August 20, 2014

Against Regulatory Displacement: An Institutional Analysis of Financial Crises

Jonathan C. Lipson, Temple University

Available at: https://works.bepress.com/jonathan_lipson/5/
AGAINST REGULATORY DISPLACEMENT: AN INSTITUTIONAL ANALYSIS OF FINANCIAL CRISSES

JONATHAN C. LIPSON*

Please do not cite or quote without the author’s permission

This paper uses “institutional analysis”—the study of the relative capacities of markets, courts, and regulators—to make three claims about financial crises.

First, financial crises are increasingly a problem of “regulatory displacement.” Through the ad hoc rescues of 2008 and the Dodd-Frank reforms of 2010, regulators displace market and judicial processes that ordinarily prevent financial distress from becoming financial crises. Because regulators are vulnerable to capture by large financial services firms, however, they cannot address the pathologies that create crises: market concentration and complexity. Indeed, regulators may inadvertently aggravate these conditions through resolution tactics that consolidate firms, and the volume and complexity of regulation.

Second, I show how markets and courts have historically interacted (“braided,” in the language of contract theory literature) to create incentives to renegotiate financial distress, thus reducing the likelihood of crises. Regulators and markets braid, too. But, large financial firms will dominate the interactions to increase concentration and complexity, and thus create social costs without compensating benefits.

Third, I suggest that courts—once a bulwark against regulatory displacement—should reassert their role by more rigorously scrutinizing directors’ oversight of large financial firms. Corporate directors are likely better positioned than regulators to monitor and reduce concentration and complexity. Potential liability for failing to understand risk (due to scale and complexity) would create market incentives for directors to be more effective monitors, or to simplify financial-firm structures, or both. A reinvigorated judicial role would also promote rule-of-law values in financial crisis management, where they have been sorely lacking.

*Harold E. Kohn Professor of Law, Temple University-Beasley School of Law. I thank Daniel Bromley, Anuj Desai, Jeff Dunoff, Craig Green, Richard Hynes, Neil Komcsar, Greg Mandel, Kathleen Noonan, Mark Roe, William Simon, and David Skeel for comments and suggestions, and Jessie Bohl, Adria Crowe, Arthur Kerwin, Greg Lockwood, Erica Maier, Minli Tang, and Jeannine Zabrenski for research and administrative assistance. I also thank Cary Coglianese for inviting me to brief an earlier version of this paper at Regblog.org. Dean JoAnne Epps (Temple Law School) and Dean Margaret Raymond (University of Wisconsin Law School) provided generous financial support for this project, for which I am grateful. Prior versions of this paper were presented at Tsinghua University Law School, Renmin (People’s) University (Beijing), The University of Wisconsin Law School, and Temple Law School. Errors and omissions are mine, alone. © 2014 Jonathan C. Lipson, all rights reserved.
TABLE OF CONTENTS

INTRODUCTION ......................................................................................................................... 1
1. Concentration, Complexity, and Capture—The Doom Loop.................................................. 6
   1.1 Concentration .................................................................................................................. 6
   1.2 Complexity .................................................................................................................... 9
   1.3 Capture ........................................................................................................................ 11
2. Theories of Institutional Choice ........................................................................................... 13
   2.1 The Contribution of Hart & Sacks: Institutional Settlement ............................................ 14
   2.2 The Contribution of Komesar—Comparative Institutional Analysis ............................... 17
   2.3 The Contribution of Gilson, Sabel and Scott—“Braiding” .............................................. 19
3. An Institutional Analysis of Financial Distress Systems ...................................................... 20
   3.1 Market Resolution ......................................................................................................... 20
   3.2 Judicial Resolution ........................................................................................................ 23
   3.3 Regulatory Resolution ................................................................................................. 26
4. Dodd-Frank and Regulatory Displacement .......................................................................... 30
   4.1 Orderly Liquidation Authority ..................................................................................... 30
   4.2 Single Point of Entry .................................................................................................... 33
5. Against Regulatory Displacement—Judicial Responses ....................................................... 36
   5.1 Bankruptcy Code Chapter 14 ....................................................................................... 37
   5.2 Duty to Be Informed ..................................................................................................... 40

CONCLUSION ............................................................................................................................. 45
AGAINST REGULATORY DISPLACEMENT: AN INSTITUTIONAL ANALYSIS OF
FINANCIAL CRISSES

"They should have let Bear Stearns fail"

Introduction

As we gain perspective on the financial crisis of 2008, it becomes increasingly clear that institutional choice will affect the likelihood and severity of future crises. “Institutional choice” means that different large-scale social processes—here, markets, courts, and regulators—have different capacities to prevent or minimize the effects of financial distress that could cascade into crises. 2 Although scholars have begun to recognize that financial distress has an institutional dimension, they have largely failed to analyze institutional choice.

I use the literature of institutional analysis to undertake this project. 4 “Institutional analysis” starts from the premise that most social institutions could solve most problems most of the time, but some will do so better than others. The important questions are: Which among them best solves which problems, and how are those choices to be made?

Institutional analysis answers these questions as a function of “participation.” Those who have the most at stake will choose the institution that best serves their perceived needs. 5 In the case of financial distress, for example, markets have historically been the dominant institutional choice. 6 If Firm A defaults on its debt, it will most likely negotiate restructured debt contracts with its creditors. This means that market participation solves the problem. If Firm A cannot agree to revised terms with its creditors, some or all of them may go to bankruptcy court. Stakeholders would then participate in a judicial process that would either

---


2 For discussions of the distinction between isolated failures and crises that induce panic, see, for example, CHARLES P. KINDLEBERGER & ROBERT Z. ALBER, MANIAS, PANICS AND CRASHES (6th ed. 2011); Charles W. Calomiris & Joseph R. Mason, Fundamentals, Panics, and Bank Distress During the Depression, 93 AM. ECON. REV. 1615 (2003); Douglas W. Diamond & Philip H. Dybvig, Bank Runs, Deposit Insurance, and Liquidity, 91 J. POL. ECON. 401 (1983).

3 See discussion in Part 3, below. A notable exception is David Skeel’s excellent paper, David A. Skeel, Jr., Institutional Choice in an Economic Crisis, 2013 WIS. L. REV. 629, 630 (2013).


5 See KOMESAR, 1994, id. See also the discussion in Part 2.2

6 See discussion in Part 3.1.
holding. Market and judicial efforts at—s as the institutional choice to prevent or 14 12.  Asset
available at 9 14 12.  ages
available at 9 14 12.  C:

The Supreme Court has FDIC resolution of the bank subsidiary. The bank holding company (BHC) is not the bank itself, however: It is the parent corporation of the bank. See discussion in Part 3.3.

Why a regulatory resolution for banks but not other types of firms? Again, participation is the answer. Banks presumptively lend long (e.g., 30-year mortgages) and borrow short (on demand) from widely dispersed retail depositors who lack the skill or resources to negotiate with the bank if it gets into trouble. Market and judicial efforts at bank resolution would be much worse than regulatory resolution, because these processes would reveal the bank’s condition. This would cause panic and cascades of defaults—the very things the bank regulatory system means to prevent. Thus, banks were “special,”31 and so required a special failure regime.

The financial crisis changed this, both through regulators’ ad hoc market interventions and through increased power given to regulators under the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank), the main reform after the crisis.12 Regulators’ growing role in this context results in “regulatory displacement”: Regulators increasingly displace markets and courts as the institutional choice to prevent or resolve financial distress.

New accounts of the crisis by key regulators such as Tim Geithner (then President of the New York Federal Reserve Bank)13 and Henry Paulson (then Secretary of the Treasury)14

7 See discussion in Part 3.2.

8 Insurance companies and certain stock brokerages are also subject to regulatory resolution. Because Dodd-Frank is modeled on the bank failure system, I do not discuss these other systems. See discussion in Part 3.3.


10 Of course, bank holding companies can into bankruptcy. The bank holding company (BHC) is not the bank itself, however: It is the parent corporation of the bank. See 12 U.S.C. § 1841(a)(1) (“‘bank holding company’ means any company which has control over any bank or over any company that is or becomes a bank holding company by virtue of this chapter.”). If a BHC goes into bankruptcy, it will often do so in concert with an FDIC resolution of the bank subsidiary. See, e.g., In re Washington Mutual, Inc., et al., No. 08-12229 (Bankr. Del.). The Supreme Court has assessed the relationship between bankruptcy and the regulation of bank holding companies in Bd. Of Governors of the Fed. Reserve Sys. of the U.S. v. MCorp Fin., Inc., 502 U.S. 32, 37-42 (1991) (sustaining Federal Reserve supervisory power over bankruptcy stay).


13 TIMOTHY F. GEITHNER, STRESS TEST, REFLECTIONS ON FINANCIAL CRISIS, 133 (New York 2014).

14 Hank Paulson, This is What it was Like to Face the Financial Crisis, BLOOMBERG BUSINESSWEEK, Sept. 12, 2013, available at http://www.businessweek.com/articles/2013-09-12/hank-paulson-this-is-what-it-was-like-to-face-the-financial-crisis (visited Aug 6, 2014).
show how this happened. They saw themselves as the first line of defense against financial crisis for large financial firms, whether banks or nonbanks, displacing markets and courts. These firms, in turn, chose regulators, because they believed that regulators would provide greater protection at lower individual cost than markets or courts.

Consider, for example, Geithner’s response when he learned in March 2008 that Bear Stearns, a large non-bank financial services firm, planned to commence a bankruptcy case: “Yikes!” Its “failure”—by which Geithner meant bankruptcy—would “trigger[] a chain reaction of fear and uncertainty that could imperil the entire system.” Thus, when it subsidized JPMorgan Chase’s acquisition of Bear, Geithner acknowledged that the Federal Reserve (“Fed”) “cross[ed] a line [that it] had not crossed since the Great Depression, indirectly lending to a brokerage house that was supposed to function outside the bank [regulatory] safety net.”

In retrospect, this was a poor institutional choice. If Bear Stearns had been forced to use market or judicial resolution processes, managers of other large financial firms would have done the same. Because Bear’s counterparties were not retail depositors, but other sophisticated financial firms, market negotiations or judicial resolution would have redistributed losses in a more fair and efficient way than regulatory intervention. This would have reduced (but of course not eliminated) the damage from the crisis. Nevertheless, throughout the crisis, the Fed “crossed the line” repeatedly. Worse, it did so unpredictably: It crossed the line to bail out AIG, but simultaneously refused to do so for Lehman Brothers, which was forced into bankruptcy. The Fed and Treasury radically expanded de facto resolution powers through the crisis, largely immune from judicial scrutiny or the rule-of-law values courts tend to advance.

15 Geithner, supra note 13, at 149. Although “only the seventeenth largest U.S. financial institution at the time”—and not a bank subject to Federal Reserve regulation—it was, in Geithner’s view “completely enmeshed in the fabric of the financial system. It had four hundred subsidiaries. It had trading positions with five thousand counterparties around the world.” Id. at 150.

16 Id. at 151.

17 Id.


19 The story of the financial crisis—from Bear Stearns through AIG—is told by many authors. A leading summary appears in the FCIC Report, supra note 18. Of course, regulators did not act without political cover. In particular, they sought and obtained Congressional support for their actions under the Troubled Asset Relief Program. Emergency Economic Stabilization Act of 2008, Pub. Law No. 111-343, §121(a), (f), 122 Stat. 3765, 3788, 3790.

Dodd-Frank was enacted on the promise that there would be “no more bailouts.” 21 Few believe this. 22 Its “orderly liquidation authority” gives regulators the power to seize a much broader range of firms than just banks—any firm that regulators deem to be “systemically important financial institutions” (SIFIs). While there is a very modest judicial check on this, David Skeel has observed that “Dodd-Frank enshrines a system of ad hoc interventions by regulators [] divorced from basic rule of law constraints. The unconstrained regulatory discretion reaches its zenith with the new resolution rules for financial institutions in distress.” 23 The current proposal to operationalize the resolution authority through a so-called “single point of entry”—which would give regulators the power to seize the parent company in a large corporate structure—does nothing to address this. 24 Dodd-Frank codifies regulatory displacement.

This paper uses institutional analysis to make three claims about regulatory displacement.

First, institutional analysis provides a systematic way to compare the capacities of markets, courts, and regulators to prevent and resolve financial crises, and thus to determine how regulatory displacement arises and becomes problematic. I draw from literature on the “braiding” of formal and informal contracts to show that in the context of financial distress, different institutions also braid. 25 Markets and courts tend to reinforce one another through debt restructuring or asset liquidation. In most cases, they should be the first line of defense against crises, because they tend to reduce information asymmetries, effectively align incentives, and thus produce outcomes that are, broadly speaking, more likely to be interpreted as legitimate. Regulators, too, braid with markets, but this can be problematic, as

---

21 According to The Federal Register, “Regulations and other documents issued under the Dodd-Frank Wall Street Reform Act are intended to promote the financial stability of the United States by improving accountability and transparency in the financial system, to end “too big to fail” bailouts of financial companies, and to protect consumers from abusive financial services practices.” Dodd-Frank Wall Street Reform, Fed. Reg., available at https://www.federalregister.gov/dodd-frank-wall-street-reform (accessed Aug. 15, 2014);

22 DAVID SKEEL, THE NEW FINANCIAL DEAL: UNDERSTANDING THE DODD-FRANK ACT AND ITS (UNINTENDED) CONSEQUENCES [7] (2011) [hereinafter, “SKEEL, NEW DEAL”]. “The adjustments that purport to end bailouts and ad hoc interventions will do nothing of the kind. Although the restrictions on the Federal Reserve’s emergency lending authority are based on a valuable principle—that the Fed should not single out individual firms for rescue—they will not prevent future bailouts.”); VERN MCKINLEY, FINANCING FAILURE: A CENTURY OF BAILOUTS 283 (2011) (“Although the goal of ending taxpayer bailouts once and for all is a noble objective, the likelihood that the Dodd-Frank legislation has accomplished this is quite small.”). See also Peter Conti-Brown, Elective Shareholder Liability, 64 STAN. L. REV. 409, 412 (2012) (“Any policy reaction to bailouts must deal with [the] complexity [that] bailouts are almost always the wrong policy approach, except when they are not.”).

23 SKEEL, NEW DEAL, supra note 22, at [6].


25 See Part 2.2.
it reflects a “deep capture” that renders regulators the institutional preference of the regulated—large financial firms.  

Second, institutional analysis shows that regulatory displacement is problematic not only because regulators threaten rule-of-law values but—more practically—cannot attack the two pathologies that produce financial crises in the first place: market concentration and complexity.  

By forcing failed firms to consolidate, and promulgating mind-numbing regulation, regulators actually exacerbate concentration and complexity. The combination of concentration, complexity, and capture leave us in what Andrew Haldane calls a “doom loop,” an unsustainable cycle of boom and bailout.

