

The Case Against the Dodd-Frank Act's Living Wills: Contingency Planning Following the Financial Crisis

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The Dodd-Frank Act's "living will" requirement mandates that systemically important financial institutions develop wide-ranging strategic analyses of their business affairs, and submit comprehensive contingency plans for reorganization or resolution of their operations to regulators. The goal is to mitigate risks to the financial stability of the United States and encourage last-resort planning, which will allow for a rapid and efficient response in the event of an emergency. Beyond the general framework set forth in the Dodd-Frank Act, very little is known about living wills; no legal literature currently exists on what the concept entails, and regulators have not yet finalized any rules that detail how living wills will operate. Nevertheless, living wills are perceived to be a successful regulatory solution to the problems highlighted by the recent financial crisis. Accordingly, nine of the world's biggest financial firms submitted to the regulators, and gave the public a peek at, their living wills in July 2012, as required by the new regulation.

This article focuses on two issues. First, the article examines the implementation and operation of living wills for systemically important financial institutions. Second, the article presents the problematic aspects of living wills, and how they can lead to the failure of even the most ideally planned living wills, including: (i) the difficulty in identifying and predicting risk; (ii) the failure to solve the too-big-to-fail problem; (iii) the failure to solve the cross-border insolvency problem; (iv) the costs associated with living wills; (v) the confidentiality problem; (vi) the potential failure of the living wills solution in a market-wide crisis; (vii) the problem of creating a false sense of security; (viii) the problem of contingency planning in a vacuum; (ix) the problems resulting from regulator intervention; and (x) the issue of liability

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and the difficulty in getting SIFI board approvals. The article concludes that living wills are merely a disclosure requirement with high expectations, but only limited power; accordingly, they should not be perceived as a comprehensive, satisfactory regulatory solution to the too-big-to-fail problem.

Introduction	31
I. Why Living Wills?	37
II. Living Wills – The ABCs	39
A. Information Gathering and Data Architecture	39
B. SIFIs' Internal and Preventive Measures and Recovery Plans	42
i. Guidelines for Recovery Plans	43
ii. Preventive Measures.....	44
(a) Capital Planning and Buffers	44
(b) Liquidity Buffers.....	49
(c) Leverage Ratio Limitations.....	50
(d) Organizational Measures.....	51
C. Resolution Plans	52
i. The Framework for the Authorities' Decision.....	54
ii. The Different Resolution Methods	55
iii. Financial Institutions Fund	58
III. Preparing for Unknown Hazards and Stress Tests.....	59
A. Risk Management and Preparing for Potential Hazards	59
B. Stress-Testing and Scenario Planning.....	63
i. Scenario Planning	66
ii. War Games and Simulations	67
C. Black Swans and Tail Risk	71
IV. Supervision.....	72
V. Difficulties in the Implementation of Living Wills.....	75
A. The Difficulty in Identifying and Predicting Risk	75
B. The Too-Big-To-Fail Problem Has Not Been Solved	77
C. The Cross-Border Insolvency Issue Has Not Been Solved.....	80
D. The Costs Associated with the Living Wills Might Outweigh the Benefits	84
E. Confidentiality Issues.....	85
F. The Failure of the Living Wills in a Market-Wide Crisis	87
G. Overconfidence and a False Sense of Security	87
H. Contingency Planning in a Vacuum	88
I. The Regulator's Intervention and Its Impact.....	89
J. The Issue of Liability and the Difficulty of Obtaining SIFI Board Approvals.....	90
VI. Conclusion.....	90

The Case Against the Dodd-Frank Act's Living Wills

INTRODUCTION

The recent financial crisis was the product of a flawed and fragmented regulatory system, which operated under outdated notions of systemic risk,¹ and resulted in poorly informed regulators who lacked the authority to properly supervise big financial conglomerates.² Financial institutions were practically encouraged to increase their leverage levels because of malfunctioning systems of executive compensation.³ And the speedy growth in the unregulated financial market sectors, such as the derivatives trading market, made it even more complicated for regulators to obtain the information necessary to properly oversee and manage systemic risk.⁴ Attempting to resolve these problems and prevent future similar crises, lawmakers sought significant regulatory reform. Consequently, the Dodd–Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), was signed into law on July 21, 2010.⁵

The Dodd-Frank Act, a product of a sweeping financial regulatory reform, calls for systemic risk supervision using traditional techniques of regulating financial institutions: improved capital, liquidity, and risk management standards. It turns the Federal Reserve into a “super-regulator” for a larger number of financial conglomerates, including previously unregulated financial

1. Professor Steven Schwarcz defines systemic risk as “the risk that (i) an economic shock such as market or institutional failure triggers (through a panic or otherwise) either (X) the failure of a chain of markets or institutions or (Y) a chain of significant losses to financial institutions, (ii) resulting in increases in the cost of capital or decreases in its availability, often evidenced by substantial financial-market price volatility.” Steven L. Schwarcz, *Systemic Risk*, 97 GEO. L.J. 193, 204 (2008).

2. See, e.g., *The Causes and Current State of the Financial Crisis: Hearing Before the Financial Crisis Inquiry Commission*, 111th Cong. 1-2 (2010) (statement of Sheila C. Bair, Chairman, Federal Deposit Insurance Corporation), available at <http://www.fcic.gov/hearings/pdfs/2010-0114-Bair.pdf>; Timothy Geithner & Lawrence Summers, *A New Financial Foundation*, WASH. POST, June 15, 2009, at A15; see also Arthur E. Wilmarth, Jr., *The Transformation of the U.S. Financial Services Industry, 1975-2000: Competition, Consolidation, and Increased Risks*, 2002 U. ILL. L. REV. 215, 305 (2002) (arguing that the biggest international banks have become too big to supervise and manage effectively). But certain commentators argued that it is de-regulation rather than weak and outdated regulation that caused the financial crisis. See, e.g., Amar Bhade, *Why Bankers Got Reckless*, BUS. WK., Feb. 9, 2009, at 31 (“[L]et’s revive the radical idea of narrow commercial banking. Let’s tightly limit bank activity to taking deposits and making loans Anyone else—investment banks, hedge funds, trusts—would be allowed to innovate and speculate, free of additional oversight.”); Nouriel Roubini, *‘Too Big to Fail’ Revisited*, FORBES, Nov. 5, 2009, <http://www.forbes.com/2009/11/04/too-big-to-fail-volcker-greenspan-mervyn-king-opinions-columnists-nouriel-roubini.html> (“A separation of commercial banking and risky investment banking should also be considered.”).

3. See, e.g., John C. Coffee, Jr., *Bail-Ins versus Bail-Outs: Using Contingent Capital to Mitigate Systemic Risk* 2-4 (Columbia Law Sch. Law & Econ. Working Paper No. 380, 2010), available at <http://ssrn.com/abstract=1675015>; Lucian A. Bebchuk & Holger Spemann, *Regulating Bankers’ Pay*, 98 GEO. L.J. 247 (2010); Lucian A. Bebchuk, Alma Cohen, & Holger Spemann, *The Wages of Failure: Executive Compensation at Bear Stearns and Lehman 2000-2008*, 27 YALE J. ON REG. 257 (2010).

4. See Renee M. Jones, *Back To Basics: Why Financial Regulatory Overhaul Is Overrated*, 4 ENTREP. BUS. L.J. 389, 393 (2010).

5. Pub. L. No. 111-203, 124 Stat. 1376.

entities.⁶ Such entities include private equity firms, hedge funds, insurance groups, and other systemically risky financial institutions. The Dodd-Frank Act also creates new regulatory agencies such as the Financial Stability Oversight Council (FSOC) to monitor financial institutions. The FSOC supervises systemic risk⁷ and tasks multiple agencies with supervising different parts of the financial system while mandating their cooperation.⁸ For example, the FSOC can mandate the cooperation of the Federal Reserve and the Federal Deposit Insurance Corporation (FDIC) in winding-down financial institutions.⁹

One of the Dodd-Frank Act's main goals is to solve the too-big-to-fail problem—the problem caused when certain multinational financial institutions are so large that their insolvency could shake the entire financial system and the economy.¹⁰ This goal became a global priority in the wake of the recent

6. Together, these financial entities are referred to as the “shadow banking system.” For more on the shadow banking system see Gary Gorton & Andrew Metrick, *Regulating the Shadow Banking System*, BROOKING PAPERS ON ECONOMIC ACTIVITY, Fall 2010, available at <http://ssrn.com/abstract=1676947> (arguing that although the shadow banking system greatly contributed to the recent financial crisis, it remained relatively unregulated even after the enactment of the Dodd-Frank Act).

