Treasury Report Recommends Retaining, but Significantly Limiting, Orderly Liquidation Authority and Reforming the Bankruptcy Code

Summary: In April 2017, President Trump directed Treasury Secretary Steven Mnuchin to review several post-financial crisis banking regulations as part of the administration’s efforts to scale back Obama-era regulations that it believes have failed to hold Wall Street firms accountable. Included among these directives was an examination of the Orderly Liquidation Authority (OLA). In response, the Treasury Department recently published a report that recommends retaining, but significantly altering, OLA and also reforming the Bankruptcy Code to better hold financial firms accountable for their failures.

Outlook: Orderly Liquidation Authority (OLA)—the federal receivership process created by Title II of the Dodd-Frank Act—permits the FDIC to serve as receiver of a severely distressed financial company if the company’s failure poses a significant risk to the financial stability of the United States. Signed into law by President Obama in the aftermath of the 2008 financial crisis, OLA was intended to create a winding-down process for large, failing financial companies that would protect against another taxpayer-funded bailout. However, critics of OLA—including several key officials in the Trump administration—have argued that the policy actually enshrines the “too big to fail” mentality instead of protecting against it, by conferring administrative discretion that is far too broad and thus ripe for abuse by officials who could too easily use OLA to bail out creditors instead of saving the market in exceptional circumstances.

Earlier this year, the Trump administration reiterated its desire to hold financial companies accountable through deregulation. On February 3, President Trump issued an Executive Order outlining seven “Core Principles” meant to inform financial regulation in the U.S. In addition to fostering economic growth at home and abroad, the principles focus on restoring public accountability of financial agencies, tailoring financial regulations for greater efficiency, and preventing taxpayer-funded bailouts of failed financial companies. The Executive Order also directed Treasury Secretary Mnuchin—in consultation with the Financial Stability Oversight Council—to prepare a report for the president discussing how existing financial laws and regulations should be changed to better align with the Core Principles.
In response to these presidential mandates, Treasury released a report on February 21 that recommends altering the Bankruptcy Code by adding procedural features to the existing bankruptcy process in order to make bankruptcy a more effective option for financial companies. Treasury acknowledged, however, that even with these changes, bankruptcy may still not be feasible for financial companies in certain circumstances. Accordingly, Treasury recommends retaining OLA, but only permitting its use as “an emergency tool” under “extraordinary circumstances” and with significant alterations.

**Bankruptcy Code Reform**

In its report, Treasury concluded “unequivocally” that bankruptcy should be a failing financial company’s first and best solution, because it incentivizes companies not to take excessive risks and holds them accountable by providing a “predictable, judicially administered allocation of losses” that are borne by the companies’ shareholders, executives, and creditors instead of the public. However, Treasury determined that the Bankruptcy Code, as currently written, fails to address debtors that are engaged in certain kinds of large-scale, complex transactions. Accordingly, Treasury recommends a new Chapter 14 of the Bankruptcy Code that includes procedural features tailored to the unique challenges of large, interconnected financial companies, such as an expedited two-entity bankruptcy filing model that would permit a distressed financial company to continue operations by transferring most of its assets to a newly-formed bridge company within 48 hours of filing for bankruptcy. Most importantly for Treasury, these operations would not require any taxpayer support.

Treasury believes the new Chapter 14 would help mitigate any potential destabilizing effects a large financial firm’s failure might have on the economy, rendering OLA unnecessary in most circumstances.

**Orderly Liquidation Authority (OLA) Reform**

In addition to limiting the circumstances in which OLA would be necessary, Treasury proposes significant reforms to OLA to “correct” what it considers to be “serious problems” in the way OLA operates—namely, that it gives “excessively broad discretion [to the FDIC] on several key issues, including the treatment of creditors.” Accordingly, Treasury recommends eliminating FDIC’s ability to treat similarly situated creditors differently and instead requiring them to be treated equally, in accordance with established Bankruptcy Code principles. To further bolster impartiality and fairness, Treasury proposes that a bankruptcy court, and no longer the FDIC, be responsible for adjudicating a failing firm’s claim; FDIC could participate in the proceedings and would manage the transfer and disposition of the newly formed bridge company, but it would no longer oversee a claim’s resolution. Additionally, Treasury recommends repealing the tax-exempt status of the newly-formed bridge company, arguing that no private corporation—especially a failed one—should enjoy “a large government-confferred competitive advantage.”

The report also recommends strengthening current protections against taxpayer exposure for a failing firm’s losses. Specifically, Treasury recommends that OLA should be limited to loan guarantees of private funding instead of direct lending, which it believes would permit the new bridge company to return to private funding sources more quickly. Further, where direct lending is the only option, the FDIC should only lend on a secured basis, for a limited fixed term that is only as long as necessary to meet the failed firm’s liquidity needs. Treasury also recommends that if any part of a loan remains unpaid, the current backstop mechanism should be imposed as soon as reasonably possible instead of closer to the five-year deadline in the current law.

Finally, Treasury recommends expanding judicial review of the government’s decision to invoke OLA; currently, a district court conducts a limited, 24-hour review of only two of the seven factors
the Treasury Secretary is required to consider in determining whether to invoke OLA. Treasury recommends a full-scale review of the entire seven factors in order to provide “additional assurance that the government’s [OLA] decision” is well-reasoned. Treasury further calls upon Congress to either replace the limited pre-OLA review with a robust post-OLA review of whether the FDIC should be removed as receiver or permit an appeals court to review the district court’s limited pre-OLA review de novo (anew, instead of only for error).

What it means and what to expect: Treasury’s recommendation to retain OLA has been met with relief by some large banks and overseas regulators who seem to be of the view that OLA decreases systemic risk and could make a U.S.-based global bank safer in the event of its failure. These entities appear to consider Treasury’s approach—retaining OLA but with significant reforms—a signal that the Trump administration is taking a measured approach to deregulation. However, many conservative Republicans have pushed for a repeal of Dodd-Frank altogether and some have thus expressed their disappointment in the Treasury’s recommendation to retain OLA.

Although Congress has the power to repeal the OLA, the Treasury’s recommendation weighs heavily in the discussion. Nevertheless, Republicans’ disappointment, coupled with the fact that Congressional action is needed to make statutory changes to the bankruptcy code, might revitalize financial legislation that is currently before lawmakers, such as the Financial CHOICE Act (H.R. 10) and the Financial Institution Bankruptcy Act (H.R. 1667), both of which passed the House with bipartisan support and are awaiting Senate consideration. Although it remains uncertain when these bills will be debated on the Senate floor, we expect financial reform efforts to intensify, once again, in the wake of this report.

Craig Saperstein, a member of NACHA’s Government Relations Advisory Group, is an attorney in the Public Policy practice of Pillsbury Winthrop Shaw Pittman LLP in Washington, D.C. In this capacity, he provides legal analysis for clients on legislative and regulatory developments and lobbies congressional and Executive Branch officials on behalf of companies in the payments industry. Deborah Thoren-Peden is a partner and member of the Financial Institutions Team at Pillsbury Winthrop Shaw Pittman LLP. She provides advice to financial institutions, bank and non-bank, and financial services companies. Andrew Caplan is an associate and member of the Financial Institutions Group and the Privacy, Data Security, and Information Use Focus Team at Pillsbury Winthrop Shaw Pittman LLP. He counsels and defends financial institutions, technology companies, and other clients that offer consumer products or services on a range of issues related to credit, payments, data privacy, cybersecurity, and e-commerce. The information contained in this update does not constitute legal advice and no attorney-client relationship is formed based upon the provision thereof.