Third, institutional analysis offers a solution to the problem of regulatory displacement: courts. As Hart and Sacks, founders of institutional analysis, observed many years ago, courts are the necessary counterweight to other institutions. I assess both a proposal to amend the Bankruptcy Code to add a “chapter 14” for large financial firms, and a novel proposal to subject directors of such firms to a heightened duty of oversight. While I find that the case has not yet been made to amend the Bankruptcy Code as proposed, taking directors’ duties more seriously in this context might produce better outcomes. It would likely lead to more actively engaged directors, or to smaller and simpler financial firms, or both. This judicial-market (braided) approach would seem better suited to prevent (or ameliorate) future crises than Dodd-Frank’s massive and unpredictable orderly liquidation authority. It would also do so in ways that advance rule-of-law values.

Thus, the title of this paper: It identifies and confronts the problem of regulatory displacement in the context of financial distress. Institutional analysis both explains the pattern and offers solutions.

The paper proceeds in five parts. Part 1 describes the underlying problems of concentration and complexity, and explains why capture prevents regulators from solving them. Part 2 develops a three-step framework for comparing institutional responses to financial distress and crises. Part 3 uses the framework from Part 2 to compare the capacities of markets, courts, and regulators to prevent and manage financial crises, and shows why large financial firms prefer regulators to markets or courts. Part 4 looks more deeply at the problem of regulatory displacement as it is currently playing out in proposals to operationalize Dodd-Frank’s orderly liquidation authority through the so-called “single point of entry,” seizure only of the parent (or top troubled) entity in a financial firm complex. Part 5 offers alternatives, assessing both proposed amendments to the Bankruptcy Code to accommodate the failures of large financial firms as well as a novel—and probably controversial—proposal that courts should more rigorously review directors’ discharge of their oversight duties.


27 See discussion in Part 1.3, below.


29 See Legal Process, supra note 4. See also discussion in Part 2.1.

30 See Part 5.
Institutional analysis cautions that no choice is optimal—we have only “imperfect alternatives,” as Neil Komesar has observed. Nevertheless, a failure to look closely at the choices we have, and to understand their costs and benefits, is vital if we wish to better manage the financial system to prevent or ameliorate future crises.

1. **Concentration, Complexity, and Capture—The Doom Loop**

In order to understand the work that institutional analysis can do, it is first important to understand the problem that it would solve. Haldane’s “doom loop,” noted in the Introduction, is the product of three problems: concentration in financial services, complexity in financial transactions and their regulation, and political cycles that result in regulatory capture. Being captured, regulators cannot be expected to reduce concentration or complexity. Indeed, they appear to contribute to both.

1.1 **Concentration**

Concentration is a compact reference to the “too big to fail” (TBTF) problem: some financial services firms will be so large in terms of assets and liabilities that the government will have no choice but to bail them out. Dodd-Frank was enacted on the promise that there would be no more bailouts. To the extent that financial firms continue to grow inversely in number and size—fewer but bigger—there is understandable fear that Dodd-Frank will fail.

Title I of Dodd-Frank sets forth rules meant to constrain concentration. In April 2014, banking agencies adopted a final rule requiring U.S. bank holding companies (BHCs) to reduce their leverage ratios. According to the Financial Stability Oversight Council created by Dodd-Frank (FSOC), “the rule is intended to constrain the buildup of financial leverage at the largest banking organizations and place additional private capital at risk before the Deposit Insurance Fund or government resolution mechanisms would need to be called upon.” Through the so-called “Volcker Rule” and stricter capital requirements, Dodd-Frank would also reduce firms’ leverage ratios. In this respect, it may render firms at least somewhat less concentrated.

---

31 See KOMESAR, 1994, supra note 4.
32 As President Obama argued in support of Dodd-Frank: “We will not go back to the days of reckless behavior and unchecked excess that was at the heart of the crisis, where too many were motivated only by the appetite for quick kills and bloated bonuses . . . [T]he old ways that led to this crisis cannot stand. And the extent that some have so readily returned to them underscores the need for change and change now. History cannot be allowed to repeat itself.” Barack Obama, Remarks by the President on Financial Rescue and Reform (Sept. 1, 2009), available at http://www.whitehouse.gov/the_press_office/Remarks-by-the-President-on-Financial-Rescue-and-Reform-at-Federal-Hall (accessed Aug. 17, 2014).
33 FSOC 2014 ANN. REP. 92. BHCs with over $700 billion in total consolidated assets or assets under custody of at least $10 trillion must maintain a 6 percent supplementary leverage ratio requirement, and domestic top-tier holding companies must maintain a 5 percent supplementary leverage ratio requirement. Id.
34 Id.
35 Section 619 of Dodd-Frank added the so-called “Volcker Rule” (name for former Federal Reserve Chairman Paul Volcker, who is credited as its chief architect). This would prohibit a banking entity “Banking entity” from “engag[ing] in proprietary trading” or “acquir[ing] or retain[ing] any equity, partnership, or other ownership interest in or sponsor[ing] a hedge fund or private equity fund.” Dodd-Frank Act sec. 619, § 13(a)(1) (amending the Bank Holding Company Act of 1956, 12 U.S.C.A. § 1841 (West 2010)).
Yet, observers have limited confidence in these efforts to reduce concentration or its risks. As Haldane notes, even using capital controls more stringent than those envisioned by Dodd-Frank, “an unexpected loss in a bank’s assets of just 4 per cent will be enough to render it insolvent.”37 A 2014 report by the United States Government Accountability Office (GAO) found that “recent regulatory reforms”—Dodd-Frank—“have reduced but not eliminated the likelihood the federal government would prevent the failure of one of the largest bank holding companies.”38 The inference is that the market perceives large banks to be too big to fail, and thus too concentrated.39

Observers believe that concentration has accelerated due to the repeal of the “Glass-Steagall” wall that separated commercial banking from non-depository financial services.40 Under the Glass-Steagall Act of 1933,41 commercial banks were separated from other, non-banking financial services businesses, such as investment banking, securities underwriting, and insurance, and prohibited from engaging in those activities, to the competitive disadvantage of commercial banks. The Gramm-Leach-Bliley Act of 1999 reduced or eliminated many of these barriers, making way for large complexes of “universal” financial services firms, one component of which might be a commercial bank.42 In theory, concentration is a problem that political action could correct, as those who would resurrect the Glass-Steagall wall have argued.43

The financial crisis of 2008 appears to have increased—not reduced—concentration. “Our biggest banks are bigger now than they were in 2008,” a recent story in Forbes explains, “when the Troubled Asset Relief Program dedicated billions of taxpayer dollars to make sure they didn’t fail. In part, that has happened because the government forced the merging of Merrill Lynch, Washington Mutual, Bear Stearns, Countrywide, and Wachovia into the largest banks, making them even larger.”44 Economist Philip Strahan concurs: “In the wake

37 Haldane, *Doom Loop*, supra note 28.


of the Financial Crisis of 2007–2008, it seems increased concentration in the financial industry has worsened the TBTF problem.” This suggests that Simon Johnson and James Kwak may be correct in arguing that we will ultimately be left with six “oligarch” banks.

The oligarchic character of concentration stems from growing mutual dependence between financial firms and the government that would regulate them. According to Alessandri and Haldane, the relationship between banks and government has long been deep and intimate, although the valence of influence has shifted over time. Historically, banks were lenders and governments were borrowers.

For the past two centuries, the tables have progressively turned. The state has instead become the last-resort financier of the banks. As with the state, banks’ needs have typically been greatest at times of financial crisis. And like the state, last-resort financing has not always been repaid in full and on time. . . . Today, perhaps the biggest risk to the sovereign comes from the banks. Causality has reversed.

The chief evil of concentration is that it seems to lead inevitably to a government subsidy for large banks. As John Coffee explains “The larger the bank, the cheaper it could borrow, in part because all assumed that the government would not allow the bank to fail. Seeing this subsidy, the shareholders and managers of such financial institutions rationally exploited it by taking on excessive debt and leverage.” This, in turn, presents problems of externality and moral hazard that few would defend.

47 Piergiorgio Alessandri & Andrew G. Haldane, Banking on the State, 139 B.I.S. REVIEW (2009) available at http://www.bis.org/review/r091111e.pdf?frames=0 (visited Aug. 17, 2014). They observe that this state of affairs reflects a profound shift in power: Historically, the link between the state and the banking system has been umbilical. Starting with the first Italian banking houses in the 13th century, banks were financiers of the sovereign. . . . For the past two centuries, the tables have progressively turned. The state has instead become the last-resort financier of the banks. As with the state, banks’ needs have typically been greatest at times of financial crisis. And like the state, last-resort financing has not always been repaid in full and on time. . . . Today, perhaps the biggest risk to the sovereign comes from the banks. Causality has reversed.

Id. at 1.
48 Id. “As awareness of sovereign risk grew, banks began to charge higher loan rates to the sovereign than to commercial entities. In the 15th century, Charles VIII of France paid up to 100% on war loans to Italian banks, which were at the same time charging Italian merchants 5-10%. The Bank of England’s first loan to government carried an interest rate of 8% – double the rate at which the Bank discounted trade bills.” (citations omitted).
49 Id.
50 John C. Coffee, Jr., The Political Economy of Dodd-Frank: Why Financial Reform Tends to Be Frustrated and Systemic Risk Perpetuated, 97 CORNELL L. REV. 1019, 1048 (2012) (arguing that mandatory sunset provisions would be “an unnecessary fifth wheel, given the case with which business interest groups can push back, repealing or downsizing legislation whenever they can make a colorable case that the legislation’s costs exceed its benefits.”) [hereinafter, “Coffee, Political Economy”].
51 Compare Adam J. Levitin, In Defense of Bailouts, 99 GEO. L.J. 435, 483 (2011) (discussing the need for bailouts
1.2 Complexity

Although Dodd-Frank has made a modest—and largely unsuccessful—attempt to reduce concentration, it does nothing to reduce complexity. “Complexity” in the context of the financial crisis refers to three specific phenomena: (1) transactional complexity, as is found in securitization and other derivative transactions; (2) structural complexity, as is evident in the hundreds or thousands of subsidiaries in which financial services (or other) firms may have an interest; and (3) regulatory complexity, reflected in the hundreds of pages of Dodd-Frank legislation, and thousands of pages of regulations implemented or proposed in support of Dodd-Frank. As Professor Schwarcz has argued, complexity in the financial markets is “the greatest financial-market challenge of the future.” It is a problem that regulatory displacement will worsen.

Transactional complexity reflects the development of securitization and other financial derivatives that involve multiple steps and parties endowed with highly contingent rights and responsibilities. A securitization generally involves at least three parties and two sets of transfers to effect what is, in essence a capital-markets financing: the originator (e.g., a lender who creates a “financial asset”); a special purpose entity that purchases the financial asset; and an underwriter who pools the financial assets and issues securities whose value is determined in part or in whole by the predicted value of the financial assets. Any given offering of securities in a securitization could involve hundreds, perhaps thousands, of pages of disclosure. As Kathryn Judge has observed, this structure produces “fragmentation nodes” that contribute materially to the complexity of the financial system. Despite its complexity, securitization shows every sign of reviving.

Structural complexity refers to the number of entities (e.g., special purpose entities created in securitizations) that a large financial services firm may have. When it declared bankruptcy September 15, 2008, Lehman Brothers had 209 subsidiaries registered in twenty-

under certain circumstances).


54 Lipson, Defining, supra note 53; Judge, Fragmentation, supra note 53.


56 See Judge, Fragmentation, supra note 53, at 661 (“Four specific sources of complexity are highlighted: (1) fragmentation, (2) the creation of contingent and dynamic economic interests in the underlying assets, (3) a latent competitive tendency among different classes of investors, and (4) the lengthening of the chain separating an investor from the assets ultimately underlying its investment.”). Like many writers, Judge does not tell us what a securitization is, only that a class of transactions loosely defined as such has these attributes. The foregoing four-part description could describe any corporation’s capital structure; she fails to indicate what it is about securitization that makes it especially complex, although there is little doubt that the complexity of securitizations and similar transactions contributed significantly to the financial crisis.

one countries; they were party to about 900,000 derivatives contracts.\textsuperscript{58} Frequently, large financial firms are connected to one another through shared ownership in these entities, or interests in the assets these entities hold. Interconnectedness among financial services firms significantly increases the likelihood of cascading failures—and crises—because the failure of a sponsoring (parent) bank may impair the value of investments held by otherwise healthy firms in the failing bank’s subsidiaries.\textsuperscript{59}

Regulatory complexity is perhaps the biggest problem because it means that the cure is, in fact, the disease. Financial services regulation has followed a steep trajectory in volume: the Federal Reserve Act (1913)\textsuperscript{60} and the Glass-Steagall Act (1933)\textsuperscript{61} are twenty-four and thirty-seven pages, respectively; the Sarbanes-Oxley Act of 2002 is sixty-six pages long and the Dodd- Frank Wall Street Reform and Consumer Protection Act of 2010 weighs in at 848 pages.\textsuperscript{62} With a little more than half (52\%, or 208 of 398) of its required rulemakings finalized, regulations implementing Dodd-Frank amount to about 50,000 pages.\textsuperscript{63} Scholars fear that complexity will stultify efforts to bring stability to the financial system.\textsuperscript{64} Henry Hu worries that financial services firms are “too complex to depict.”\textsuperscript{65} David Driesen points out that complexity challenges the economic assumptions on which financial regulation is based: “in a dynamic system with significant discontinuities and true uncertainties, complexity defeats optimality as a goal for legal decisions, because optimality becomes impossible to calculate and relatively unimportant.”\textsuperscript{66} Despite this, Dodd-Frank is insensible to problems of complexity. As Steve Schwarz points out, “[t]he Dodd-Frank Act puts great stock in the idea of improving disclosure, but its efficacy will be limited.”


\textsuperscript{59} Kathryn Judge, Interbank Discipline, 60 UCLA L. REV. 1262, 1267 (2013) [hereinafter, “Judge, Discipline”].


\textsuperscript{64} David M. Driesen, Legal Theory Lessons from the Financial Crisis, 40 J. Corp. L. ___, 35 (forthcoming 2014) (draft of May 5, 2014 available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2446165 (“This problem of complexity making identification of an efficient outcome impossible or arbitrary and unreliable exists not just in the area of finance (as we have seen), but in a lot of other areas as well.”)). See, e.g., FRANK PARTNOY, INFECTIOUS GREED: HOW DECEIT AND RISK CORRUPTED THE FINANCIAL MARKETS (2d ed. 2009).