7. Pursuant to section 111 of Title I of the Dodd-Frank Act, the FDIC Board of Directors approved on March 29, 2011 a joint Notice of Proposed Rulemaking (NPR) for covered systemic organizations to file and report resolution plans and credit exposure reports. 76 Fed. Reg. 22648 (proposed Apr. 22, 2011) [hereinafter FDIC’s NPR]; 12 U.S.C. § 5321 (the FDIC’s NPR is available online at <http://www.fdic.gov/news/board/29Marchno4.pdf>). And shortly after, following the Federal Reserve approval, the FDIC and the Federal Reserve invited public comment on a Notice of Proposed Rulemaking: Resolution Plans and Credit Exposure Reports Required. *Id.* Several months after, on September 13, 2011, the FDIC Board of Directors approved a final rule to be issued jointly by the FDIC and the Federal Reserve Board to implement Section 165(d) of the Dodd-Frank Act, laying out what the largest and most complex financial firms must include in living wills. *Id.* (the FDIC’s final rule is available online at <http://www.fdic.gov/news/board/Sept13no4.pdf>). And on October 17, 2011, the Federal Reserve announced that it has approved the final rule, which became effective November 30, 2011. *Id.* The Federal Reserve’s approval is available online at <http://www.federalreserve.gov/newsevents/press/bcreg/20111017a.htm>, and the final rule is available online at <http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20111017a1.pdf> [hereinafter Final Rule].

8. For example, on September 13, 2011, the FDIC Board of Directors approved a complementary Interim Final Rule under the Federal Deposit Insurance Act to require insured depository institutions with \$50 billion or more in total assets to submit periodic contingency plans to the FDIC for resolution in the event of the depository institution failure. Pursuant to FDIC Acting Chairman Martin J. Gruenberg, “The FDIC’s Interim Final Rule . . . is intended to serve as a complement to the joint rulemaking with the Federal Reserve under the Dodd-Frank Act . . . These two rules will ensure the comprehensive and coordinated resolution planning for both the insured depository and its holding company and affiliates in the event that an orderly liquidation is required.” See FDIC, *FDIC Board Approves Interim Final Rule Requiring Resolution Plans for Insured Depository Institutions Over \$50 Billion*, <http://www.fdic.gov/news/news/press/2011/pr11150.html>; Special Reporting, Analysis and Contingent Resolution Plans at Certain Large Insured Depository Institutions, 75 FR 27,464 (May 17, 2010) (to be codified at 12 CFR Part 360). The FDIC’s Interim Final rule is available online at <http://www.fdic.gov/news/board/Sept13no6.pdf>. Thus, the Dodd-Frank Act does not fully adopt the Universal Regulator financial regulation model that prevails in the U.K., nor does it fully adopt the Twin Peaks model. See Jones, *supra* note 4, at 394-97; Joseph J. Norton, *Global Financial Sector Reform: The Single Financial Regulator Model Based on the United Kingdom FSA Experience - A Critical Reevaluation*, 39 INT’L LAW 15 (2005).

9. See Dodd-Frank Act tit. I, §165(d)(3), (4), (5).

10. “Too-big-to-fail” was first termed in 1984, concerning the federal bank’s intervention to prevent Continental Illinois National Bank from failing. See DAVID S. HOLLAND, WHEN REGULATION

The Case Against the Dodd-Frank Act's Living Wills

financial crisis¹¹ because many felt that society should not and could not afford the costs associated with the too-big-to-fail status quo.¹² Indeed, during the recent financial crisis, in order to maintain the stability of the economy, the U.S. government provided subsidies to the bigger financial institutions totaling approximately \$1.525 trillion through the Troubled Asset Relief Program (TARP)¹³ and the Stimulus Package.¹⁴ Moreover, these programs, which were criticized for having used taxpayers' money to save Wall Street,¹⁵ were accompanied by many government-assisted financial transactions and bailouts for the too-big-to-fail financial institutions.¹⁶ Such institutions greatly profited

WAS TOO SUCCESSFUL – THE SIXTH DECADE OF DEPOSIT INSURANCE: A HISTORY OF THE TROUBLES OF THE U.S. BANKING INDUSTRY IN THE 1980S AND EARLY 1990S 37-51 (1998). The term has received great attention in the last two decades. See, e.g., Lawrence A. Cunningham, *Too Big to Fail: Moral Hazard in Auditing and the Need to Restructure the Industry Before It Unravels*, 106 COLUM. L. REV. 1698, 1726-27 (2006); Helen A. Garten, *Banking on the Market: Relying on Depositors to Control Bank Risks*, 4 YALE J. ON REG. 129, 146 (1986); Benton E. Gup, *Are Fannie Mae and Freddie Mac Too Big to Fail?*, in POLICIES AND PRACTICES IN GOVERNMENT BAILOUTS 285, 310 (Benton E. Gup ed., 2003); Jeffrey E. Garten, Op-Ed., *Too Big to Fail: Megamergers Could Create Economic Havoc*, N.Y. TIMES, Sept. 26, 1997, at A27. During the recent financial crisis, regulators announced that the government would provide capital to the top nineteen biggest bank holding companies, if they needed it, based on "stress tests" results, but could not raise it on their own. Consequently, the government ended up injecting more than \$220 billion of capital into 18 of those conglomerates, and by doing so indicated that all nineteen firms were presumptively too-big-to-fail at the time. See E. Wilmeth, Jr., *Reforming Financial Regulation to Address the Too-Big-To-Fail Problem*, 35 BROOK. J. INT'L L. 707, 713 (2010) [hereinafter *Reforming Too-Big-To-Fail*].

11. See, e.g., Ann Graham, *Bringing to Heel the Elephants in the Economy: The Case for Ending "Too Big To Fail,"* 8 PIERCE L. REV. 117 (2010).

12. See Cheryl D. Block, *Overt and Covert Bailouts: Developing a Public Bailout Policy*, 67 IND. L.J. 951, 991 (1992) ("The first justification for the presumption against bailout is that government intervention to protect private industry violates the free-market principles that generally govern our economy."); *Regulating and Resolving Institutions Considered "Too Big to Fail:" Hearing Before the S. Comm. on Banking, Hous. & Urban Affairs*, 111th Cong. 6 (2009) (statement of Gary H. Stern, President and CEO, Fed. Reserve Bank of Minneapolis), available at http://www.minneapolisfed.org/news_events/pres/stern testimony05-06-09.pdf; see also Gary H. Stern, President, Fed. Reserve Bank of Minneapolis, Address at Winona State University: Too Big to Fail: The Way Forward (Nov. 13, 2008), available at http://www.minneapolisfed.org/news_events/pres/stern11-13-08.cfm ("Once immediate fires have been doused, policymakers will have to turn to reining in TBTF because, left unchecked, the TBTF embers remaining from our emergency response will likely contribute to future financial conflagrations.").

