planning that happens outside the public eye – but that happens in chapter 11 and SIPA proceedings too.

The decision to put initial review of the case in a secret proceeding in front of the D.C. District Court, a court not particularly known for its insolvency expertise, and place FDIC in charge of all aspects of the resolution process thereafter strikes me as misguided. Transparency and speed are not necessarily incompatible – the sale hearing in Lehman proves that. And transparency is exactly what was lacking in the resolutions of Bear Sterns, AIG, and the apparent resolution of Citibank. OLA will find much greater public acceptance if it is recast with some public window into the proceedings.

More broadly, our financial markets would be well served if OLA were re-formed in a way that increased the transparency and certainty of the process. One key step in achieving this goal will be to better examine how the OLA fits with the existing insolvency systems, such as chapter 11, FDIA, SIPA, and the state insurance receivership statutes.

I appreciate the opportunity to appear before the Committee today to share my views and look forward to any questions.

United States House of Representatives
Committee on Financial Services

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Clause 2(g) of rule XI of the Rules of the House of Representatives and the Rules of the Committee on Financial Services require the disclosure of the following information. A copy of this form should be attached to your written testimony.

1. Name:

Stephen J. Lubben

2. Organization or organizations you are representing:

n/a

3. Business Address and telephone number:

[redacted]

4. Have you received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2008 related to the subject on which you have been invited to testify?

☐ Yes ☑ No

5. Have any of the organizations you are representing received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2008 related to the subject on which you have been invited to testify?

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