\textsuperscript{66} Driesen, supra note 64, at 1 (citing Alex Rosenberg & Tyler Curtain, What is Economics Good For?, N.Y. TIMES, Aug. 25, 2013, at SR 9)).
Some financial structures are getting so complex that they are incomprehensible. Furthermore, it may well be rational for an investor to invest in high-yielding complex securities without fully understanding them. Among other reasons, the investor simply may not have the staffing to evaluate the securities, whereas failure to invest would appear to—and in fact could—competitively prejudice the investor vis-à-vis others who invest.\(^67\)

In its 2014 annual report, the Financial Stability Oversight Council found that large financial services firms had modestly reduced their complexity and interconnectedness in 2013, based on the decreased number of assets where fair value measurement is based on unobservable inputs and the estimated size of potential fire-sale externalities.\(^68\) Yet, most observers are resigned to a future in which complexity is an ever-increasing aspect of financial life.\(^69\) It has grave systemic implications\(^70\) because it presses the limits of human cognition: It is simply not possible to make good judgments about risk, reward and so on in the face of great complexity.\(^71\)

1.3 Capture

Among the most despondent observers would be Roberta Romano, who fears that regulators will never be able to keep up, and are thus always likely to do more harm than good.\(^72\) Yet, she concedes, politicians (and, thus regulators) are nevertheless forced to take some action in response to crises, so the pattern is that regulation inevitably follows crises. But political motives are not pure. Rather, she argues that “policy entrepreneurs” foist “quack” legislation on the financial system, ignorant of, or indifferent to, the problems it may create.\(^74\) In this sense, politicians are captured by majoritarian bias. To counteract this,


\(^{68}\) FSOC 2014 ANN. REP. 116. Indeed, sophisticated participants in government recognize the need, at least in theory, to reduce complexity, even if they cannot accomplish it in practice. See CASS R. SUNSTEIN, SIMPLER: THE FUTURE OF GOVERNMENT 7 (2013) (stating that OIRA frequently rejected rules in order to “reduce cumulative burdens” and to reduce complexity).

\(^{69}\) Judge, *Fragmentation*, supra note 53, at 660 (“By focusing on sources of complexity that are likely to be present in other financial innovations that shift financing activities out of banks and into the shadow banking system, this Article suggests that these dynamics are likely to arise again.”).


“the nub of the regulatory problem derives from the fact that financial firms operate in a dynamic environment in which there are many unknowns and unknowables and state-of-the-art knowledge quickly obsolesces. In such a context, even the most informed regulatory response—which Congress’s reaction in the recent crises was not—will be prone to error and is likely to produce backward-looking regulation that takes aim at yesterday’s perceived problem, rather than tomorrow’s.

\(^{73}\) Romano, *Dark*, id. at 88.

she would require that financial regulation enacted in the wake of a crisis come with an automatic sunset provision, presuming repeal unless a later legislature reauthorized the law.\textsuperscript{75}

John Coffee has been among Romano’s strongest antagonists, arguing that she fails to understand the dynamics of legislation or the real influence that sophisticated financial actors wield in the regulatory process, both during a crisis, and in the deregulatory repose that follows.\textsuperscript{76} Drawing on the work of Mancur Olson, Coffee argues that “once a crisis subsides, more organized interests groups”—such as financial services firms—“regain the upper hand and begin to extract concessions, exemptions, or outright repeal.”\textsuperscript{77} Coffee, then, worries about a different kind of capture, one that reflects minoritarian bias.

Whether majoritarian or minoritarian, there is little doubt that capture presents a serious problem in the regulation of financial services.\textsuperscript{78} In the crisis, a (small) majority supported the Troubled Asset Relief Program (TARP), which became the basis for the massive regulatory “bailout” of (mostly) financial services firms.\textsuperscript{79} Thereafter, the small minority of financial services firms who benefitted from TARP aggressively sought to control the regulatory implementation of Dodd-Frank. Through the laborious notice and comment process, they have largely succeeded in both minimizing Dodd-Frank’s impact and becoming further enmeshed with regulators.

Although not coined by George Stigler, the term “regulatory capture” is regularly associated with his insight that regulators may serve those they regulate more than the public. Regulation, he argued, is a “good” that regulators sell to the highest bidder.\textsuperscript{80} The regulated are willing to pay for it as a way to create barriers to entry for competitors (not to improve the quality of their own products), as this may be a more granular and politically palatable path to (anti)competitive advantage than an outright government subsidy. (In the

\textsuperscript{75} See Romano, Quack, supra note 72, at 1600–02.

\textsuperscript{76} Coffee, Political Economy, supra note 50, at 1026 (arguing that mandatory sunset provisions would be “an unnecessary fifth wheel, given the ease with which business interest groups can push back, repealing or downsizing legislation whenever they can make a colorable case that the legislation’s costs exceed its benefits.”). See also John C. Coffee, Jr., Systemic Risk After Dodd-Frank: Contingent Capital and the Need for Regulatory Strategies Beyond Oversight, 111 COLUM. L. REV. 795, 800–01 (2011).

\textsuperscript{77} Coffee, Political Economy, id. (referencing MANCUR OLSON, THE LOGIC OF COLLECTIVE ACTION: PUBLIC GOODS AND THE THEORY OF GROUPS 33–36 (2d ed. 1971)).

\textsuperscript{78} Perhaps the best early account of the symbiotic relationship between large financial firms and regulators appears in ANDREW ROSS SORKIN, TOO BIG TO FAIL: THE INSIDE STORY OF HOW WALL STREET AND WASHINGTON FOUGHT TO SAVE THE FINANCIAL SYSTEM---AND THEMSELVES (2009).


case of bailouts, it may be both.) The regulators are compliant for many reasons, including that they lack the resources and expertise to compete with—and thus to regulate—the regulated.

The problem of “capture” has generated an enormous body of literature. Some question whether it exists or, if it exists, is a problem, because it may simply correspond with legislative preferences for a particular industry.81 The fact that regulators privilege one sector may reflect the delegation of larger popular will.82 Others worry that “deep capture,” in the words of Hanson and Yosifon, reveals “disproportionate and self-serving influence that the relatively powerful tend to exert over all the exterior and interior situational features that materially influence the maintenance and extension of that power—including those features that purport to be, and that we experience as, independent, volitional, and benign.”83

A strong example of this—whether malignant or benign—reflects what Wendy Wagner calls “information capture”: “the excessive use of information and related information costs as a means of gaining control over regulatory decision-making in informal rulemakings.”84 This is possible—and a well-known problem in the process of enacting rules under Dodd-Frank—because “The law does not permit the agency to shield itself from this flood of information and focus on developing its own expert conception of the project. Instead, the agency is required by law to “consider” all of the input received.”85

Whatever one may think of problems of capture, one thing is clear: through crises and recovery, both concentration and complexity have grown. Regulators cannot meaningfully reduce either, and probably worsen both. Thus, regulatory capture makes it implausible that regulators will be able to reduce or manage the two problems likely to contribute most to the next financial crisis. Indeed, regulators may end up more cause than the cure.

2. Theories of Institutional Choice

If regulators appear unlikely to reduce concentration and complexity, what other institutions can? In order to answer this question, it is necessary to understand the work that institutional analysis can do. This part develops a three-part institutional framework that explains the growth of regulatory displacement and how courts may ameliorate it.

---


83 See Hanson & Yosifon, supra note 26, at 202-204.


85 Id. (citing 5 U.S.C. § 553(c) (2006)).
Although the term “institution” is the subject of many definitions, it is for purposes of developing a better understanding of financial distress and crises “large-scale social decision-making processes,” in particular markets, courts, and regulators. The analysis of institutional choice is not new, but scholars are just now beginning to consider its implications for financial failure.

2.1 The Contribution of Hart & Sacks: Institutional Settlement

Institutional analysis is rooted in the work of Henry M. Hart and Albert M. Sacks, who taught at Harvard Law School from 1932-1969 and 1952-1991, respectively. They famously observed that courts are but one of many institutions available to solve social problems: “[D]ifferent procedures and personnel of different qualifications invariably prove to be appropriate for deciding different kinds of questions,” they taught generations of law students. “So it is that every modern society differentiates among social questions,

---

86 As Jepperson points out, the following list of things could all in common understanding be considered “institutions”: “marriage, sexism, the contract, wage labor, the handshake, insurance, formal organization, the army, academic tenure, presidency, the vacation, attending college, the corporation, the motel, the academic discipline, voting.” See Ronald L. Jepperson, Institutions, Institutional Effects, and Institutionalism, in THE NEW INSTITUTIONALISM IN ORGANIZATIONAL ANALYSIS 143, 149 (Walter W. Powell & Paul J. DiMaggio eds., 1991).

87 KOMESAR, 2001, supra note 4, at 31 (“I use the choice among these institutional processes to clarify basic issues such as the role of regulation, rights, governments, and capitals. These processes are alternative mechanisms by which societies carry out their goals.”).

88 One could argue that it began at the end of the 19th century, when Holmes opined that “[t]he duty to keep a contract at common law means a prediction that you must pay damages if you do not keep it—and nothing else . . .” Oliver Wendell Holmes, The Path of the Law, 10 Harvard L. Rev. 457, 462 (1897). So stating, he recognized the institutional optionality embedded in promissory relations. One can perform a contract one may have come to regret, in which case one has chosen the market as the institution to solve his or her problem. If, instead, one chooses to pay damages, one is acting directly or indirectly to courts, which (in general) determine whether damages must be paid and, if so, in what amounts.


92 LEGAL PROCESS, supra note 4, at 4. As Wisconsin’s Lloyd Garrison and Willard Hurst, early classroom teachers of institutional analysis wrote, “the various agencies of the law, such as legislatures, courts and commissions, are themselves often in conflict; and that they together are only one of the many means of social control, which includes churches, schools, families, newspapers and so on.” See Lloyd K. Garrison & Willard Hurst, LAW IN SOCIETY: A COURSE DESIGNED FOR UNDERGRADUATES AND BEGINNING LAW STUDENTS, 272 (rev. ed. 1940 1941) (quoted in William N. Eskridge, Jr. & Philip P. Frickey, An Historical and Critical Introduction to The Legal Process, in Hart and Sacks, supra note 4, at lxiv. Volume I of the 1941 edition of the Garrison/Hurst materials may be found at
accepting one mode of decision for one kind and other modes for others—e.g., courts for “judicial” decisions and legislatures for “legislative” decisions.”

Through their legendary teaching materials, Hart and Sacks had an enormous effect on generations of lawyers. Their starting point was not controversial: Social institutions exist to “maximiz[e] the total satisfactions of valid human wants, and its corollary of a fair division of the presently available benefits of group living.” The important question for Hart and Sacks was not the meaning of words such as “maximize” “satisfaction” “valid,” “fair” or “benefits.” Rather, meaning would be invested in those terms procedurally, through what they called “institutional settlement.”

“The principle of institutional settlement,” they explained, “expresses the judgment that decisions which are the duly arrived at result of duly established procedures of this kind ought to be accepted as binding upon the whole society unless and until they are duly changed.” The key for Hart and Sacks, therefore, was process quality: If enough people accepted the process enough of the time, the result would probably be good enough, enough of the time. While this would not necessarily produce optimal results, the alternative was much worse, a Hobbesian war of all against all. “[R]egularized and peaceable methods of decision,” they argued, were the “alternative to disintegrating resort to violence.”

The concept of institutional settlement exists in a complex, reciprocating relationship with rule-of-law values, without which process would have little (or less) meaning. According to Eskridge and Frickey, Hart and Sacks “designated the judiciary as the guardians of rule-of-law values and envisioned the duty of judges to be the ‘reasoned elaboration’ of ‘neutral principles’ and legislative ‘purposes.'” They developed the now-common distinction between “rules” and “standards” by which judges would have discretion

http://libcd.law.wisc.edu/hurst/SERIES%202/BOX%203/FOLDER%201/ITEM%201.PDF (visited Aug. 17, 2014).

93 LEGAL PROCESS, supra note 4.

94 The materials were never published in their lifetimes. See William Eskridge & James Frickey, Commentary: the Making of the Legal Process, 107 HARV. L. REV. 2031, 2046 (1994). They were later organized and published by Eskridge and Frickey as LEGAL PROCESS, supra note 4. Hart and Sacks’ work has been called “the most influential work not produced in movable type since Gutenberg.” See Eskridge & Frickey, id., at 2031 (quoting J. D. Hyman, Constitutional Jurisprudence and the Teaching of Constitutional Law, 28 SYAN. L. REV. 1271, 1286 n. 70 (1976)).

95 LEGAL PROCESS, supra note 4, at 105.

96 Id. at 4 (emphasis in original). “[T]he principle of institutional settlement . . . builds upon the basic and inescapable facts of social living . . . namely, the fact that human societies are made up of human beings striving to satisfy their respective wants under conditions of interdependence, and the fact that this common enterprise inevitably generates questions of common concern which have to be settled, one way or another, if the enterprise is to maintain itself and to continue to serve the purposes which it exists to serve.”

97 Id. at 4.

98 Id. at 4.

99 For example, in discussing the interplay between contract doctrine and federal agricultural regulation, they observed that “private decisions and official decisions” developed in ways that reflect a “chicken-and-egg relationship” that “def[ies] any facile description.” Id. at 8-9.

100 Eskridge & Frickey, supra note 94, at 2048 (quoting LEGAL PROCESS, supra note 4, at 15 (“reasoned explanation”); 1407-26 (“principles”); 1178-1203, 1405-17 (legislative “purposes”)).
to apply edicts from other branches (i.e., Congress) depending in part on the nature of the language and purpose of the law or rule. They would not, of course, be permitted unfettered discretion.

The difficult question for Hart and Sacks was how courts would respond when confronted with rules (or standards) that they found problematic because indeterminate in application or used to respond to uncertain conditions. Because they tended to prefer deference to legislative majorities or administrative experts, they were sometimes accused of creating an intellectual justification for opposition to landmark jurisprudence that deviated from the rule of (extant) law (e.g., Brown v. Board of Education). Yet, for Hart and Sacks, the rule of law—and the role of courts in deciding what the rule of law would mean—were central. While courts may not solve all problems, through judicial review and negation they play a powerful role in determining choices among, and the boundaries of, other social institutions.

It is hard to overstate the influence of Hart and Sacks’ analysis. Yet, they could not answer certain basic questions. First, they treated social goals as exogenous to the institutions through which the goals would be implemented. How would we know, for example, what constituted “valid” human wants that social institutions should maximize? Because they expected judges to be “neutral,” this was a question for other institutions—in particular politicians and regulators. Critics such as Duncan Kennedy were, however, incredulous. This led to concern that Hart and Sacks were intellectually dishonest for failing to recognize the role that political bias plays in adjudication.

Second, if social goals were exogenous, what role remained for law, as such? The logic of their model led inexorably to the view that law was politics by other means. Politics would reflect the biases of political participants, whether voters in an electoral process or “contextualizing regimes,” in Sable and Simon’s terms, that advance special interests, such as those in financial services. Law was, in this sense, limited in its ability to expose or remedy


104 Eskridge & Frickey, supra note 94.

105 The most prominent challenge of this form comes from the Critical Legal Studies movement, whose literature is too voluminous to cite usefully here. See, e.g., Duncan Kennedy, Form and Substance in Private Law Adjudication, 89 HARV. L. REV. 1685 (1976) (“substantive and formal conflict in private law cannot be reduced to disagreement about how to apply some neutral calculus that will "maximize the total satisfactions of valid human wants." The opposed rhetorical modes lawyers use reflect a deeper level of contradiction. At this deeper level, we are divided, among ourselves and also within ourselves, between irreconcilable visions of humanity and society, and between radically different aspirations for our common future.” (quoting LEGAL PROCESS, supra note 4, at 113); Robert W. Gordon, Critical Legal Histories, 36 STAN. L. REV. 57 (1984).