13. See Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, 122 Stat. 3765 ("EESA"). EESA helped establish the TARP, which enabled the Treasury to purchase or guarantee up to \$700 billion in troubled assets that were owned by financial institutions. *Id.*

14. See American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, 123 Stat. 115 (2009).

15. See Jonathan Weber, *The Wall Street Bailout: What About Main Street?*, NEWWEST, Sept. 23, 2008, http://www.newwest.net/topic/article/what_does_the_wall_st_bailout_mean_for_you/C35/L35/; *Main Street's Resentment Over Wall Street Bailout*, HUFFINGTON POST, Sept. 22, 2008, available at http://www.huffingtonpost.com/2008/09/22/main-streets-resentment-o_n_128206.html. Indeed, Neil Barovsky, the Special Inspector General for Troubled Asset Relief Program ("SIGTARP"), argued that \$23.7 trillion in taxpayer money could be expended through various programs that were meant to re-stabilize the U.S. financial system and help the economy. *Id.*

16. A U.S. Department of the Treasury website provides details on programs designed to supply continued capital to financial institutions and to conduct stress tests to the biggest most systemically important financial institutions to make sure they are capable of surviving the financial crisis. *Financial Stability*, U.S. DEP'T OF TREAS., <http://www.treasury.gov/initiatives/financial-stability/Pages/default.aspx>.

from those public subsidies, which distorted economic incentives and further pushed the too-big-to-fail institutions toward excessive risk-taking.¹⁷

The Dodd-Frank Act includes an enhanced supervisory scheme for systemically important financial institutions (SIFIs).¹⁸ It forces such SIFIs to internalize the costs and risks of their activities.¹⁹ Indeed, pursuant to the Dodd-Frank Act, non-bank financial companies and bank holding companies with total consolidated assets equal to or greater than \$50 billion, or financial companies that have been designated as systemically important, require special monitoring and supervisory schemes.²⁰ The purpose of this supervision is “to prevent or mitigate risks to the financial stability of the United States that could arise from the material financial distress or failure, or ongoing activities, of large, interconnected financial institutions.”²¹

To monitor, reduce and ideally even prevent such risk, the Dodd-Frank Act requires that SIFIs prepare reorganization and liquidation plans,²² commonly

aspx (last visited May 4, 2011); *see also Turmoil in U.S. Credit Markets: Examining the Recent Actions of Federal Financial Regulators: Hearing Before the S. Comm. on Banking, Hous. & Urban Affairs*, 110th Cong. (2008), available at http://banking.senate.gov/public/index.cfm?FuseAction=Hearings.Hearing&Hearing_ID=ec013d8f-fe1e-4fb6-a514-ab93be32ad38; KATE KELLY, STREET FIGHTERS: THE LAST 72 HOURS OF BEAR STEARNS, THE TOUGHEST FIRM ON WALL STREET 181-214 (2009); Press Release, Fed. Deposit Ins. Corp., FDIC Closes Sale of Indymac Federal Bank, Pasadena, California (Mar. 19, 2009), available at <http://www.fdic.gov/news/news/press/2009/pr09042.html>; Failed Bank Information, FDIC, <http://www.fdic.gov/bank/individual/failed/IndyMac.html> (last visited Jan. 28, 2010); Press Release, U.S. Dept. of Treasury, Statement by Henry M. Paulson, Jr. on Treasury and Federal Housing Finance Agency Action to Protect Financial Markets and Taxpayers (Sept. 7, 2008), available at <http://www.treasury.gov/press-center/press-releases/Pages/hp1129.aspx>; Matthew Karnitschnig et al., *U.S. to Take Over AIG in \$85B Bailout; Central Banks Inject Cash as Credit Dries Up*, WALL ST. J., Sept. 17, 2008, at A1; *Feds Give Green Light to Wells Fargo-Wachovia*, NEWSPER, Oct. 10, 2008, <http://www.newspaper.com/story/39663/feds-give-green-light-to-wells-fargo-wachovia.html>; *Following the Bailout Money to Wells Fargo*, CBSNEWS, Feb. 9, 2009, <http://www.cbsnews.com/stories/2009/02/09/eveningnews/main4788018.shtml>; Liz Rappaport, *Lewis Testifies U.S. Urged Silence on Deal*, WALL ST. J., Apr. 23, 2009, at A1; David Enrich & Deborah Solomon, *Citi, U.S. Reach Accord on a Third Bailout*, WALL ST. J., Feb. 28, 2009, at B1.

17. *See generally Reforming Too-Big-To-Fail*, *supra* note 10.

18. Pursuant to the Dodd-Frank Act, SIFIs are institutions that are so essential to the US financial system that their failure would cause traumatic damage to the financial markets, as well as the entire economy. Nevertheless, it is not clear if all SIFIs must be defined as such, or only those where the FSOC believes it is required to do so. *See* Dodd-Frank Act tit. I, §113(a)(1) (§113 uses the term “may,” while §112(a)(12)(H) indicates a requirement).

19. *See generally Reforming Too-Big-To-Fail*, *supra* note 10.

20. Dodd-Frank Act tit. I, § 165(d)(1). Indeed, pursuant to Final Rule, the law “applies to any bank holding company that has \$50 billion or more in total consolidated assets, as determined based on the average of the company’s four most recent Consolidated Financial Statements for Bank Holding Companies as reported on the Board’s Form FR Y-9C. It also applies to any foreign bank or company that is, or is treated as, a bank holding company under section 8(a) of the International Banking Act of 1978 [12 U.S.C. 3106(a)] and that has \$50 billion or more in total consolidated assets, as determined based on the average of the foreign bank’s or company’s four most recent quarterly Capital and Asset Reports for Foreign Banking Organizations as reported on the Board’s Form FR Y-7Q (or, if applicable, its most recent annual Form Y-7Q). . . [and] any nonbank financial company that the Council has determined under section 113 of the Dodd-Frank Act must be supervised.” Final Rule, *supra* note 7.

21. Dodd-Frank Act tit. I, § 165(a)(1).

22. Pursuant to the FDIC’s NPR and the Final Rule, “rapid and orderly resolution” means “reorganization or liquidation of the covered company. . . under the Bankruptcy Code.” FDIC’s NPR

The Case Against the Dodd-Frank Act's Living Wills

known as “living wills,”²³ and submit them for review to the Federal Reserve Board, the FDIC and the FSOC.²⁴ These living wills, which in essence are a type of a disclosure requirement,²⁵ also mandate that each SIFI²⁶ internally manage and better monitor its business and financial risks, as well as report periodically on its credit exposure to other SIFIs,²⁷ and on the other SIFIs’ exposure to the reporting SIFI.²⁸

The U.S. is not alone in adopting regulations that call for the preparation of corporate living wills. Nearly everyone thinks living wills are just about the perfect solution to the problems highlighted in the recent financial crisis; regulators from all over the world strongly support the concept and have been advocating for its implementation.²⁹ Most notably is the United Kingdom,

and Final Rule, *supra* note 7; see also Dodd-Frank Act tit. I, § 165(d)(1).

23. Pursuant to the Final Rule, each covered company must “produce a resolution plan, or “living will,” that includes information regarding the manner and extent to which any insured depository institution affiliated with the company is adequately protected from risks arising from the activities of nonbank subsidiaries of the company; detailed descriptions of the ownership structure, assets, liabilities, and contractual obligations of the company; identification of the cross-guarantees tied to different securities; identification of major counterparties; a process for determining to whom the collateral of the company is pledged; and other information that the Board and the Corporation jointly require by rule or order.” Final Rule, *supra* note 7. These financial plans are named after the “traditional” living will, legal scheme, which provide for a patient’s wishes concerning the use of specific life-sustaining treatments given the commencement of that patient’s terminal disease or another catastrophic accident. See, e.g., Patrick Webster, *Enforcement Problems Arising From Conflicting Views of Living Wills in the Legal, Medical and Patient Communities*, 62 U. Pitt. L. REV. 793, 793 (2001).

24. See Dodd-Frank Act tit. I, § 165(d)(3), (4), (5); Final Rule, *supra* note 7. Accordingly, in July 2012, nine of the world’s biggest financial institutions submitted to the U.S. regulators, and gave the public a peek at, their living wills, as requested. See Jessica Holzer, *Banks’ Living Wills’ Unveiled*, WALL ST. J., July 3, 2012, available at <http://online.wsj.com/article/SB10001424052702304211804577505011956447968.html>.

25. See DAVID SKEEL, THE NEW FINANCIAL DEAL: UNDERSTANDING THE DODD-FRANK ACT AND ITS (UNINTENDED) CONSEQUENCES 185 (2010) [hereinafter UNDERSTANDING THE DODD-FRANK].

26. “FDIC officials said 124 banks would be subject to the rule, 26 of which are U.S. bank holding companies. The rest are subsidiaries of foreign-owned banks.” Victoria McGrane & Alan Zibel, *FDIC Drafts Rule on ‘Living Wills’ for Banks*, WALL ST. J., Mar. 29, 2011, available at http://online.wsj.com/article/SB10001424052748704559904576230842703099306.html?mod=googlenews_wsj.