106 See Sabel & Simon, supra note 102.
political biases because it was always a product of those biases. Regulatory capture is simply a strong example of this.

Third, it offered no insight into how choices among institutions would or should be made. It made little effort to compare rigorously different institutions’ attributes or their efficacy at solving particular problems. Nor did it offer a descriptive or prescriptive theory about how choices would or should be made. Of course, courts could not act on their own initiative, needing always a case or controversy to trigger their involvement. But, under what conditions would or should courts be a better institutional choice than markets or regulators or other institutional actors? While few would quibble with the goal of institutional settlement—“legitimacy” in modern parlance—more work would be needed in order to understand how different institutional choices would make this more likely.

2.2 The Contribution of Komesar—Comparative Institutional Analysis

That work would be undertaken by Neil Komesar. Komesar made two significant contributions to institutional analysis. First, he recognized that the minoritarian bias reflected in interest group analysis is only half the story: consistent with the political cycling of financial regulation described in Part 1, there are important moments when political institutions will make majoritarian decisions. Institutional choices and performance are subject to what he calls a “two-force” model—minoritarian versus majoritarian forces. In the case of financial distress, majoritarian preferences will dominate in the wake of a crisis, when public desperation or ire were at their peak; thereafter, as Coffee noted, well-resourced minorities gain the upper hand in recovery.

Second, and perhaps more important, he developed a theory about how and why institutional choices are and should be made, through what he called a “participation centered” model. This recognizes that different institutions have different comparative advantages, and different stakeholders will choose the institution that best suits their interests. All institutions will perform imperfectly, but some will be better than others. The important work is to compare the costs and benefits of the available choices.

---

107 A word about the word “bias.” I use it here to refer to preferences of stakeholders. Bias is an inevitable feature of stakeholder participation, and so is not necessarily problematic. Bias becomes troublesome, however, when it produces net social costs (however measured) not internalized by active stakeholders. Economists would refer to the product of bias as “externalities,” “transactions costs,” or “market failures.” To the extent bias is problematic, better institutional choices will help to reduce—but never eliminate—the costs of those biases.


109 See discussion in Part 1.3.

110 KOMESAR, 1994, supra note 4, at 6.

111 Participation, Komesar has argued, is determined by the interaction between the benefits of that participation and the costs of that participation. The benefit side focuses on the characteristics of the distribution of benefits or stakes across the relevant populations. The central determinants are the average per capita stakes and the extent to which per capita stakes vary within the population. The cost side focuses on the costs of participating in the institutions—transaction costs, litigation costs, political participation costs. These
Using the simple example of tort law, Komesar showed how the distribution of stakes affects participants, and thus institutional performance and choice. Ordinarily, manufacturers will have higher per capita stakes in the sales of their products than will consumers. In most cases, no single product will affect an individual purchaser as much as all sales will affect the seller. If a product is defective, the manufacturer in many cases will want to repair or replace it. The market is an effective institution for both sales of goods and for correcting occasional errors. Manufacturers thus prefer the market, unburdened by judicial or regulatory intervention. Having the most at stake relative to consumers, that is the institution that will be chosen.

If, however, the product turns out to be significantly harmful, there may be what Komesar calls a “shifted distribution.” In a shifted distribution, “victims’ low distribution ex ante becomes a high uniform distribution ex post.” In these cases, courts may be the better institutional choice, because through the litigation process, harms will be measured and (roughly speaking) redressed. As in the famous exploding Ford Pinto case, Grimshaw, courts will not be perfect—many think the award there too high—but the ex post ability to determine liability and provide a mass remedy made the court a better choice than markets or regulators, which could not determine or remedy the harm caused. Moreover, because judicial opinions are public, they have an important deterrent effect on other manufacturers, for whom the risk of multi-million dollar liability creates very high stakes.

Two particular factors are likely to affect how participation occurs, and thus make Komesar’s theory of institutional choice especially useful in understanding financial distress: “complexity and numbers.” These factors mirror those that present the greatest challenges in preventing financial crises—concentration (scale) and complexity, discussed in Part 1. Prior to a shift in distribution, markets and regulators tend to be better at managing problems of scale and complexity than courts. Courts, Komesar argues, are generally better at addressing simpler problems involving smaller numbers. When a debtor first defaults, it will probably use market mechanisms to resolve the problem, if possible. If not, a shifted distribution may occur, in which case courts are likely to be the institution chosen by the stakeholders with the greatest interest in the outcome.

costs generally fall into one of two broad categories—the cost of information and the cost of organizing collective action.”


112 Id.
113 Id. at 135.
115 KOMESAR, 2001, supra note 4, at 23 (“Numbers and complexity are variables of great import. They generate shifts and cycles in law and rights. Viewed through the lens[] of comparative institutional analysis, it is a pattern of shifts and cycles more compelling and intriguing than that generated by single institutional analysis.”).
116 “Courts’ ability decreases as the number of parties and the complexity of the issues increases. As the number of potential plaintiffs or defendants increases, the costs of bringing actions increase and the dynamics of litigation become more complex . . . . The problems of collective action that plague market transactions as numbers increase also plague adjudication: larger numbers mean more hold-outs and greater likelihood of failed settlement.” KOMESAR, 2001, supra note 4, at 21.
This was not, however, what happened in the financial crisis. Rather, as noted in the Introduction, the deeply symbiotic relationship between regulators and the regulated made it difficult for key regulators such as Geithner or Paulson to ignore pleas for help from large financial firms.\footnote{See Geithner, supra note 13, at 158-161.} Given their willingness to help, it would have been equally difficult for those who managed large, complex financial firms not to seek regulatory aid for their firms. Thus, regulators—acting on their own and later under the Troubled Asset Relief Program—were an irresistible choice for the regulated. Dodd-Frank simply codified this dynamic. As explained in Part 3, this is likely to be a choice with significant social costs.

Komesar generally compares institutions in isolation. Courts are, for example, an alternative to markets or regulators. Yet, in the context of financial distress, institutions do not operate in isolation. Instead, they interact, “braiding” with one another in important ways.

2.3 The Contribution of Gilson, Sabel and Scott—“Braiding”

“Braiding” is a concept developed in contract theory by Professors Gilson, Sabel and Scott. In an important 2010 paper, they argued that braiding bridges a long-standing gap in contract theory about the role of “formal” and “informal” contract enforcement mechanisms.\footnote{Ronald J. Gilson, Charles F. Sabel, & Robert E. Scott, Braiding: The Interaction of Formal and Informal Contracting in Theory, Practice, and Doctrine, 110 Colum. L. Rev. 1377 (2010) [hereinafter, “Gilson et al., Braiding”]. They thus develop both prior work of their own, e.g., Ronald J. Gilson, Charles F. Sabel & Robert E. Scott, Contracting for Innovation: Vertical Disintegration and Interfirm Collaboration, 109 Colum. L. Rev. 431, 458–71 (2009), as well as that of pioneers at boundary between formal and informal contracting. See, e.g., Stewart Macaulay, Non-Contractual Relations in Business: A Preliminary Study, 28 Am. Soc. Rev. 55, 56–57, 62–63 (1963).} By “formal” they mean chiefly the work of courts, recruited by disappointed parties to enforce promises and provide a remedy for their breach.\footnote{Gilson et al., Braiding, supra note 118 at 1379 (“Parties may choose by formal contract to enlist the judicial system to assess the parties’ performance of their specified rights and obligations and impose remedies in the event of breach.”).} By “informal” they mean the non-judicial networks of interpersonal effects that accompany default—effects supported by a large body of empirical and experimental work.\footnote{Id. at 1379 (“performance is encouraged and breach penalized by the cancellation of expected future dealings with the counterparty, by the loss of reputation (with the resulting reduction in future business with other potential counterparties in the relevant economic and social communities), or by an individual disposition toward reciprocity (and thus a willingness to reward cooperation and punish defection).”) (citations omitted).} To resolve the seeming dichotomy, they argue that, at least in certain classes of contracts—in particular, contracts involving innovation and new technologies—parties will choose not one or the other, but both:

These [braiding] parties write contracts that intertwine elements of formal and informal contracting in a way that allows the parties to assess each other’s disposition and capacity to respond cooperatively and effectively to unforeseen circumstances. In these contracts, the informal obligations interact within a formal governance structure that regulates the exchange of highly revealing information, but does not necessarily impose legally enforceable obligations to buy or sell anything. All such contracts share a common focus: collaborative innovation in a world of heightened
uncertainty. The concept has captured academic imaginations. It has been extended to analyses of secured credit, explaining patterns in contractual information sharing, and even the development of “special purpose acquisition corporations.”

We can analogize from contracts to institutions. Courts and regulators will tend to be more formal, in the sense that they are subject to more elaborately drawn rules and restrictions on their conduct. Markets tend to be less formal, in the sense that parties have a broader range of discretion to choose the rules that will govern their relationship. So analogized, braiding offers two insights into how institutions prevent and resolve financial distress.

First, Gilson, Sabel & Scott focus on contracts for innovation, in particular technology-related contracts, where they assume uncertainty to be quite high. Contracts for the resolution of financial distress—renegotiated debt contracts—have much in common with contracts for innovation because they, too, involve high degrees of uncertainty and creativity best addressed through both informal and formal mechanisms, such as markets and courts. Second, and more importantly, as explained in the next Part institutions themselves braid in addressing financial distress.

3. An Institutional Analysis of Financial Distress Systems

The prior Part developed a three-step institutional framework: (i) per Hart and Sacks, institutional settlement (legitimacy) is the goal; (ii) per Komesar, scale and complexity will influence institutional competence, while participation will determine institutional choice; and (iii) per Gilson, Sabel, and Scott, institutions braid in addressing financial distress. This Part applies the framework to compare the three major institutional choices available in the prevention and resolution of financial distress, markets, courts and regulators. It explains why markets and courts will often be better first-line responses to distress than regulators, even though they are being displaced by regulators. It also explains why financial services firms would choose regulatory resolution as it is currently proposed.

3.1 Market Resolution

There is a tendency to assume that financial distress is a problem that courts—in particular bankruptcy courts—chiefly solve. But this is a law-(and lawyer-) centered view
that is incomplete. Rather, debtors and creditors are far more likely to renegotiate financial distress inter se—or simply to walk away—than to use any other single institution. This institutional choice has important benefits which often outweigh its costs.

As in other contexts, the institutional choice will turn in large part on the number of participants and the complexity of their stakes. In the simplest case—a single debtor and creditor—only a market transaction is needed. It is unlikely that any other institution would offer superior prevention or resolution mechanisms. While creditors may have to use the state court collection process to enforce their claims, this would seem to be a fairly unusual result given the case with which debtors and creditors can either rewrite the debt contract or the debtor can cede its assets to the creditor (“walk away”). In most cases, judicial process in binary debtor-creditor disputes is not cost justified, and so not chosen by either party.

As the number and/or complexity of stakeholders and claims grows, however, judicial process becomes more appealing. The debtor may be recalcitrant in negotiations; some creditors may hold out for a better deal. The debt contracts may be interwoven in complex ways that leave the parties in doubt about their relative rights. When a debtor with many creditors in complex contracts defaults, there will be a shifted distribution of stakes. Prior to default, the debtor’s many creditors may have paid little attention to their rights against the debtor, or inter se. After default, understanding and acting on those rights becomes imperative.

In the first instance, this shifted distribution will produce the classic “workout” negotiation which will more likely than not result in resolution. Yet, because it always occurs in the shadow of some court—either a state court for collection purposes or a federal bankruptcy court for broader and deeper defaults—it is important to recognize that markets and courts “braid” in this context. Here, braiding means that neither informal renegotiation nor formal judicial resolution (e.g., through judgment and execution) is likely to be the exclusive institutional choice. Rather, each reinforces the other. Markets will be the dominant institution, with courts performing a second, in terrorem, role. The promise of contractual renegotiation forms the “carrot”; the threat of judicial action is the “stick.”

This kind of participation has three important benefits. First, the parties are better positioned to make judgments about their capacity to commit credibly to a revised payment

---

127 An early recognition that courts did not have to be the chief institutional choice for financial distress appears in DAVID T. STANLEY & MARJorie GIRTH, BANKRUPTCY 147–72 (1971). They argued for an administrative resolution mechanism for individual debtors, in order to reduce the cost and delay of individual filings in bankruptcy courts.

128 The work of Nini, et al., for example, shows that fewer than 7% of distressed publicly-traded firms (defined as those announcing a debt-covenant default) declare bankruptcy or liquidate through a judicial proceeding. See Greg Nini, David C. Smith & Amir Sufi, Creditor Control Rights, Corporate Governance, and Firm Value, 11-13 (Working Paper Series, 2010), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1344302. For smaller firms, the percentage is higher, nearly 10%. In 2010, for example, 690,504 businesses closed (some of which may have been public firms), while 56,282 businesses (less than 10%) went into bankruptcy. See Quarterly Business Filings by Year (1994-2012), http://www.abiworld.org/AM/AMTemplate.cfm?Section=Home&TEMPLATE=/CM/ContentDisplay.cfm&CONTENTID=65641 (describing number of business bankruptcies) and Business Dynamics Statistics, http://www.census.gov/ces/dataproducts/bds/data_firm.html (U.S. Census data on 2010 business closures).

schedule (in the case of a debtor) or to absorb a loss (in the case of a creditor) than other institutional actors. This will, on average, lead them to align their incentives with their capacities to perform, if they believe performance is plausible. This, in turn, is like to reduce both economic (e.g., transactions) and normative (e.g., moral hazard) costs.

Second, it is an ex ante solution, in the sense that it comes prior to other institutional involvement. Because preventing (or quickly resolving) distress is the first line of defense in preventing crises, market resolution has a greater capacity to avoid the need for ex post resolution efforts, e.g. through bankruptcy or regulatory intervention.

Third, market resolution can reflect an important kind of institutional settlement. Absent significant information asymmetry or externalities, a consensual workout is one that most would recognize as “duly” authorized by the parties directly involved. If debtors and creditors of roughly comparable bargaining power renegotiate defaulted debt contracts, it is hard to see who loses—especially if the knock-on effect is to avoid cascading losses that could become a crisis.

Yet, institutional analysis requires us to assess both the benefits and the costs of any institutional choice, and market resolution is not perfect. First, information asymmetry can be highly problematic in this context. As I have observed elsewhere, the pre-bankruptcy workout process can be fraught with sharp dealing.130 Investors, for example, may hold short positions through credit default swaps (CDS) that pay off if the debtor’s workout fails. This might create the incentive to impede workout efforts. Because such positions are not publicly registered, other stakeholders would not know how to bargain around them.131 Such positions may not rise to the level of fraud, yet they will create opacity and suspicion that can make market resolution prohibitively costly.132 Because they are inherently complex instruments to begin with—and can involve enormous sums of money—information failures of this sort can cause values to plummet precipitously. It is not surprising that the information asymmetry created by short positions made renegotiating pre-crisis transactions difficult. It may also have contributed to panic in the market and a rapid decline in asset values.

Second, as debtors grow in scale and complexity, the problem of holdouts becomes more acute. A debtor can only work out debt privately if all or a vast majority of creditors agree. A debtor with publicly traded bonds, for example, cannot generally restructure the bonds, such as by reducing payments, without the consent of all or most bondholders.133 Given the rise of distressed-debt investing, it is not surprising that sophisticated creditors may be tempted to hold out for a better deal, foiling market-based resolution.

Third, there are transaction costs. Corporate restructurings usually involve professionals such as lawyers, accountants, and bankers, who do not work for free. Moreover, given the uncertainty that is always present in restructurings, the parties could

131 Dodd-Frank has proposed to create clearinghouses for certain such instruments. But, as with other aspects of Dodd-Frank, there are concerns that regulation will not keep pace with transactional developments. See, e.g., Romano, Dark, supra note 72.
132 Lipson, Defining Securitization, supra note 53, at 1253, n. 77 (discussing “Abacus” and “Magnetar” trades).
133 Lipson, Governance, supra note 129.
restructure the debt only to see the debtor default again. This would either require further negotiations or, more likely, a bankruptcy filing.

Finally, there may be social costs not internalized by the principal parties to the workout. Some stakeholders may have little or no say in the outcome of the restructuring, but are nonetheless affected by it. The classic examples will be low-level, non-union employees and smaller trade and tax creditors of the corporate debtor.\(^\text{134}\) From an institutional perspective, we would say that these creditors may have small stakes relative to those of large creditors, but nevertheless, the loss of a job or pension means a great deal to that creditor. The workout process may not protect these stakeholders, because they will lack the resources or sophistication to participate in it. Yet if, as is entirely plausible, a restructuring results in outsourcing or downsizing, these stakeholders would surely be adversely affected by the negotiations of the larger stakeholders.

The market cannot correct for all of these costs. Indeed, the presence of these costs—from holdouts to externalities—is good reason to resort to other institutions, in particular bankruptcy courts. Yet, the important question is not whether market-based solutions are optimal or costly, but how the costs and benefits of this choice compare to the costs and benefits of other available choices. When stakeholders can participate in resolution in some meaningful way that produces institutional settlement, other institutions are unlikely to do a better job. Rather, other institutions will outperform the market only when participants are, in aggregate, unable to come to some reasonably fair and efficient resolution of financial distress.

3.2 Judicial Resolution

It is at this point that courts and markets flip, with courts (usually bankruptcy courts) becoming the dominant institution and markets playing a secondary role. Bankruptcy offers essentially two models: straight liquidation (usually under chapter 7 of the Bankruptcy Code) or reorganization (usually under chapters 11 or 13), which are in essence moderately coerced workouts.

Both models depend on several basic legal mechanisms. First, a stay is automatically imposed on most collection efforts (as discussed below, derivatives contracts are an important exception).\(^\text{135}\) Although this halts one form of participation—the collection suit—it actually promotes participation because it channels all stakeholders into a single forum, where they can more efficiently assess, and negotiate, their relative rights against the debtor. Second, an estate is created that is composed of all of the debtor’s property.\(^\text{136}\) This preserves the debtor’s assets with the goal of maximizing recoveries, whether through reorganization or liquidation.

Third, the level of participation in resolution will largely be determined by the size and complexity of the debtor involved. Consumer cases will usually be liquidations under chapter 7 or “wage earner” plans under chapter 13. Neither involves voting by creditors. A corporation with meaningful going concern value is likely to propose a plan of


reorganization under chapter 11, in which creditors would get a vote.\textsuperscript{137} Presumptively, chapter 11’s more elaborate disclosure and voting rules create opportunities for greater stakeholder participation.

As in market resolution, judicial resolution involves braiding, here chiefly with markets. Thus, in the corporate context, the workout negotiations that began and failed prior to bankruptcy are highly likely to continue once the debtor enters bankruptcy. These negotiations perform filtering and sorting functions that enable bankruptcy courts to manage the large and complex cases they are often asked to address. Institutional braiding provides the flexibility to produce more nuanced results than either judicial or market-based resolution could produce in isolation.

Moreover, unlike courts of general jurisdiction, bankruptcy judges are usually expert in the problems that are asked to deal with. Most large corporate bankruptcies, for example, are filed in the Southern District of New York or the District of Delaware.\textsuperscript{138} The clustering of complex cases in these jurisdictions has doubtless contributed to the expertise of the judges in these courts, who are widely recognized as among the nation’s most sophisticated.\textsuperscript{139} These judges are aided by an extremely sophisticated bar, which also benefits from repeat play. While these judges are hardly infallible—and some worry that they defer too readily to the bar and “insiders” in the process\textsuperscript{140}—there is little doubt that they are not daunted by the size or complexity of the cases before them.

Judicial resolution in bankruptcy has other benefits. First, to the extent that disputes are actually litigated, they will be adjudicated using ordinary rule-of-law mechanisms. The common law, precedent, the rules of proceeding and proof all apply in bankruptcy. Bankruptcy courts write reasoned, published opinions that affect both the parties to the dispute and the incremental development of the law. Bankruptcy courts’ decisions are subject to appellate review more or less as would be the case for other federal courts.\textsuperscript{141} Thus, to the extent the judiciary ever has the capacity to produce institutional settlement, so, too in bankruptcy.

Second, bankruptcy reorganization tends to be a reasonably transparent process. This is due largely to the fact that it is subject to court supervision, so most important matters will be subject to pleading and judicial approval.\textsuperscript{142} Because pleadings are presumptively public, the process itself will be far less opaque than a market-based resolution, which is ordinarily subject to no mandatory disclosure (outside of federal securities laws, if they apply). Transparency contributes to the legitimacy of bankruptcy resolutions.

\textsuperscript{137} Under 11 U.S.C. § 1126(c), “impaired” classes of creditors are entitled to vote on the plan. Under 11 U.S.C. § 1129, a court cannot approve the plan unless it has the requisite number and amount of creditor support. There are, of course, variations on this, but the details are unimportant the institutional analysis presented here.


\textsuperscript{139} LYNN LOPOCKI, \textit{COURTING FAILURE: HOW COMPETITION FOR BIG CASES IS CORRUPTING THE BANKRUPTCY COURTS} (2005) [hereinafter, “LOPOCKI, COURTING FAILURE”].

\textsuperscript{140} Id.


Third, perhaps the most important benefit of this institutional interaction is its ex ante effects: the costs of the bankruptcy process—transaction costs, delay, etc.—may be the most important incentive parties have to work out financial distress consensually in the first place. Bankruptcy is, in other words, the law in whose shadow market resolution typically occurs.

Yet, as with all institutional choices, the institutional choice of bankruptcy has costs. First, the reality that large, complex cases are concentrated in two districts has led many to worry that the judges in these courts are captured by the bar, much as regulators may be captured by sophisticated financial firms. While there is not the kind of "revolving door" that worries many about regulation, the transparency that can give bankruptcy its legitimacy also produces a deluge of information that no judge can fully absorb. It is highly unlikely that Judge Peck read all of the thousands of pages reflected in examiner’s report in that case, or the disclosure statements that accompanied the iterations of its reorganization plan. The volume of information, in turn, will place pressure on them to rely more on counsel in the cases before them. The lawyers may feel pressure to get a reorganization plan approved once the parties have come to agreement. Thus, the worry is that judges in Manhattan and Wilmington defer too much to the lawyers before them, confirming reorganization plans that are not truly feasible. But this may produce "serial bankruptcies," such as those of US Airways (three bankruptcy cases), which are probably wasteful.

Second, bankruptcy can depress values. There is concern that chapter 11 has become little more than a venue for the sale of distressed business, mergers and acquisitions by other means. Bankruptcy sales—like all judicial sales—are unlikely to produce as much value as an arms-length sale out of court. This has led some to worry that bankruptcy increasingly produces "fire sales" rather than reorganizations, which are generally thought to preserve greater value. Many are cautioned by the low price at which Barclay’s snapped up Lehman Brothers’ brokerage business only several days into the case. Jacoby and Janger note that bankruptcy recognizes a “speed premium” that may benefit purchasers more than the debtor-sellers.

Thus, bankruptcy is not a perfect institutional choice, but under many circumstances will be better than alternatives. As explained in the introduction, there is good reason to

---

143 LoPucki, COURTING FAILURE, supra note 139. “Feasibility” is one of the standards required to confirm a reorganization plan. 11 U.S.C. § 1129(a)(3). It means that the court has concluded that the debtor under the plan is not likely to need further bankruptcy proceedings.

144 See Jonathan C. Lipson & Christopher diVirgilio, Controlling the Market for Information in Reorganization, 18 AM. BANKR. INST. L.J. 647 (2010)


146 One day after Lehman went into bankruptcy, Barclays purchased such core Lehman assets as its prime brokerage, investment bank and headquarters for about $1.3 billion. Judge Peck was quoted as saying “I have to approve this transaction because it is the only available transaction” See BBC News, Judge approves $1.3bn Lehman deal, Sept. 20, 2008, available at http://news.bbc.co.uk/2/hi/business/7626624.stm (accessed Aug. 18. 2014).

believe that if Bear Stearns had been permitted (or forced) to go into bankruptcy in 2008, the crisis would have had very different characteristics. Tim Geithner is likely correct that a Bear Stearns bankruptcy would have been very problematic. But, the very fear that such a bankruptcy would have created should have led market participants—that is, the CEOs of other large financial firms—to begin the hard work of renegotiating amongst themselves. So far as we can tell, this did not occur. Instead, as noted in the Introduction, they sought (and in most cases received) support from regulators. But, as explained in the next part, regulators should be a last line of defense—not the first.

3.3 Regulatory Resolution

Regulatory resolution in the United States has historically been limited to specialized industries, in particular commercial banks, which are not permitted to be debtors under the Bankruptcy Code. As a result, they are subject to a well-established federal regime, the Federal Deposit Insurance Act ("FDI Act"). Moreover, Dodd-Frank’s process for resolving what it calls “systemically important financial institutions” (SIFIs) was expressly modeled on the federal bank resolution model.

Under federal banking law, the Federal Deposit Insurance Corporation (FDIC) or other designated regulator may seize a bank that is “critically undercapitalized,” a minimum of two percent equity capital to total assets. When a bank is insolvent, the bank’s charter will be revoked and the primary regulator will appoint a conservator or receiver to administer the insolvency proceedings. If the FDIC is appointed receiver, it has complete


149 The relevant statutory provisions of the FDI Act are 12 U.S.C. §§ 1821-1825. See also Robert R. Bliss & George G. Kaufmann, U.S. Corporate and Bank Insolvency Regimes: A Comparison and Evaluation, 2 VA. L. & BUS. REV. 143, 145 (2007). Insurance companies are generally regulated at the state level, so their resolution procedures are subject to greater variation.

150 As Assistant Treasury Secretary Michael Barr said in testimony on behalf of the legislation that became Dodd-Frank: “Our proposal does little more than apply to” systematically important non-bank institutions “the same model that Congress has developed, that the FDIC has executed, and that courts have respected, over the course of more than three-quarters of a century.” Press Release, Assistant Secretary Michael Barr Written Testimony, House Judiciary Committee Subcommittee on Commercial and Administrative Law (Oct. 22, 2009), available at http://www.treasury.gov/press-center/press-releases/Pages/tg327.aspx (accessed Aug. 17, 2014). See also Paul L. Lee, The Dodd Frank Act Orderly Liquidation Authority: A Preliminary Analysis and Critique, 128 BANKING L.J. 771, 786 (2011).

In what could be seen in hindsight as a political misstep, the Treasury Department noted in its press release that the new authority was modeled on the FDIC’s existing resolution authority for depository institutions and on the Federal Housing Finance Agency’s resolution authority for government sponsored entities. The indirect allusion to the conservatorship of treatment of Fannie Mae and Freddie Mac exposed the Treasury to the criticism that its proposal would provide a source of ongoing federal assistance to other companies on financial life support.

Id. at 784 (quoting Ben Bernanke).

151 Bliss & Kaufmann, supra note 149, at 156.

power over the assets and liabilities of the failed bank. These powers are largely outside the judicial system and few FDIC decisions are subject to judicial review.

When appointed receiver, the FDIC must decide what to do with the failed institution. In theory, it has a range of options. It can “liquidate the institution, organize a new bank or a temporary bridge bank, take over some or all of the assets and liabilities, or arrange a merger or purchase of assets and assumption of liabilities.” In fact, federal law requires the FDIC to choose a resolution method that imposes the “least cost on the insurance fund, unless the FDIC determines that doing so is necessary to avert systematic risk.” Data suggest that in most cases, the FDIC found a bank that was willing to assume some or all of the failed bank’s liabilities and purchase some or all of the failed bank’s assets, typically through a transaction known as a “purchase and assumption” (P&A).

In a P&A, the government secures the commitment of a “healthy” bank to take over the assets of the troubled bank. This is how the FDIC is able to “seize a failed bank on a Friday, and some of the failed bank’s office reopen as part of the acquiring bank the following Monday.” This means, in essence, that the government and markets must work together—again, a kind of “braiding”—quickly and quietly to resolve the bank’s distress. Courts effectively have no role here.

Commentators on bank insolvency procedures have suggested various policy reasons for the procedures outlined above. In theory, they create a resolution before an “actual event of economic insolvency or financial default.” This advances one very obvious—and vital—policy goal: the prevention of bank runs. While it is easy to exaggerate the severity of bank panics, they nevertheless have a long history of worrying public officials. One observer characterized the English bank panic of 1825 as follows: “A panic seized upon the public, such as had never been witnessed before: everybody begging for money—money—but money was hardly on any condition to be had.” Common images of bank panics include lines of anxious depositors clamoring to withdraw their savings from banks that suffer from what economists euphemistically call a timing problem.