27. Under the Final Rule, companies need to submit their initial plans on a staggered basis. The first group of companies, including mainly companies with \$250 billion or more in non-bank assets, must submit their initial plans on or before July 1, 2012; the second group, generally those with \$100 billion or more, but less than \$250 billion, in total non-bank assets, must submit their initial plans on or before July 1, 2013; and the remaining companies, including mainly companies subject to the rule with less than \$100 billion in total non-bank assets, need to submit their initial plans on or before December 31, 2013. Final Rule, *supra* note 7. After the initial resolution plan is submitted, each covered company is required to submit an updated resolution plan annually on or before the anniversary date of the date for submission of its initial plan. The Final Rule also requires companies to file a notice with the Federal Reserve and the FDIC upon the occurrence of a restructuring, acquisition, or sale, no later than 45 days after such an event, or change that results in, or could reasonably be foreseen to have, a material effect on the resolution plan of the covered company, takes place. *Id.*

28. See Dodd-Frank Act tit. I, § 165(d)(2).

29. For the different official commentaries of different international associations, organizations and nations advocating for living wills, see Bradley J. Gans, *Living Wills—Official Commentaries*, in NINTH ANNUAL INSTITUTE ON SECURITIES REGULATION IN EUROPE: A CONTRAST IN EU & U.S. PROVISIONS 581 (Practicing Law Institute Corp. Law & Practice, 2010). Such commentators include the G20

which led the initiative to adopt such regulations and mandated the preparation of Recovery and Resolution Plans.³⁰

But living wills are not the silver bullet that regulators seem to think they are. This Article will show that there are a lot of open issues concerning living wills, and that there are real questions as to how effective they can be. Beyond the general framework set forth in the Dodd-Frank Act, very little is known about what the living wills scheme will include. No legal literature currently exists on what the concept entails, and regulators have not yet created any rules that detail how it will operate. This Article focuses on two issues: (i) the implementation and operation of living wills for systemically important financial institutions; and (ii) the problematic aspects of living wills, and how they can lead to the failure of even the most ideally planned living wills. The Article commences by presenting the concept of living wills.³¹ In theory, living wills force SIFIs to simplify their structures and business models³² and to better prepare conceptually and organizationally for a last resort option.³³ The Article then describes the process a SIFI should use to prepare a living will, highlighting potentially important provisions. First, a SIFI needs to create a comprehensive real-time database that houses all essential information to the SIFI's financial, organizational, and legal operations, as well as all client-related and cross-industry financial information. Second, using that database, a

members, the Financial Services Secretary, Paul Myners, the Chairman of the FSA, Adair Turner, and the FSA Chief Executive, Hector Sants. *Id.*

30. The Financial Services Bill received Royal Assent on 8th April 2010. The bill places a legal duty on the Financial Services Authority (FSA) to make rules requiring financial institutions to create and maintain recovery and resolution plans. The FSA indicated in October 2009 that it was minded to extend the requirement to all UK deposit takers in addition to systemically important firms. The UK Financial Services Act 2010 simply creates the legal support for this. See TREASURY COMMITTEE, REPORT: TOO IMPORTANT TO FAIL - TOO IMPORTANT TO IGNORE, 2009-10, H.C. (U.K.), available at <http://www.publications.parliament.uk/pa/cm200910/cmselect/cmtreasy/261/26102.htm>; Conference Report, Fin. Servs. Auth., Turner Review Conference Discussion Paper: A Regulatory Response to the Global Banking Crisis: Systematically Important Banks and Assessing the Cumulative Impact (Oct. 2009), www.fsa.gov.uk/pubs/discussion/dp09_04.pdf; HM TREASURY, ESTABLISHING RESOLUTION ARRANGEMENTS FOR INVESTMENT BANKS, 2009, available at <http://www.hm-treasury.gov.uk>; Paul Tucker, Deputy Governor Bank of England, Address at Barclays Annual Lecture: The Debate on Financial System Resilience: Macroprudential Instruments (Oct. 22, 2009), available at <http://www.bankofengland.co.uk/publications/speeches/2009/speech407.pdf>. For more background on the U.K. regulatory changes, including the living wills model, see George A. Walker, *Financial Crisis-U.K. Policy And Regulatory Response*, 44 INT'L LAW 751, 776 (2010).

31. Thomas F. Huertas, Director, Banking Sector, FSA, & Vice Chairman, CEBS, Speech at the Wharton School of Management: Living Wills: How Can the Concept Be Implemented? 1 (Feb. 12, 2010) [hereinafter Huertas Speech], available at http://www.fsa.gov.uk/Pages/Library/Communication/Speeches/2010/0212_Th.Shtml.

32. See UNDERSTANDING THE DODD-FRANK, *supra* note 25, at 178, 186. It is argued that as a result of the living wills requirement, SIFIs may "reduce their risk exposures because of greater awareness of the board, more thorough analysis by supervisors, and great discipline by creditors and counterparties." Richard J. Herring, *Wind-Down Plans as an Alternative to Bailouts: The Cross Border Challengers*, in ENDING BAOLUTS AS WE KNOW THEM 125, 141 (Kenneth E. Scott et al. eds., 2009), available at <http://fic.wharton.upenn.edu/fic/papers/10/10-08.pdf>.

33. Huertas Speech, *supra* note 31, at 1.

The Case Against the Dodd-Frank Act's Living Wills

SIFI must create guidelines for business and financial recovery plans (including preventive measures) and tailor options for different resolution plans. Third, a SIFI must invest in better risk management procedures, deal better with risk resulting from unknown factors, and use game simulations as a method to improve risk monitoring. But the success of this process depends on regulators as well as on the SIFIs. Thus, the Article also reviews the significant role that regulator supervision plays in the success of living wills and the measures that should be taken by regulators to improve the effectiveness of the monitoring process.

The article then introduces the significant problems and difficulties associated with the implementation of the living wills concept, which have not been properly addressed by the concept's many supporters, including: (i) the difficulty in identifying and predicting risk; (ii) the failure to solve the too-big-to-fail problem; (iii) the failure to solve the cross-border insolvency problem; (iv) the costs associated with living wills; (v) the confidentiality problem; (vi) the potential failure of the living wills solution in a market-wide crisis; (vii) the problem of creating a false sense of security; (viii) the problem of contingency planning in a vacuum; (ix) the problems resulting from regulator intervention; and (x) the issue of liability and the difficulty in getting SIFI board approvals. Finally, the article concludes that despite the popularity and the high expectations of living wills, the requirement for living wills is not a substantive regulation, but an incomplete procedural response to the problem posed by SIFIs, with many problematic aspects to it. Therefore, although the Dodd-Frank Act's living wills requirement is meant to improve regulatory oversight, its power is limited and even the most carefully, ideally drafted living wills can fail as a result of the difficulties associated with their implementation. Accordingly, it is unlikely that bailouts will be completely discontinued, or that regulators will entirely change their ways and intervene early in future crises merely because of the Dodd-Frank Act's goals and provisions.

The Article is structured as follows: Part I introduces the living will concept and discusses the perceived benefits of living wills. Part II suggests what a living will should include. Part III discusses methods to minimize and reduce unknown potential hazards and focuses on risk management, stress-testing and the phenomenon of black swans. Part IV discusses regulator supervision of SIFIs' living wills. Part V outlines the difficulties and problems associated with the implementation of living wills. Finally, the article concludes with some criticisms of using living wills as the leading regulatory response to the problems posed by SIFIs.

I. WHY LIVING WILLS?

Those supporting living wills emphasize four advantages. First, "living wills can help create a better financial system—a system resilient to shocks that

assures that banks are not ‘too-big’ or ‘too-interconnected’ to fail.”³⁴ Second, requiring international enterprises to undertake the process of devising, in advance, “well conceived and well maintained recovery plans should lessen the probability that resolutions would be required.”³⁵ Third, living wills would allow institutions to more easily evaluate restructuring solutions either through the Dodd-Frank Act or the bankruptcy courts, and avoid situations such as the Lehman’s case, where having a plan in advance would have saved the estate at least \$75 million.³⁶ Fourth, mandating SIFIs to devise living wills would result in simplified financial institutions, which will be easier for regulators to oversee.³⁷ Indeed, forcing a SIFI’s management to plan how to preserve the SIFI on an ongoing basis—and not only during crisis times—would focus efforts on the areas where the SIFI’s business strategies fall short of best practice.³⁸ As part of such an improvement process, SIFIs will review and revise their business operations structure. That structure is usually extremely complex as a result of SIFIs: (i) operating via multiple entities;³⁹ (ii) participating in various mergers; (iii) creating business operational structures for tax purposes; and (iv) maneuvering around regulations.⁴⁰ By targeting the contractual, legal, and business relationships between a SIFI’s different entities, management would be able to improve the SIFI’s efficiency. Thus, going through the living wills process could result in meaningful benefits and better prudential supervision in booming times, and, of course, in times of crisis. Additionally, some industry experts have noted that the living wills concept is relatively advantageous to a high-impact and high-cost regulatory solution that may otherwise ensue.⁴¹

34. *Id.* An approved liquidation plan would result in greater legal, and, in particular, functional separation of affiliates within these large financial holding companies and greater autonomy and firewalls surrounding insured banks.” *The Causes and Current State of the Financial Crisis: Hearing Before the Financial Crisis Inquiry Commission*, 111th Cong. 40 (2010) (statement of Sheila C. Bair, Chairman, FDIC), available at <http://www.fdic.gov/news/news/speeches/chairman/spjan1410.html>.