Another major policy goal is the need to protect the FDIC’s insurance fund. This policy goal is reflected in Congress’ requirement that the FDIC choose a resolution plan that

---

154 Bliss & Kaufmann, supra note 149, at 160.
155 Lubben, supra note 126, at 1266.
157 Id. at 1002.
158 Hynes & Walt, supra note 156, at 989.
159 Bliss & Kauffman, supra note 149, at 152.
160 See Diamond & Dybvig, supra note 2; Peter P. Swire, Bank Insolvency Law Now That it Matters Again, 42 DUKE L.J. 469, 474 (1992).
162 Swire, supra note 160, at 474.
has the lowest impact on the fund unless the FDIC determines that doing so is necessary to avert systemic risk.\footnote{See 12 U.S.C. § 1823(c)(4)(A) (2006) (providing the limited circumstances under which the least-cost resolution method will not be required).} Foreshadowing Dodd-Frank’s distributed authority resolution procedures, the FDIC may deviate from the least-cost method only with the approval of the Chairman of the Federal Reserve and the Treasury Secretary, and they must consult with the President.\footnote{See id. § 1823(c)(4)(G) (stating that “the Corporation may take other action or provide assistance under this section as necessary to avoid or mitigate such effects” with the approval of the Board of Directors, the Board of Governors of the Federal Reserve System, and the Secretary of the Treasury).} Not surprisingly, it has been invoked rarely.\footnote{It appears to have been used twice since 1995 in order to provide assistance to Citigroup, Bank of America and their subsidiaries The FDIC also invoked this exception when approving financing for Citibank’s bid to buy Wachovia. See Editorial, Whos Too Big to Fail?, WALL ST. J., Sept. 13, 2009, at A14 (“To provide assistance, the [FDIC] board had to invoke the ‘systemic risk’ exception in the Federal Deposit insurance Act ....”). However, this transaction was not consummated as Wells Fargo purchased Wachovia instead. See id. (“Yet days later, Wachovia cut a better deal to sell itself to Wells Fargo, instead of Citi.”).}

It would appear that the bank failure system is a reasonable institutional choice given the alternatives. If the goal in the first instance is to instill confidence in the banking system, and thus to broaden participation in it at the retail level, deposit insurance was probably the most effective mechanism available. While markets could have invented this, it appears that they either did not do so in the 1930s, or simply lacked government’s credibility as insurer of last resort. While markets are secondarily important in the event a failed bank is the subject of a P&A, government will call the shots, acting chiefly as proxy for the retail depositors it is assigned to protect.

So, too, for courts. While courts certainly could supervise bank failures—and do so in many nations\footnote{A recent study shows that a majority of nations (56% in a sample of 142 countries) require judicial intervention in a bank failure. See Matej Marin & Vasja Rant, A cross-country analysis of bank bankruptcy regimes, 13 J. Fin. STAB. 134 10 (forthcoming 2014) (draft of April 24, 2014 available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2463623). (“Court approval is required to declare insolvency in 56% of countries”). The authors find an association between the presence of an administrative model and pronounced effects from the crisis. But, consistent with the observations above, they also find that a judicial model is associated with higher transaction costs and value depreciation. Id. at 2 (“We find some support that an administrative bank bankruptcy regime is positively associated with the presence of the global financial crisis compared to a court-led bank bankruptcy regime. On the other hand, court involvement in bank bankruptcy is associated with higher output loss and fiscal costs in the global financial crisis.”.).}—there are sound institutional reasons for leaving that choice with government. Among other things, the bank regulatory system appears to depend on a very constricted flow information and prompt corrective action. Unlike courts, regulators do not generally make reports about troubled banks available in real time (although they will do so after the fact).\footnote{See Sumit Agarwal, David Lucca, Amit Seru & Francesco Trebbi, Inconsistent Regulators: Evidence From Banking, 1 (Working Paper No. 17736), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1978548 (visited Aug. 17, 2014), discussing use of bank regulatory reports. See also Joe Adler, Bank Exam Ratings Might Not Be as Secret as You Think, AM. BANKER Aug. 12, 2011, available at http://www.americanbanker.com/issues/176_157/fdic-bank-failures-1041141-1.html?zkPrintable=1&nopagination=1 (visited Aug. 17, 2014) (describing market efforts to approximate regulatory CAMEL ratings through independent analysis due to the official confidentiality of the process).} Nor should they: to release information about troubled banks in real time would risk inducing the very thing—panicked withdrawals—the system seeks to avoid.
Courts, by contrast, depend to a much greater degree on transparency. In theory, pleadings filed in court are public records. Transparency, in turn, facilitates participation in the bankruptcy process. While a bankruptcy system could be modified to exempt retail depositors from the stay (in order to preserve their liquidity), the optical effect of a bank’s bankruptcy may be quite damaging to the bank’s reputation and to individual depositor confidence in it and the banking system as a whole.

The bank resolution model also involves braiding. Here, regulators are the dominant institution, working with the market (through a P&A) in a secondary role. The braiding works because it permits regulators and the regulated to respond more quickly and efficiently to bank failure than market- or court-dominant choices. As with braiding in contracts, it permits flexibility across more and less formal mechanisms in order to preserve stability in the banking system. While it severely constricts stakeholder participation—neither depositors nor bank shareholders are likely to be consulted in the resolution process—concerns about the chaotic nature of participation (bank panics) would appear to make regulatory resolution a sensible choice for banks with retail depositors.

As with all institutional choices, there are costs to this model. First, braiding here is weak because it is unlikely there is true market participation. It is possible that regulators engage in some kind of competitive bidding when they find healthy bank to takeover a failed bank. But the need for speed and secrecy in the process make this implausible. Thus, to the extent that market resolution involves a kind of braiding that depends heavily on stakeholder participation, one can say that regulatory resolution is significantly less participatory than other forms of resolution. Indeed the lack of participation may be one of the key benefits of regulatory resolution.

Yet, this places great pressure on the quality of decision-making by regulators. In the context of bank failure, there is no serious claim that bank regulators are corrupt or incompetent. But, there is also no reason to believe that they are immune from the public-choice challenges that burden other regulators. As in other regulatory settings, the regulated may well have the upper hand, whether because of the revolving door or informational overload or significant disparities in resource deployment. Thus, the second cost of regulatory resolution will be the loss of the legitimacy that we otherwise associate with market or judicial resolutions.

Third, as noted above, the unpredictability of regulatory resolution materially affects its ex ante incentives. Unlike market or judicial resolution, regulators intentionally keep the market in the dark about potential bank receiverships. Some workout activity may occur at the bank holding company level, as these may be publicly traded entities, which will disclose financial information. The information needed to engage in a pre-resolution workout of the bank itself is, however, unlikely to be available to the full range of potential participants. It will be available to those participants regulators choose to share the information with. Of course, bank managers themselves should know that the bank is in trouble. If so, they may seek market-based resolution, through additional capital infusions or other transactions. But if they believe that a regulator will provide support, it is not clear why they would want to. Moreover, the same fear of panic that motivates regulators to conceal the possibility of receivership will deter bank managers from revealing the full nature of the bank’s troubles to potential suitors or investors—assuming they even understand it. Rescue investors in a bank should always worry that their efforts to save the bank will be rewarded with a receivership—which is no reward at all.
To be sure, the bank regulatory model produces a kind of institutional settlement, in that it preserves the stability of the system. But the process is intentionally and necessarily opaque, giving regulators enormous discretion to pick winners and losers largely free of either market or judicial checks and balances. While Congress may have “duly” vested regulators with authority to seize failed banks, there is far less process and accountability in this model than in those in which markets or courts are the dominant institutions.

Yet, once we expand the regulatory umbrella to reach non-bank firms, all of the costs and few of the benefits would seem to follow because the braiding dynamic inverts. As explained in Part 1, the ability of large financial firms to capture their regulators is acute, and unlikely to change on its own. Their ability to overwhelm regulators with information and complexity empowers them to determine—up to a point—the conditions of regulation, and perhaps even resolution. The inherent uncertainty of Dodd-Frank’s resolution authority creates a kind of “mutually assured destruction” in which neither SIFIs nor regulators is likely to pull the trigger. Yet, this simply means that the underlying conditions that both create—concentration and complexity—will worsen. It means that regulators will feel increasing pressure to make shotgun marriages in order to resolve troubled firms, finding creative ways to tap the public fisc when needed to cinch the deal. This will privilege the largest firms, as it will enable them to gain and lock in market advantages over smaller firms. Yet it will inevitably corrode confidence that regulators in this context operate under the rule of law.

4. **Dodd-Frank and Regulatory Displacement**

The foregoing has shown how concentration, complexity, and capture have contributed to regulatory displacement of markets and courts as a first line of defense in preventing financial crises. This part uses the foregoing analysis to explain in greater detail certain problems with Dodd-Frank, in particular the “single point of entry” mechanism currently proposed to operationalize its “orderly liquidation authority.”

4.1 **Orderly Liquidation Authority**

The most prominent example of regulatory displacement involves the so-called “orderly liquidation authority” (OLA) created by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank). Under the OLA a series of government regulators—not markets or courts—can determine that a “systemically important” entity threatens the financial system and place it in a “resolution” proceeding of uncertain scope, duration or result.

A financial institution will be subject to the OLA if it is a bank holding company, or if the Financial Stability Oversight Council (FSOC) created by Dodd-Frank determines

---

168 Pub. L. No. 111-203, 124 Stat. 1376 (2010). As President Obama explained: “We will not go back to the days of reckless behavior and unchecked excess that was at the heart of the crisis, where too many were motivated only by the appetite for quick kills and bloated bonuses . . . [T]he old ways that led to this crisis cannot stand. And the extent that some have so readily returned to them underscores the need for change and change now. History cannot be allowed to repeat itself.” Barack Obama, *Remarks by the President on Financial Rescue and Reform* (Sept. 1, 2009), available at [http://www.whitehouse.gov/the_press_office/Remarks-by-the-President-on-Financial-Rescue-and-Reform-at-Federal-Hall](http://www.whitehouse.gov/the_press_office/Remarks-by-the-President-on-Financial-Rescue-and-Reform-at-Federal-Hall) (visited Aug. 17, 2014).

169 Dodd-Frank, § 203.

170 Id. § 201(a)(11).
that the company is chiefly (more than 85%) engaged in financial activities, or if it has been deemed a "systemically important non-bank financial institution." This means, among other things, that while bankruptcy remains a possible institutional choice for a failing firm, OLA will trump it, if it is invoked.

The decision whether to put a financial company into the resolution regime is made by regulators, not market actors (e.g., the firm itself) or any other institutional player. If the Secretary of the Treasury concludes that a systemically important company is "in default or in danger of default," two-thirds of the Federal Reserve Board and two-thirds of the FDIC board have recommended resolution, and he has also consulted with the President, the Secretary can initiate the new resolution process. The Treasury Secretary's decision is subject to 24-hour, confidential review by the United States District Court in the District of Washington, D.C. Observers expect that judicial review is unlikely to be a meaningful check on the administrative process.

If a firm is subject to the OLA, it would be treated as a receivership run by the Federal Deposit Insurance Corporation (FDIC). The FDIC's resolution powers authorize it to transfer some or all of the financial company's assets or liabilities to a third party, or to establish a temporary "bridge" company to hold the assets until some sort of orderly liquidation or sale is possible. The FDIC has virtually unfettered discretion to allow or disallow claims against the firm, although a creditor can challenge the determination in the U.S. District Court where the firm is located.

Although enacted with (barely) bipartisan support, Dodd-Frank and the OLA have been subject to withering criticism. The chief concern is that the OLA creates

---

171 Id. §§ 201(b), 117. Under this test, 85% of the company’s total consolidated revenues must come from activities the FSOC deems financial in nature, or more than 85% of the firm’s consolidated assets are financial assets. Id. § 201(b).

172 Id. § 165.

173 Id. § 170.

174 Id. § 203(a)(2)(F).


176 Dodd-Frank, § 203.

177 Id. § 210(a)(1)(G).

178 Id. § 210(b).

179 Id. §§ 210(a)(2), (a)(7), (b).

“uncertainty.” The uncertainty reflects the facts, among others, that we may not know, ex ante (1) whether a firm is subject to the OLA; (2) if it is, whether it will be upheld if invoked, and (3) how the firm’s distress will be resolved. Some have argued that OLA may be unconstitutional.

To be sure, the FSOC has already designated a number of firms to be SIFIs, including thirty very large bank holding companies (BHCs), three non-banking financial services firms and eight “financial market utilities.” In 2014, thirty BHC SIFIs underwent so-called “stress tests” required by Dodd-Frank to determine whether their failure could be resolved in an orderly way through a bankruptcy proceeding (as noted above, BHCs can go into bankruptcy). The Federal Reserve found that the BHCs would experience “substantial losses” under “adverse” scenarios. In theory, “[t]he disclosure of stress test results informs market participants and the public, enhances transparency, and promotes market discipline.”

While this sounds good, it seems implausible. The FSOC has the capacity to designate other non-bank (or BHC) firms SIFIs with little notice or process. The complexity and contingency of the results of stress tests make it unlikely that disclosure will in fact help market participants adjust their collective or respective exposures. Thus, it is not surprising that the GAO more recently found evidence that market participants still believe that if a SIFI encounters serious trouble, there will be some sort of regulatory support. Thus, despite the OLA and “stress tests,” the market—or at its largest participants—chooses regulatory displacement.

Yet, the costs of regulatory displacement likely swamp its benefits. Unlike the FDIC’s regulation of bank solvency, for example, it is not clear who ex ante will be subject to the OLA. It is thus not clear how regulators will be able to anticipate which firms may be large enough and important enough—and troubled enough—to warrant intervention—until it is too late. Given the erratic nature of the regulatory response to the crisis of 2008—saving Bear Stearns and AIG, but not Lehman Brothers—it is unlikely that regulators in the next crisis will act with greater predictability or evenhandedness.

Moreover, the participatory justifications for the FDIC’s resolution authority do not exist here. Non-bank firms that are likely candidates for orderly resolution are not like banks in a key participatory way: they do not have retail depositors, for whom regulators proxy.

---

181 See, e.g., Lubben, supra note 126, at 1271.


185 Id. at 3.

186 Id. at 3.

187 See GAO Report, supra note 38.
Instead, their counterparts are largely other financial firms, all run by highly sophisticated, well-resourced professionals. They are or should be capable of the monitoring and renegotiation historically found in non-bank distress renegotiations. While stress tests are laudable—and may help firms plan—this seems unlikely given the levels of concentration and complexity that still characterize the largest firms.

4.2 Single Point of Entry

Perhaps the most powerful evidence that firm- and structural-complexity stymie regulators is the strategy chosen to implement the OLA: the so-called “single point of entry” (SPOE). Under SPOE, the FDIC need not decide which of a firm’s hundreds or thousands of subsidiaries to liquidate: it need only look at the top-tier (parent) entity, and seize that one. That is, they need not understand much about the many tentacles—they only need to capture the head.

That entity will be placed in receivership, its assets (subsidiaries) remaining technically outside the process. Under SPOE, a “bridge” financial company would continue to provide the same functions as the holding company of the covered financial company, which would then convert to a “NewCo” successor to the failed firm. Independent experts would perform a valuation of the bridge financial company, and upon the FDIC’s approval of the value, payments of claims in the receivership will be made through issuance of securities in a securities-through-claims exchange. The exchange would avoid liquidating the bridge financial company’s assets while providing value to its creditors by issuing to the receiver new debt and equity in NewCo, the company that will succeed the bridge financial company, which the receiver would exchange for the creditors’ claims.