35. Huertas Speech, *supra* note 31, at 1.

36. See Herring, *supra* note 32, at 141.

37. See UNDERSTANDING THE DODD-FRANK, *supra* note 25, at 186.

38. Daniel K. Tarullo, Speech at the Institute of International Bankers Conference on Cross-Border Insolvency Issues: Supervising and Resolving Large Financial Institutions (Nov. 10, 2009) [hereinafter Supervising and Resolving], available at <http://www.federalreserve.gov/newsevents/speech/tarullo20091110a.htm>.

39. For example, a few years ago Citigroup operated its business through 2,435 different legal entities, which included different partnerships, trusts, and corporations. See UNDERSTANDING THE DODD-FRANK, *supra* note 25, at 178.

40. See *id.* at 177-80.

41. Huertas Speech, *supra* note 31, at 2.

The Case Against the Dodd-Frank Act's Living Wills

II. LIVING WILLS – THE ABCS

A. Information Gathering and Data Architecture

A great amount of information regarding all aspects of a SIFI's business must be collected in order for the SIFI to be able to successfully implement preventive measures and design the best possible business reorganization and liquidation plans while under extreme duress. Thus, to be effective, each SIFI will need to invest in a sophisticated management information system (MIS),⁴² which will enable it to obtain, store, update, and easily pull information about its activities and structure.⁴³ Such a MIS will provide a complete picture of the SIFI's positions, trading, and custody systems at any given time, and will provide key information as to where each system is located and the essential personnel to operate each system. More importantly, information relating to all operational aspects of the SIFI will be integrated into one centralized system for full transparency.⁴⁴

The type of information that a SIFI should have readily accessible—outlined in detail below—is the same type of information that bankruptcy practitioners should ideally have prior to commencing proceedings under the Bankruptcy Code.⁴⁵ This information is needed for several reasons. First, it will help a SIFI to better prepare the best recovery plan possible, which also needs to be quickly executable under the worst-case scenario. Second, if the SIFI's recovery plan fails, the relevant governmental authorities will need the SIFI to be able to generate such information at a short notice, so that they can make decisions regarding the best choice of a resolution method.⁴⁶ Since all resolution methods have massive implications for the financial institutions in question and the economy at large, the relevant governmental authorities must be able to consider all relevant information. Nevertheless, since the decisions will be made quickly—typically in the thirty-six to forty-eight hours between the close of business on Friday in North America, and the opening of business in Asia on a Monday—such information needs to be readily available, properly organized, and updated.⁴⁷ Third, a properly functioning MIS will also assist

42. STIJN CLAESSENS ET AL., A SAFER WORLD FINANCIAL SYSTEM: IMPROVING THE RESOLUTION OF SYSTEMIC INSTITUTIONS 62-63 (Int'l Ctr. for Monetary & Banking Studies, Geneva Reports on the World Economy No. 12, 2010) [hereinafter GENEVA REPORT], available at <http://personal.vu.nl/d.schoenmaker/Geneva12.pdf>.

43. See BASEL COMM. ON BANKING SUPERVISION, REPORT AND RECOMMENDATIONS OF THE CROSS-BORDER BANK RESOLUTION GROUP 32 (Mar. 2010), available at <http://www.bis.org/publ/bcbs169.pdf>.

44. See Report of Anton R. Valukas, Examiner, at 1549-51, *In re Lehman Bros. Holdings, Inc.*, No. 08-13555 (JMP) (Bankr. S.D.N.Y. filed Mar. 11, 2010) [hereinafter Lehman Examiner Report].

45. Huertas Speech, *supra* note 31, at 12.

46. Huertas Speech, *supra* note 31, at 12.

47. *Id.*

SIFIs with monitoring the location of their liquidity and with organizing their counterparty and instrument related data. Fourth, as mentioned above, one of the central assumptions of the living wills concept is that the process of having a SIFI collect and organize all of its information will make the SIFI simplify its operations and organizational structure, and thus guarantee that an orderly liquidation is feasible.⁴⁸ Finally, an improved MIS will most likely help with the ongoing risk management of SIFIs, as it will make information more accessible to be analyzed, which will logically simplify risk supervision.

In creating a MIS, each SIFI should, as an initial organizational step, inventory all of its legal entities, collect information about the legal regimes that are applicable to each entity, and categorize the SIFI's business lines into legal entities. Then, a SIFI should list all of its inter-affiliate guarantees, hedging, and funding, and provide data regarding its information technology and all other key services that the SIFI employs.⁴⁹

While collecting such information and organizing it, each SIFI should verify that it uses proper corporate governance procedures and that it maintains all of its books and records in good order, including the separateness of all of its individual legal entities' books, records, assets, bank accounts, and liabilities.⁵⁰ This entails that each SIFI sets, maintains, or keeps clear records in its MIS of the following: a list of all intercompany debt; procedures regarding funds transfer; procedures for segregating trust funds such as deposits or taxes from operating funds; procedures to allow for ready-access of financial information regarding cash and securities positions; a list of all the main contracts and unexpired leases to which the SIFI is a party—including collective bargaining agreements—so that the SIFI will be able to determine quickly, if need be, whether or not such contracts should be rejected; data concerning the SIFI's membership in payments; the SIFI's clearing and

48. Under Dodd-Frank Act, the FDIC and the Federal Reserve wield considerable authority to shape the content of these [living will] plans. If the plans are not found to be credible, the FDIC and the Fed can even compel the divestiture of activities that would unduly interfere with the orderly liquidation of these companies. The success or failure of the new regulatory regime will hinge, in large part, on how credible those resolution plans are as guides to resolving those companies. And let us be clear: We will require these institutions to make substantial changes to their structure and activities if necessary to ensure orderly resolution. If we fail to follow through, and don't ensure that these institutions can be unwound in an orderly fashion during a crisis, we will have fallen short of our goal of ending Too Big to Fail. Neil Barofsky, *Does Dodd-Frank Cure 'Too Big To Fail'?*, MORTGAGEORB (Feb. 4, 2011), http://www.mortgageorb.com/e107_plugins/content/content.php?content.7730.

49. Pursuant to the Bankruptcy Code, the Federal Rules of Bankruptcy Procedure, and applicable local court rules there are certain procedures that a company commencing bankruptcy must follow. These sources contain explicit provisions concerning the information that must be provided by a company in order for it to commence a Chapter 11 case. The information provided herein is based on these sources as well as on information provided to the author in private conversations with restructuring specialists, regarding how a company should best prepare for restructuring procedures. Such preparations are similar to those that will be required under the living wills requirements. Huertas Speech, *supra* note 31, at 12.

50. *Id.*

The Case Against the Dodd-Frank Act's Living Wills

settlement facilities and infrastructures; records regarding the segregation of client assets and the procedures by which such assets could be reassigned to third parties;⁵¹ and data regarding the SIFI's deposit base, including records regarding what is insured and what is not, and the items and conditions of the deposits and their maturity structure.⁵²

Additionally, any SIFI's MIS should include information concerning the SIFI's: (i) unpledged collateral; (ii) funding, and accessible lines of credit; (iii) cash flows and earnings; (iv) capital; (v) a summary of total assets and total liabilities; (vi) an approximation of the amount of secured debt; (vii) debt securities; (viii) other fixed liabilities; (ix) the number of shares of common or preferred stock; and (x) the approximate number of holders of each of the categories of debt and securities—organized based on parameters such as legal entity, counterparty, the business line, or legal regime. Such information must also be collected on the entities that control or are controlled by the SIFI's operational and financially significant entities.