Before the bridge financial company can be terminated and NewCo established, the bridge financial company must establish a plan and timeframe for restructuring that would allow for resolution under the Bankruptcy Code and prepare a new living will, and the board of directors of NewCo must agree to adhere to the restructuring plan in order to gain approval of its holding company application. In addition, NewCo must show that it meets

---


189 Id. at 76,616. The FDIC summarizes the implementation of SPOE as follows:

“To implement the SPOE strategy the FDIC would be appointed receiver only of the top-tier U.S. holding company, and subsidiaries would remain open and continue operations. The FDIC would organize a bridge financial company, into which it would transfer assets from the receivership estate, primarily the covered financial company’s investments in and loans to subsidiaries. Losses would be apportioned according to the order of statutory priority among the claims of the former equity holders and unsecured creditors, whose equity, subordinated debt and senior unsecured debt would remain in the receivership. Through a securities-for-claims exchange the claims of creditors in the receivership would be satisfied by issuance of securities representing debt and equity of the new holding company or holding companies (NewCo or NewCos). In this manner, debt in the failed company would be converted into equity that would serve to ensure that the new operations would be well-capitalized.”

190 Id.

191 Id. at 76,618.

192 Id.

193 Id. at 76,620-21.
or exceeds the regulations regarding the amount of available capital. Once these requirements have been met, the bridge financial company will be allowed to execute its securities-for-claims exchange, which will end the bridge financial company’s charter and create NewCo. The FDIC expects that the entire process from its appointment as receiver through the establishment of NewCo will last between 180 and 270 days. The FDIC is still in the process of determining the sufficient amount of equity and unsecured debt at the holding company level to successfully resolve the institution under SPOE, and has sought public comment on this question.

The FDIC believes that the SPOE resolution strategy will be effective at minimizing disruption and instability because the subsidiaries will continue to perform critical operations for the financial system, instead of causing disruption by closing. The FDIC also claims that the SPOE strategy will reduce the risk of spillover effects to counterparties because the subsidiaries would remain in operation and the bridge financial company would assume any obligations supporting subsidiaries’ contracts. Thus, “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.”

Although SPOE creates the appearance of a simplifying regime, it in fact appears to defer rather than resolve the informational problems created by the complexity of large financial firms deeply intertwined with their regulators. Commentators have focused on three problems with SPOE.

First, David Skeel has observed that SPOE does little to solve problems of uncertainty under the FDIC’s orderly liquidation authority, because Dodd-Frank Act/SPOE does not impose a time requirement for the FDIC to act or take other measures to mitigate this problem. The chance that regulators will either jump the gun or delay interfering increases if a major subsidiary suffers severe financial distress and capital and liquidity are not sufficient to resolve it, as SPOE does not give regulators additional means to provide support to the subsidiary. Even if the government attempts to interfere in such a situation, the resolution may fail or the SIFI could be under the regulators’ authority for a much longer time than planned under the SPOE strategy. These problems could be

---

194 Id. at 76,620.
195 Id.
196 Id.
197 Id. at 76,623.
198 Id. at 76,616.
199 Id.
200 Id.
202 Id.
203 Id.
further exacerbated if the troubled subsidiary is in a foreign country and the U.S. has less incentive to provide as much support as it would if the subsidiary were domestic.\textsuperscript{204}

Second, some critics have raised concerns that some bank holding companies (BHCs) may be too complex for SPOE to be an effective resolution strategy for large international BHCs.\textsuperscript{205} Questions have arisen, for example, about whether SPOE will be able to effect orderly resolution over qualified financial contracts (QFCs) due to the differing laws between countries such as the U.S. and European Union countries.\textsuperscript{206} Similarly, Stephen Lubben has noted that focusing on the holding company may be unhelpful, because it is unlikely to be the cause of the SIFIs financial distress, or have the proper location in the capital structure to provide a basis for a remedy.\textsuperscript{207} For example, with respect to the proposal to recapitalize operating subsidiaries by forgiving intercompany debt owed to the parent company, it “seems unreasonable” that managers and regulators would be able to ensure that there is enough intercompany debt at the struggling subsidiary when cosigning the debt.\textsuperscript{208} Therefore, the FDIC must consider additional sources of recapitalization for the subsidiary, such as “the creation of a new, post-OLA intercompany debt funded by the parent’s own borrowing.”\textsuperscript{209} Furthermore, because the FDIC has not clarified how it will value the holding company’s assets, this lending could potentially become a “disguised bailout” because a loan to an insolvent subsidiary could only be secured by the value of the SIFI’s other subsidiaries, which may not be sufficient to support the liquidity needs of the insolvent subsidiary.\textsuperscript{210} Nor has the FDIC explained how it will resolve a SIFI that has multiple struggling subsidiaries.\textsuperscript{211}

Third, others worry that SPOE may not be the only strategy used.\textsuperscript{212} This may lead to creditors, counterparties, and foreign regulators being reluctant to rely on an SPOE because they may worry that the FDIC will instead use its Title II resolution authority to resolve a global financial services firm in other ways that harm their interests. If this occurs, “creditors

\textsuperscript{204} Id.


\textsuperscript{206} Id. at 4.


\textsuperscript{208} Id.

\textsuperscript{209} Id. at 2.

\textsuperscript{210} Id.

\textsuperscript{211} In such a situation, the FDIC may have used SPOE as an ideal approach but realistically would have to use a strategy more similar to a multiple point of entry approach because “in many cases it seems likely that the FDIC might have to conduct receivership proceedings with respect to an offending subsidiary, in addition to the holding company, and that in many such cases it might not be possible to do anything but liquidate that subsidiary to avoid complete devastation of the remaining group.” Id.

and counterparties with the legal right and practical ability to run may run, and foreign regulators may ring-fence local assets rather than rely on and cooperate with the FDIC.” Therefore, SPOE could aggravate financial instability if the public is not confident that the FDIC is fully committed to implementing it.

These problems with SPOE—timing, firm complexity, and mechanism choice—bespeak the problems with regulatory displacement in the prevention and resolution of financial distress. The resolution process and its triggers will remain essentially secret, discouraging more participatory market-based resolution efforts. While managers may have contingent plans for dealing with distress, nothing in the law tells them when the FDIC would invoke its OLA authority, whether (or how) it would use SPOE, or whether it would respect the “living wills” created by large firms. The OLA/SPOE strategy—like any regulator-heavy approach—will thus displace for a larger (and indeterminate) class of firms the market/bankruptcy court braided institutional solutions traditionally used.

Compared to other institutional choices, the OLA is clearly troubling. It is simply not clear why, in many cases, a market-based solution would not be the first and best. As discussed above, large, sophisticated firms are well-resourced, having access to top talent and technologies. It seems highly likely that they would be in the best position to anticipate and unwind or renegotiate losses, sell the distressed the firm, or otherwise resolve the problem without direct government involvement. Even a market-based solution facilitated by the federal government, as happened with Long-Term Capital Management, would be better than the poorly conceived procedural transplant envisioned here.

I do not mean that government has no role in resolving the distress of large, systemically important firms that are not insured depositaries. It seems inevitable that government will have some role. Rather, the important point, which seems to have gone largely unnoticed, is that government will be the appropriate institutional choice only under certain circumstances—chiefly when stakeholders are incapable of resolving the distress ex ante through negotiation or a judicial proceeding. Dodd-Frank displaces these other institutions because it is opaque and without participatory incentives. Like the last-minute decision to allow Lehman Brothers to go into bankruptcy (while nevertheless bailing out AIG) government has in effect codified in the OLA the unpredictability and lawlessness that likely made the financial crisis worse than it needed to be.

If institutional legitimacy is ultimately about stakeholder acceptance—institutional settlement in Hart and Sacks’ terms—it is difficult to see how most stakeholders affected by the OLA, whether those present at the time of a crisis, or future generations asked to bear the costs, could view such a system as legitimate. It promises to constrain chaos, but the promise rings hollow and comes at a higher cost than other institutional alternatives.

5. Against Regulatory Displacement—Judicial Responses

If regulatory displacement is likely to maintain the “doom loop” described in Part 1, how do we get out of it? Given the political economy of financial regulation, it is unlikely

213 BPC Comment Letter, supra note 212, at 7.

214 Id.

215 See FCIC REPORT, supra note 18, at 57 (discussing resolution of failed hedge fund brokered by New York Fed, which “involved no government funds.”).
that Congress or regulators will address the underlying pathologies of concentration, complexity, and capture. Nor do markets alone have the incentive to do so. Regulators and large firms appear to braid with one another, notwithstanding the economic and normative costs associated with this trend. This leaves the judiciary to produce what Hart and Sacks call “institutional settlement,” aided perhaps by market forces. This part discusses two strategies to reassert the institutional authority of the judiciary to prevent or resolve financial distress, the proposed “chapter 14” amendment to the Bankruptcy Code and a novel approach to fiduciary review of directors’ duty of oversight.

5.1 Bankruptcy Code Chapter 14

Many recognize that courts should play a larger role in preventing and resolving financial distress, and so look to the judicial process that has traditionally addressed failure: bankruptcy. Perhaps the most ambitious effort comes from Stanford’s Hoover Institute, which has proposed an entirely new chapter to the Bankruptcy Code, chapter 14, which would be available exclusively to the same systemically important financial firms that Dodd-Frank purports to regulate, but would choose a different institution—courts.\(^\text{216}\) Bowing to the political reality that Dodd-Frank is a law whose repeal is unlikely, however, it is offered “either in addition to or as an alternative to” Dodd-Frank.\(^\text{217}\)

The main contribution of chapter 14 can be understood in institutional terms: It would take some resolution authority away from regulators, and give it to courts: “we believe it is possible to take advantage of a judicial proceeding . . . in such a way as to minimize the felt necessity to use the alternative government agency resolution process recently enacted as a part of [Dodd-Frank].”\(^\text{218}\)

The motivation is laudable: judges are (probably) likely to produce decisions that are more transparent, precedent-bound, and thus more predictable than regulators. The goal of chapter 14 is, according to its proponents, “to ensure that the covered financial institutions, creditors dealing with them, and other market participants, know in advance, in a clear and predictable way, how losses will be allocated if the institution fails.”\(^\text{219}\) The theoretical justification is that bailouts distort incentives. “If the creditors of a failed financial institution are protected (bailed out), then the strongest and most rapidly responding constraint on risk-taking by the financial institution’s management is destroyed, and their losses are transferred to others.”\(^\text{220}\)

The functional heart of the proposal would limit derivatives counterparties from closing out their positions up bankruptcy, as happened in Lehman Brothers with problematic

\(^{216}\) As Thomas Jackson, the principal author of the proposal and one of the nation’s leading experts on bankruptcy explains, the chapter 14 proposal is designed “especially for the complexity and potential systemic consequences, of the failure of [a] large financial institution[]. Thomas Jackson, Bankruptcy Code Chapter 14: A Proposal, 2 (draft of Feb. 28, 2012), available at http://media.hoover.org/sites/default/files/documents/Bankruptcy-Code-Chapter-14-Proposal-20120228.pdf (visited Aug. 17, 2014).

\(^{217}\) Id.

\(^{218}\) Id. at 2.

\(^{219}\) Id.

\(^{220}\) Id.
The Bankruptcy Code creates a series of “safe harbors” under which parties to certain kinds of derivatives are not stayed by bankruptcy from enforcing their rights. Originally meant to promote market stability, they have in fact permitted the kinds of “runs” that bankruptcy was meant to prevent. The “single most important “fix”” in the chapter 14 proposal would give financial firm debtors in chapter 14 three days to decide whether to perform these contracts, or let the counterparties terminate them (which they can currently do immediately). There is much to be said for this element of the chapter 14 proposal.

The problem is that the case to amend the Bankruptcy Code to create a full-blown chapter 14 has not yet been made. First, the proposals on derivative contracts should apply not only to large financial firms under chapter 14, but all firms in bankruptcy. As Mark Roe has observed, those safe harbors have become financial crisis “accelerators” that contributed to the crisis, undermining their original goal of preserving market stability.

Second, the chapter 14 proposal’s political pragmatism undermines its goal of creating institutional predictability. The authors sensibly recognize that Dodd-Frank is not likely to be repealed. So, they cagily suggest that chapter 14 could comfortably co-exist with Dodd-Frank. But if we do not know when or to whom Dodd-Frank is to apply, why would a dual, judicial track create greater certainty? It would not.

Third, they recognize that bankruptcy courts currently have uncertain authority. This is due to a series of Supreme Court decisions holding that bankruptcy judges, as Article I actors, “lack authority under Article III of the Constitution to enter final judgments on claims that constitute the stuff of the traditional actions at common law tried by the courts at Westminster in 1789.” While it is far from clear what this means in practice, the chapter 14 proposal would avoid the problem by taking these resolutions away from bankruptcy judges, too. Instead, such cases would be “funnel[ed]” to “a limited set of pre-picked Article III district judges.”

They may be correct that placing these decisions with U.S. District Judges avoids possible constitutional challenges over bankruptcy judges’ authority. But this is not their rationale. Rather, they argue, somewhat surprisingly, that “it is unlikely that the nation’s several hundred bankruptcy judges—all of whom can be presumed to have important


224 See Jackson, supra note 216, at 36.

225 See Roe, supra note 221.


227 Jackson, supra note 216, at 9.
knowledge of the Bankruptcy Code itself—will have the requisite financial expertise to deal, in real time, with the nation’s largest financial institutions.228 They also question the independence of bankruptcy judges who, as Article I actors, may be susceptible to political influence (e.g., from the Congress that sets their pay). “[T]he essential need for complete independence from any perception of influence by the financial institution, the government, or a particularly significant creditor, suggests that any bankruptcy system designed for the nation’s largest financial institutions would want those institutions to have their cases and ancillary proceedings heard before an Article III judge . . . [the] ‘gold-plated’ standard of independence from government.”229

This is curious for many reasons. It is, for example, hard to imagine judges with greater expertise in dealing with the failures of large financial institutions than Robert Drain, the bankruptcy judge who oversaw the Refco case, Mary Walrath, who oversaw the bankruptcy of WaMu’s parent holding company, or James Peck, the bankruptcy judge who oversaw the Lehman Brothers case. There may be arguments from pragmatism for taking this work away from them—or more plausibly providing for dual bankruptcy-district judge appointments—but it is inappropriate to question their expertise or independence. Moreover, anyone who believes that Article III courts are the “gold-plated standard of independence” has not spent time in Washington D.C. recently. There is concern that the D.C. Circuit is every bit as captured as regulators.230 A large body of empirical literature has shown that even Article III judges are as likely to vote their ideology as to follow precedent.231 Such bias appears to be an unavoidable fact of institutional life.