SIFIs should also need to provide information on third-party entities, and their relationships with them. Indeed, because SIFIs should be required to identify which counterparties they can turn to in order to raise liquidity or capital if need be, SIFIs should have readily available information concerning the complete universe of exposures to counterparties. Such categorization will enable more efficient retrieval of relevant information based on the characteristics of the stress or crisis at hand. It will also enable the SIFI to more easily update and maintain the information, which can change drastically even on a daily basis.

But despite the obvious need for SIFIs to invest in and maintain a sophisticated MIS, there is a high likelihood that SIFIs will not do so unless strictly required. Because upgrading data architecture into a sophisticated MIS will undoubtedly result in a considerable expense to SIFIs, some SIFIs might not believe that the benefits associated with such an investment will outweigh the costs and will therefore attempt to minimize their investment. Accordingly, the requirement that SIFIs invest in a better MIS must be coupled with tight regulator supervision to ensure the SIFIs' compliance. Regulators must verify that each SIFI has established a functioning MIS that is capable of generating relevant information quickly. Regulators should conduct frequent tests to ensure that SIFIs can populate a data room with information needed for the urgent implementation of a reorganization and liquidation plan.⁵³

51. *Id.* at 12-13.

52. *Id.* at 13.

53. For more information about data rooms see Sacha Pfeiffer, *The Data Room*, BOSTON GLOBE, Jan. 23, 2006, http://www.boston.com/business/technology/articles/2006/01/23/the_data_room/.

B. SIFIs' Internal and Preventive Measures and Recovery Plans

Once a proper MIS is installed, a SIFI should—based on the business, financial and organizational information gathered—review, analyze, and revise its internal measures to be more efficient. The purpose of such an exercise is to improve the financial and business structure, standing, and operations of each SIFI and reduce all SIFIs' exposure to risks and failure due to controllable factors. As part of a SIFI's revision of its internal measures, a special focus should be given to the SIFI's (i) governance regulations and procedures; (ii) quality of management; (iii) business model; (iv) balance sheets; (v) methods for risk reduction;⁵⁴ (vi) compensation schemes; and (vii) risk management and control procedures and guidelines, as further discussed in Part III.

The process of review and examination of a SIFI's preventive measures—one of the stages of preparing a living will—inevitably leads to a SIFI that is better prepared to deal with extreme situations, should they materialize. Indeed, SIFIs have established approaches in dealing with natural disasters (which cannot be prevented or anticipated) such as fires, earthquakes, or flooding, or even other disasters like terrorist attacks, each of which can result in severe unexpected interruptions to the SIFI's physical infrastructure.⁵⁵ SIFIs can engage in similar planning to prepare for financial disasters.⁵⁶

A living will should include both a recovery plan—a plan to prolong the ability of a SIFI to continue in business—and a resolution plan. The recovery plan should include the SIFI's preventive measures, which would help the SIFI mitigate the impact of a crisis by providing a pre-determined set of actions that the SIFI's management can choose from. Such recovery plans should largely resemble the plans of corporate enterprises when they start considering filing for Chapter 11 under the Bankruptcy Code. The recovery plans need to be built on ordinary course of business considerations and include clearly articulated triggers. Nevertheless, the recovery plans cannot be designed solely by a SIFI's management; the help of experienced restructuring specialists is required because they better understand the practical implications of real-world issues and can walk the SIFI's management through the potential recovery steps. Such specialists can help a SIFI's management understand the key dependencies and assumptions, as well as the options to resolve possible deadlocks and logjams.

54. Indeed, risks-related controls concerning the balance sheet are aimed at limiting the amount of assets that a particular business division can originate. For example, Salomon Brothers ran down its balance sheet by approximately 35% within several weeks in 1991, following sanctions by the U.S. government. See generally R. Lane Sisung, *The Law of Salomon: A History of the Regulation of Government Securities, an Accounting of the Salomon Brothers Scandal and an Analysis of the Government Securities Act Amendments of 1993*, 40 LOY. L. REV. 313 (1994).

55. Huertas Speech, *supra* note 31, at 3.

56. See Fed. Deposit Ins. Corp., *Lessons Learned from Hurricane Katrina: Preparing Your Institution for a Catastrophic Event*, 11 No. 8 ELEC. BANKING L. & COM. REP. 6 [hereinafter *Lessons Learned*].

The Case Against the Dodd-Frank Act's Living Wills

And such recovery plans will have to evolve with the SIFI's business and economic conditions, to ensure that the preventive measures utilized in the recovery plan are best tailored to the SIFI's most current needs and circumstances during the time of crisis. The resolution plan, on the other hand, should include the SIFI's planned options for resolving its operations. A living will should therefore include a comprehensive selection of alternatives available to a SIFI, including, for example, selling subsidiaries or certain businesses lines. To be successful, the plans need to be diverse, detailed, actionable, credible, and of a material enough size that they will have an impact on the distressed SIFI entities.

i. Guidelines for Recovery Plans

A SIFI must consider a number of important factors when devising a recovery plan. First, a SIFI must construct a recovery plan that can be executed within a reasonably short timeframe or else the plan becomes futile. A SIFI's plan must be capable of being executed in several months. Plan options that entail a high level of execution risk or require an extended period of time to implement are options that will probably not lead to successful recovery of the SIFI. Second, a SIFI should prepare recovery plan options that are sizeable, both individually and in aggregate, so that the plans have a substantial likelihood of being able to turn the SIFI's business around. In other words, a recovery plan's actions must have a material impact on the SIFI and its business. Third, as explained above, a recovery plan should include diverse options that the SIFI's management can choose from, based on the circumstances prevailing at the time the SIFI finds itself in extreme stress. Finally, a successful recovery plan's options should be credible to the SIFI's main stakeholders—the depositors, shareholders, debt holders, counterparties, central banks, and, of course, the supervisors. The recovery plan should also specifically detail how the SIFI will manage its disclosure to, and communication with, such key stakeholders as well as the public. That will help all parties maintain confidence in the SIFI during its recovery process.

Consequently, preparing recovery plans force SIFIs to consider in advance some tough strategic choices. To survive, a SIFI might need to do things that it would rather not to do in good financial times, such as issue new equity capital, sell or run down some of its businesses, or even sell itself entirely. Moreover, since the SIFI's contingency plans must be prepared in compliance with the Bankruptcy Code, the principles that characterize a successful reorganization plan under the Bankruptcy Code also serve as guidelines for SIFIs preparing contingency plans in their living wills. Such principles include, for example: (i) the plan must be proposed in good faith and not by any unlawful means; (ii) all holders of a claim or interest, which will be impaired under the plan must accept the plan or receive property of a value not less than the amount that such

holder would have received in a resolution or liquidation case; and (iii) the plan must not be likely to be followed by a liquidation or another reorganization unless such liquidation or reorganization is proposed in the plan.⁵⁷ In short, a SIFI must demonstrate that the plans in its living will can actually be executed as a practical matter under the facts and circumstances.⁵⁸

ii. Preventive Measures

In addition to the guidelines listed above, a successful recovery plan should include detailed information regarding how a SIFI will implement and handle key preventive measures such as (i) capital buffers (including methods to raise and retain capital); (ii) liquidity buffers; (iii) leverage ratio limitations; and (iv) organizational measures.

(a) Capital Planning and Buffers

Leverage is one of the most basic principles in the financial industry; more leverage and lower capital requirements allow financial institutions to use more debt to finance the loans they make, thereby lowering the cost of their funds and raising their profitability.⁵⁹ But this method of increasing profitability poses great risks because the higher the leverage, the faster the equity disappears when the banks have to take losses on loans that default.⁶⁰ Consequently, as part of the aftermath of the failure of a big German bank in the 1970s, which had a rippling effect on international financial markets, the central banks belonging to the Bank for International Settlement (BIS) established the Basel Committee on Banking Supervision.⁶¹ The Basel Committee, a non-legally-binding forum for regulatory cooperation between its member countries, develops guidelines for both banks and regulators and recommends best practices. The Committee seeks to close gaps between international supervisory coverage, while making sure that each international bank is subject to supervision that is substantial enough to ensure compliance.⁶² Therefore, the Basel Committee uses banks' equity as a core tool to motivate banks' managements and owners to reduce risks and to provide a sufficient

57. These three principles are reflected in Bankruptcy Code's section 1129(a)'s requirements for confirmation of a Chapter 11 plan. The third requirement – that the plan must not be likely to be followed by a liquidation or another reorganization – does not mean that it must be proved that the plan cannot fail, but that it has a reasonable prospect for success. *See In re Jartran*, 44 B.R. 331, 393 (Bankr. N.D. Ill. 1984).

58. *In re Clarkson*, 767 F.2d 417, 420 (8th Cir. 1985).

59. *See RICHARD APOSTOLIK ET AL., FOUNDATION OF BANKING RISK: AN OVERVIEW OF BANKING, BANKING RISKS, AND RISK-BASED BANKING REGULATION* 67 (2009).

60. *Id.* at 37.

61. The Bank of International Settlements (BIS) was established in Basel, Switzerland, in 1930 and is the main center of international central bank cooperation. *See id.* at 65-67.

62. *Id.*

The Case Against the Dodd-Frank Act's Living Wills

cushion against losses. The Committee has issued several comprehensive documents since 1975 that seek to improve banking supervision.⁶³ The Basel I Accord, which was released in 1988, focused on credit risk coverage and included a capital measurement system to assist banks to better withstand shocks. Because certain banks at the time were required to maintain less capital and be more leveraged, the Basel Committee set a minimum capital requirement of eight percent for the ratio of risk-weighted assets to regulatory capital; this capital standard was implemented in 1993.⁶⁴ Later, in 1996, the Basel Committee issued a market risk related amendment, which allowed banks to use Value-at-Risk (VAR)⁶⁵—a statistical measure of the possible downsides of a single asset or multiple pooled assets⁶⁶—to measure market risk capital requirements. In 2004 the Basel II Accord was released, focusing on market, credit, and operational risk coverage. It sought to replace the 1988 Accord and better align the capital requirements with the actual risks incurred by banks.⁶⁷ Finally, the Basel III Accord was introduced in December 2010 based on conclusions resulting from the recent financial crisis. Basel III Accord seeks to strengthen bank capital requirements and introduce new regulatory requirements on bank liquidity and bank leverage.⁶⁸ It is scheduled to be fully implemented by December 31, 2019.

Given the importance of maintaining a proper level of capital, a living will needs to account for the steps that will be needed to generate additional capital in a time of distress. This is vital because when a SIFI has a low level of capital relative to its assets, there are a number of incentives against its recapitalization absent proper regulation.⁶⁹ Methods for raising additional capital that can be

63. *Id.*

64. *Id.* at 68-70.

65. VAR is an application of modern portfolio analysis as devised in the last few decades by Harry Markowitz and others. See, e.g., JUSTIN FOX, THE MYTH OF THE RATIONAL MARKET 238 (2009); PETER L. BERNSTEIN, CAPITAL IDEAS: THE IMPROBABLE ORIGINS OF MODERN WALL STREET (1992).

66. See generally Darrell Duffie & Jun Pan, *An Overview of Value at Risk*, J. DERIVATIVES, Spring 1997, at 7; MICHEL CROUHY, ET AL., THE ESSENTIALS OF RISK MANAGEMENT 149-79 (2006).

67. APOSTOLIK ET AL., *supra* note 59, at 67-72.

68. Additional information on Basel III is available at <http://www.bis.org/bcbs/basel3.htm>.

69. DARRELL DUFFIE, HOW BIG BANKS FAIL AND WHAT TO DO ABOUT IT 43 (2010). The most famous incentive against recapitalization is referred to as debt overhang. It describes the problem with the existing equity owners of a SIFI not being eager to issue new equity, because the price at which new equity can be successfully issued will most likely be so dilutive that it will be against their interests. And the SIFI's owners also have no interest in donating wealth to the SIFI's creditors, which will be the result of issuing new equity, as much of the new equity capital would go toward improving the SIFI's creditors' position, which would otherwise absorb the SIFI's losses at default. *Id.* Moreover, beyond the debt overhang problem to raising capital, there is the issue of adverse selection. New shares offered to the market by a SIFI that is not ideally performing financially, can be viewed as "lemons." Thus, investors might think that if the SIFI is willing to sell certain shares at a certain price, that means the shares should be worth at most that price that the SIFI is asking, and in most likelihood, much less than that price. *Id.* at 44-45. Finally, raising cash from the sale of assets is also not easy, because the assets themselves can be viewed as "lemons" too. Such sales are also not attractive to the SIFI's owners, because by lowering the leverage of the SIFI, its owners "would lose the advantage of profiting from

outlined in a SIFI's recovery plan include placing capital for cash without preemption,⁷⁰ placing capital for cash with clawback,⁷¹ and rights issuing.⁷² SIFIs must think of which methods to employ before a financial crisis starts. While a SIFI in distress may still be able to raise new capital by reaching out to investors, it will be extremely difficult to do so in a tight time-frame, or if other SIFIs are in financial difficulties and are therefore attempting to raise capital at the same time.⁷³ Moreover, even if a SIFI in distress does succeed in obtaining new capital, the new capital will probably be very expensive.⁷⁴ Consequently, SIFIs should consider raising capital or liquidity before an actual crisis starts by implementing certain triggers in their recovery plans. Such triggers, which would be monitored within the various planning and supervisory structures, should be based on the overall risk appetite framework,⁷⁵ the operating and capital plans, and the asset and liability committees or the SIFI's treasury

any upside return on the assets while retaining the option to default if the return on assets is poor, in which case creditors (or taxpayers) would absorb the default losses." *Id.*

70. In general, the existence of a pre-emption right protects companies' shareholders from transfer of wealth and erosion of control, when a company offers new shares for cash, by providing the existing shareholders with the ability to buy new shares before anyone else, in proportion to their existing holding. See, e.g., Bill Wishard, *Improper Issuance of Corporate Stock to Directors or Officers* § 3, in 15 AM. JUR. PROOF OF FACTS 2D 417 (1978); R. FRANKLIN BALOTTI & JESSE A. FINKELSTEIN, THE DELAWARE LAW OF CORPORATIONS AND BUSINESS ORGANIZATIONS § 5.16 (3d ed. 2010); Victor Morawetz, *The Preemptive Rights of Shareholders*, 42 HARV. L. REV. 186 (1928); Alexander Hamilton Frey, *Shareholders' Preemptive Rights*, 38 YALE L.J. 563 (1929). The pre-emption right dates back to the nineteenth and early twentieth centuries, and does not uniformly exist in all jurisdictions; although it is automatically provided for in some jurisdictions, such as the UK. See ADOLF A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 176-80, 256-59 (1932). In the US the right arises only if specifically provided for under organizational documents of the relevant company, or under the laws of a specific state, however, all states now, at a minimum, allow corporate charters to eliminate the pre-emption right. See JAMES D. COX & THOMAS LEE HAZEN, CORPORATIONS 497 (2d ed. 2003).

71. "Clawback" provisions of capital raising transactions can enable investors to claw back a part of their investment if the financial institution raises sufficient equity or participates in a merger at an effective share price, which is lower than the original investment. The clawbacks can be payable in cash with an option for the issuer to use stock. See Edward D. Herlihy et al., *Financial Institutions M&A 2010: Capital and Strategic Initiatives in an Industry and System in Transition an Annual Review of Leading Developments*, in A GUIDE TO FINANCIAL INSTITUTIONS 2011: NAVIGATING THE NEW LANDSCAPE 445, 510 (Practicing Law Institute Corp. Law & Practice, 2011).

72. Rights issuing is an offer of new shares made to the already existing shareholders on a pro rata basis to their existing holdings. It has been argued, however, that corporations commonly believe that issuing such rights to acquire shares to existing shareholders signals distress and, therefore, gets the corporation stigmatized. See, e.g., Hugo Dixon, *Demystifying Rights Issues*, WALL ST. J., May 19, 2008, at C12; Lauren Silva & Richard Beales, *Right Across the Pond*, WALL ST. J., June 3, 2008, at C14; Rob Cox, *Retro Ploy on Wall Street*, WALL ST. J., July 7, 2008, at C8; Paul Asquith & David Mullins, Jr., *Equity Issues and Offering Dilution*, 15 J. FIN. ECON. 61 (1986); Tim Loughran & Jay R. Ritter, *The New Issues Puzzle*, 50 J. FIN. 23 (1995).