Finally, any effort to amend the Bankruptcy Code is likely to be politically fraught. The last major amendment to that statute occurred in 2005, in a highly politicized process that produced amendments considered to be harmful to all but the large financial institutions that aligned to support it.232 Given the well-understood political cycle that characterizes financial regulation described in Part 1—special interests dominate except (perhaps) in a crisis—it is not clear why financial services firms would permit chapter 14 to become law, or at least in any way that does not advance their interests. There is no reason to think that an amendment to the Bankruptcy Code would be immune from the problems of capture that otherwise hamper financial regulation.

I am nevertheless sympathetic to the intuition behind this proposal. There is good reason to believe that the bankruptcy process brings with it participatory virtues lacking in Dodd-Frank. Nevertheless, it is not clear why we need a whole new chapter of the Bankruptcy Code to do this. As discussed in Part 3, there is already a chapter 11 of the Bankruptcy Code. With some of the adjustments discussed in the chapter 14 proposal, that

228 Id. at 8.
229 Id. at 9.
could work for SIFIs without need for a new chapter of the Bankruptcy Code. Without clarifying limits on regulatory OLA authority, adding chapter 14 as proposed only makes for greater complexity, which seems to be one of the root problems. In short, while I support an expanded role for the judiciary in preventing financial crises, I am not sure the case has yet been made for a new chapter 14 of the Bankruptcy Code.

5.2 Duty to Be Informed

A more effective—but more controversial—way in which the judiciary could reassert its institutional authority is by recognizing a more robust “duty to be informed” (DTBI) on the part of directors of large financial firms. Although scholars have taken a largely dim view of a DTBI, they have also not considered the operation of the doctrine in comparative institutional terms, or its capacity to influence the behavior of directors of large, complex financial firms. Recognizing such a duty—whether actual liability or through the expressive threats frequently made by the Delaware judiciary—we might see meaningful efforts to reduce the size and complexity of large financial firms.

Corporate directors have duties of care and loyalty. Whether or to what extent either imposes upon directors a duty to be actively informed about their firms has been a difficult question for courts and commentators. The analysis of the DTBI usually begins with Caremark, a controversial case that said—but did not hold—that directors’ “sustained or systematic failure . . . to exercise oversight” may be evidence of “bad faith.” In the wake of the financial crisis, angry shareholders sued directors of financial services firms alleging that directors had failed to satisfy their oversight duties. With one exception, the cases have failed to provide relief to the shareholders.

Consider, for example, the Goldman Sachs Shareholders litigation. Here, shareholders sued officers and directors of Goldman Sachs for breaching their fiduciary duty of oversight by approving excessive compensation for employees, which “led to overly-risky business decisions and unethical and illegal practices.” Goldman Sachs had experienced substantial growth since it went public in 1999, and plaintiffs alleged that its management “achieved this growth ‘through extreme leverage and significant uncontrolled exposure to risky loans and credit risks’” and that this business growth strategy was not in the shareholders’ best

---

233 See Lipson, supra note 134.

234 In re Caremark Int’l Inc. Derivative Litig., 698 A.2d 959, 971 (Del. 1996). Of course, everything about the duty of oversight in Caremark may have been dicta, since the opinion merely approved the settlement of a shareholder lawsuit stemming from a board’s failure to detect and stop fraud by corporate managers. Id. at 972.


237 Id. at *4.
interest. 238 During 2008, Goldman Sachs suffered losses of billions of dollars, and plaintiffs alleged that “but for a cash infusion from Warren Buffet, federal government intervention and Goldman's conversion into a bank holding company, Goldman would have gone into bankruptcy.” 239

Although plaintiffs conceded that Goldman Sachs had an audit committee in place, they alleged that the board violated duties under Caremark by failing to notice conflicts of interest between the company and its clients that arose from its hedging practices, and that Goldman’s methods of making profits “conflicted with its clients’ interests to the detriment of the company's reputation.” 240 Plaintiffs specified several transactions as examples of the conflicts of interest that occurred, including the Abacus transaction, which resulted in the SEC charging Goldman with fraud and led to a settlement in which Goldman paid a civil penalty and paid back its profit from the transaction. 241

In dismissing the case, the Delaware Chancery Court observed that “[t]o face a substantial likelihood of oversight liability for a Caremark claim, the Director Defendants must have '(a) ... utterly failed to implement any reporting or information system or controls” (which the Plaintiffs concede is not the case here); 'or (b) having implemented such a system or controls, consciously failed to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention.”  242 Plaintiffs only alleged “unethical” conduct, which “is not the type of wrongdoing envisioned by Caremark.” 243 The conduct that plaintiffs describe was legal business decisions, and “[l]egal, if risky, actions that are within management's discretion to pursue are not ‘red flags’ that would put a board on notice of unlawful conduct.”  244 Although plaintiffs bring up disclosure violations in their allegations regarding the Abacus transaction, they did not allege sufficient facts with respect to the Abacus transaction to show bad faith or the willful ignorance of “red flags.” 245

In part, the directors were protected by the business judgment rule. “If an actionable duty to monitor business risk exists, it cannot encompass any substantive evaluation by a court of a board’s determination of the appropriate amount of risk. Such decisions plainly involve business judgment.” 246 Plaintiffs’ other allegations attempt to find defendants personally liable for their failure to see the risk in their investments in subprime mortgages. However, the court says that plaintiffs did not plead specific facts to show that

238 Id.
239 Id.
240 Id.
241 Id.
242 Id. at *17 (quoting Stone v. Ritter, 911 A.2d 362, 370 (Del.2006)).
243 Id. at *20.
244 Id.
245 Id. at *21.
246 Id.
defendants willfully ignored their oversight duties relating to the business risk, and that they simply exercised their business judgment.247

Only one significant case has come out the other way, the Countrywide Shareholders litigation.248 Here, plaintiffs alleged that from 2002-2006, defendants increased production of non-conforming loans, which were riskier than conforming loans.249 Furthermore, plaintiffs alleged that Countrywide increased the riskiness of the loans by offering them to homebuyers without requiring proof of income, which “often violated the Company’s own loan underwriting policies,” and the complaint provided “the accounts of numerous confidential witnesses, who are mostly former employees such as underwriters and loan officers, relating how Countrywide departed from its strict underwriting standards by generating large numbers of loans without proper regard for their quality.”250 Plaintiffs further alleged that the individual defendants, as well as Countrywide’s Audit Committee, Credit Committee, Finance Committee, and Operations and Public Policy Committee ignored “red flags” that Countrywide’s loan portfolio had taken on too much risk.251 In addition, plaintiffs alleged that defendants made false and misleading statements about the health of the loans that Countrywide was originating.252 In August 2007, after Countrywide disclosed the true quality of its loans and the fact that it was facing liquidity issues, it suffered a large drop in its share price.253

Applying Delaware law, the U.S. District Court in California denied a motion to dismiss the complaint, finding that it “establishes a strong inference of deliberate recklessness for several of the Individual Defendants” because it shows that the committees on which the individual defendants sat “were directly responsible for monitoring Countrywide’s risk exposures and the financial performance of its loan portfolio, both of which implicate a fundamental part of the Company’s business—the quality of the loans originated and adherence to underwriting standards.”254

Furthermore, the court accepted testimony which “suggest[ed] a widespread Company culture that encouraged employees to push mortgages through without regard to underwriting standards.”255 Because the defendants sat on committees which were directly responsible for monitoring the risk that led to Countrywide’s losses, and they had knowledge of the “red flags,” and the fact that employees were routinely violating Countrywide’s

247 Id. at *23.


249 Id.

250 Id. at 1051.

251 The “red flags” included the facts that (1) the shift to riskier loan products; (2) the rising delinquencies in pay-option ARMs and HELOCs; (3) sharply rising rates of negative amortization and associated “phantom earnings”; (4) the “dramatic increase in retained interests held on Countrywide’s balance sheet”; (5) the fact that the Company’s valuation of MSRs, retained interests and loans held for sale “fluctuate[d] wildly without any basis,”; (6) the pitfalls of other mortgage lenders and (7) industry publications about nontraditional loans, including those that were critical of low-documentation pay option ARMs.” Id. at 1052-53.

252 Id. at 1053.

253 Id. at 1055-56.

254 Id. at 1081.

255 Id. at 1081-82.
underwriting standards, plaintiffs have established scienter.\(^{256}\) Therefore, based on its finding of scienter, the court went on to find that “the Complaint pleads evidence of a 'sustained or systematic failure of the board to exercise oversight’” as required by \textit{Caremark}.\(^{257}\) “It defies reason, given the entirety of the allegations, that these Committee members could be blind to widespread deviations from the underwriting policies and standards being committed by employees at all levels. At the same time, it does not appear that the Committees took corrective action.”\(^{258}\)

Commentators have been quick to defend the majority approach, and contain \textit{Countrywide} to facts peculiar to the nature of the company’s business. Christine Hurt, for example, has argued that “the lasting impact of \textit{Countrywide} may be limited to cases involving issuers that have one line of business and make statements--even generalized statements, regarding that business model that are fundamentally untrue where this disconnect is common knowledge within the company.”\(^{259}\) This comports with a more general skepticism about the force of any duty on the part of directors to be informed about risks undertaken by the firm. Steve Bainbridge worries that attempts to hold directors to a more rigorous DTBI would stifle innovation because risk management is both a developing art, and varies across types of firms. The problem with the financial crisis, he argues, was not necessarily the lack of boards’ attention to risk management, but that risk management was still too undeveloped to be effective.\(^{260}\) “If, in applying \textit{Caremark} to risk management failures, courts are perceived as imposing liability on boards for failing to adopt some specific model of risk management, the evolutionary market processes by which optimal best practices emerge may be aborted.”\(^{261}\) Like Hurt, Bainbridge views any duty of oversight as competing with the business judgment rule, since assessments of risk are deeply intertwined with the zone of business decisions we want directors to be able to make unfettered by worries of judicial second-guessing.

Robert Miller has a more nuanced view.\(^{262}\) He suggests that the DTBI would not require boards to implement the risk-management or oversight system that the court thinks is most appropriate. Rather, the questions are whether the board has any such systems and, if so, whether they paid attention to them.\(^{263}\)

Skepticism about DTBI for directors of large financial firms should be met with equal skepticism that recognizes the problem of regulatory displacement. If directors of large financial firms are not in a position to monitor their firms’ risks and manage them appropriately, who is? We know that regulators cannot. While executives will likely be better informed than directors, there is little reason to believe that they have the long-term

\(^{256}\) Id.

\(^{257}\) Id. (quoting In re \textit{Caremark Int'l Derivative Litig.}, 698 A.2d 959, 971 (Del.Ch.1996).

\(^{258}\) Id.


\(^{261}\) Id. at 982.


\(^{263}\) Id.
incentives to manage risk prudently. The crisis shows they were paid to ignore long-term risks.264 Rather, if they believe that regulators will save them—as happened in the crisis and as seems inevitable under regulatory displacement—they would find it difficult to manage less aggressively. They are the ones capturing regulators; we cannot expect the foxes to voluntarily exit the henhouse.

Directors, however, are in a different position. Their duties run chiefly to the firm, not to its executives. We expect them to maintain some independence from executives. If financial services firms are so complex that directors cannot meaningfully assess their risk, then they are in the most plausible position to change this. They can require executives to divest or simplify firm assets and structures. Or they can employ better technologies to manage risk. Indeed, perhaps the stress tests described above would aid this effort. If they do not, courts should take more seriously their duty of oversight, as happened in Countrywide.

I am thus not necessarily arguing that directors must simplify or reduce financial services firms. Some hope that information technologies will increasingly aid bank managers and directors in assessing risk.265 If these technologies, coupled with improved risk reporting, credibly aid directors in managing firm complexity, there may be no need. The market would then become a more plausible institutional choice. But more rigorous judicial review of the DTBI should motivate directors of large financial firms to take this duty more seriously.

Doing so would also have the salutary effect of restoring institutional balance. As others have observed, courts were disturbingly quiescent in the financial crisis, ignoring serious legal problems with the Bear Stearns bailout and the Chrysler bankruptcy, among others.266 Courts should not abdicate their duty to independently influence the conditions that give rise to financial crises. While they are not regulators, they can nevertheless counteract some of the effects of regulatory capture by compelling directors to do that which regulators apparently cannot: manage the size and complexity of large financial services firms.

The nature and effect of judicial review of directorial conduct are the subjects of a large and complex literature. Taking a duty of oversight seriously in this context would doubtless warrant further elaboration. Nevertheless, two basic points should be remembered. First, some may worry that taking fiduciary review seriously in this context would deter “good” candidates from serving as directors. The answer to this is that it seems unlikely. It may deter directors who are not smart or willing to do the hard work required to understand a financial services firm’s risk profile. But why would we want them to be directors in the first place?

Second, courts often influence director behavior through “expressive” signaling, not necessarily by finding liability.267 Caremark, for example, imposed no liability, even as it


266 See SKEEL, DEAL, supra note 22, at [] (discussing judicial abdication). See also Lipson & Vandermeuse supra note 226 (discussing Supreme Court’s handling of Chrysler bankruptcy).

267 See Jonathan C. Lipson, The Expressive Function of Directors’ Duties to Creditors, 12 STAN. J. L. FIN. & B. 224
announced what most viewed as a new standard by which to review director’s duties. This “expressive function” of judicial opinions is, itself, a subject of some complexity. But courts with gravitas—in particular, the Delaware courts—could influence the path of director oversight simply by what they say, even if they do not impose personal liability. Such expressive effects might then lead to the kind of market-judicial braiding that seems better suited to prevent financial crises in the first place.

As with all institutional choices, this proposal is not perfect. Any suggestion of litigation will introduce problems of agency cost and externality that have the potential to dampen corporate performance. Suing directors is costly, and many scholars and courts wish to protect them from taking legitimate risks. Holding them to a duty to understand risk might be misconstrued as creating liability for failing to prevent unforeseeable risks, or for losses that occurred simply because risks—no matter how well understood—don’t always pay off. Yet, the institutional error costs of requiring directors to better understand their firms in order to better manage risk seem the least problematic alternative on both economic and normative measures.

Conclusion

The watchwords of institutional analysis are “participation” and “tradeoffs.” This paper has shown that regulatory displacement is, like all problems of institutional choice, ultimately one of participation. Regulators and large financial firms increasingly appear to braid in ways that give the regulators and the regulated incentives to displace markets and courts as institutional choices to resolve financial distress. While this may benefit the firms themselves in the short run, the cautionary tale from the crisis of 2008—the doom loop in which we appear to be stuck—is that there are long-term financial and social costs associated with this institutional choice.

Yet, no institutional choice is perfect; choices can only be made intelligently by assessing the costs and benefits—tradeoffs—associated with a choice. This paper has shown both how to do this in thinking about financial crises, and why doing so may lead to better outcomes. It reveals the causes and cures of regulatory displacement, and a credible (albeit imperfect) path to restoring judicial balance in the institutional mix. While every institutional choice is flawed, ignoring institutional analysis does offer one kind of perfection: It guarantees failure.

(2007).