73. Huertas Speech, *supra* note 31, at 4.

74. See Darrell Duffie, *Contractual Methods for Out-of-Court Restructuring of Systemically Important Financial Institutions* 1-2 (Stanford Univ. Working Grp. on Econ. Pol'y, Nov. 9, 2009), available at www.darrelduffie.com/uploads/policy/DuffieRestructuringOutOfCourt2009.pdf

75. Risk appetite is an integrated measurement of the financial institution's market, event risk and counterparty credit. It often, as was in Lehman's case, represents the maximum amount of risk that a financial institution can take and still be able to return an acceptable profit, even if it suffers a severe loss. See Lehman Examiner Report, *supra* note 44, at 134.

The Case Against the Dodd-Frank Act's Living Wills

functions.

Triggers should be designed with the following guideline in mind: a failing SIFI's shareholders and creditors, rather than taxpayers, are the ones who should bear losses to the maximum extent consistent with maintaining financial stability. Indeed, basic corporate governance rules determine that the shareholders of a corporate enterprise are ultimately the ones responsible for its mismanagement and should be the first to lose their position upon failure of the corporate enterprise.⁷⁶ Thus, shareholders should pay the price for a SIFI's failure and should not profit from any rehabilitation of the SIFI through a government-managed resolution process.⁷⁷

Contingent convertibles (CoCos)—capital that initially takes the form of subordinated debt or preferred stock, but converts to core capital if a certain trigger is implemented—is a new and popular concept that follows the rationale of having a failing SIFI's shareholders bear much of the losses.⁷⁸ And pursuant to the Dodd-Frank Act, the Federal Reserve is authorized to approve a “contingent capital standard.”⁷⁹ Assuming that the trigger for conversion into capital guarantees a conversion when the SIFI needs new capital, contingent capital provides speedy execution, as well as the certainty that capital is guaranteed to the SIFI.⁸⁰ Thus the conversion mechanism strengthens the ability of a SIFI's subordinated debt and preferred stock to absorb loss while

76. It has been long held that shareholders do not have priority in a distribution of the proceeds from the dissolution of a corporation. *See Lasday v. Weiner*, 652 N.E.2d 1198 (Ill. App. Ct. 1995). Instead, the shareholders can only receive the residue of corporate funds after all the rights of corporate creditors and all the legal claims of third parties were provided. *See, e.g., Haddad v. Francis*, 537 A.2d 174 (Conn. Super. Ct. 1986), *aff'd*, 536 A.2d 597 (Conn. App. Ct. 1988); *Mid-American Elevator Co. v. Norcon, Inc.*, 679 N.E.2d 387 (Ill. App. Ct. 1996); *Succession of Mydland*, 653 So. 2d 8 (La. Ct. App. 1995); *State v. Debus*, 59 P.3d 1154 (Mont. 2002). Thus, when a corporation dissolves or is insolvent, the corporate creditors have a priority in the assets over the shareholders. *See Huff v. Harrell*, 941 S.W.2d 230 (Tex. Ct. App. 1996). And in distributing the property and assets of such a dissolved corporation, all debts and liabilities must first be satisfied and only after that can any distribution to stockholders be made. *Plastic Contact Lens Co. v. Frontier of Northeast, Inc.*, 324 F. Supp. 213 (W.D.N.Y. 1969) (applying New York law), *aff'd*, 441 F.2d 67 (2d Cir. 1971); *Zinn v. Bright*, 87 Cal. Rptr. 736 (Ct. App. 1970); *Pioneer Coal Co. v. Asher*, 276 S.W. 487 (Ky. 1925); *Drenning v. Kuebel, Inc.*, 339 So. 2d 752 (La. 1976); *Lind v. Johnson*, 236 N.W. 317 (Minn. 1931).

77. Although SIFIs' unsecured creditors should also bear some losses, in order to promote market discipline on the part of the creditors of large, interconnected SIFIs, such losses should not be as obvious as in the case of the shareholder and must depend on the individual cases' facts.

78. The concept was originally suggested by Mark J. Flannery. *See* Mark J. Flannery, *No Pain, No Gain? Effecting Market Discipline via “Reverse Convertible Debentures”*, in CAPITAL ADEQUACY BEYOND BASEL: BANKING, SECURITIES, AND INSURANCE 171 (Hal S. Scott, ed., 2005), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=352762; *see also* Huertas Speech, *supra* note 31, at 4; Darrell Duffie, *Contractual Methods for Out-of-Court Restructuring*, in ENDING GOVERNMENT BAILOUTS AS WE KNOW THEM 113-121 (Kenneth E. Scott et al., eds., 2009); Coffee, *supra* note 3, at 2-4; Mark J. Flannery, *Stabilizing Large Financial Institutions with Contingent Capital Certificates* (Univ. of Fla., Working Paper, 2009), available at <http://ssrn.com/abstract=1485689>; Robert L. McDonald, *Contingent Capital with a Dual Price Trigger* (Nw. Univ. Kellogg Sch. of Mgmt., Working Paper, 2010), available at <http://ssrn.com/abstract=1553430>.

79. *See* Dodd-Frank Act tit. I, § 165(b)(1)(B).

80. Huertas Speech, *supra* note 31, at 4.

the SIFI is a going concern. And contingent capital is, de facto, a financial continuity insurance,⁸¹ as it offers a spread⁸² that—in comparison to that of a senior debt—is significantly higher, much like an insurance premium paid to preserve new capital at a predetermined rate.⁸³

Thus, SIFIs can issue a percentage of their long-term debt capital in the form of debt that would convert into equity if the SIFIs' situation deteriorates.⁸⁴ Such conversion should take place before liquidity becomes a problem for the SIFI,⁸⁵ and turn the debt to a non-convertible, senior, preferred stock, which will have voting rights and guarantee cumulative dividends; this will help form a class of voting shareholders who will resist common shareholder pressure to increase risk and leverage, because they only obtained their voting rights when the SIFI approaches insolvency.⁸⁶ This advances the notion that debt governance can improve efficiency by controlling agency costs and discipline pressured by shareholders sub-optimal managers.⁸⁷ However, any design of such a CoCos model will have to take into consideration that it might be easier to simply mandate the infusion of additional equity capital into SIFIs, which will have the same effect for four reasons. First, the purpose of maintaining the tax benefits of debt is not a justifiable rationale for CoCos.⁸⁸ Second, the CoCos' potential role in resolving friction related to corporate and debt governance has not been established.⁸⁹ Third, the CoCos model is exposed to different types of manipulations,⁹⁰ and moral hazard incentives to increase risk,⁹¹ such as shorting the SIFI's common stock.⁹² Fourth, since regulators can

81. *Id.* at 4-5.

82. For the definition of “spread,” see, e.g., Frank Partnoy, *The Siskel and Ebert of Financial Markets?: Two Thumbs Down for the Credit Rating Agencies*, 77 WASH. U. L.Q. 619, 705 (1999), and Kenneth C. Kettlering, *Securitization and its Discontents: The Dynamics of Financial Product Development*, 29 CARDozo L. REV. 1553, 1694-95 (2008).

83. Huertas Speech, *supra* note 31, at 4.

84. See Coffee, *supra* note 3, at 9.

85. See generally Darrell Duffie, *The Failure Mechanics of Dealer Banks*, J. ECON. PERSPECTIVES, Winter 2010, at 51. Professor Duffie mentions that a mandatory rights offering can solve such a liquidity problem. See Duffie, *supra* note 74, at 1-2.

86. See generally Coffee, *supra* note 3.

87. *Id.*; see also Charles K. Whitehead, *Creditors and Debt Governance*, in RESEARCH HANDBOOK ON THE ECONOMICS OF CORPORATE LAW (Claire Hill & Brett McDonnell, eds., forthcoming 2011), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1760488.

88. It has been argued that, to the extent that interest is a tax-deductible expense, CoCos have tax advantages compared to equity. See George Pennacchi, et al., *Contingent Capital: The Case for COERCs* (Luxembourg Sch. of Fin., Centre for Econ. Policy Research Working Paper, 2011), available at <http://business.illinois.edu/gpennacc/Coercs1025.pdf>.

89. See Anat R. Admati et al., *Fallacies, Irrelevant Facts, and Myths in the Discussion of Capital Regulation: Why Bank Equity Is Not Expensive* 45-49 (Rock Ctr. for Corporate Governance at Stanford Univ., Working Paper No. 86, Stanford Graduate Sch. of Bus. Research Paper No. 2065, 2010), available at <https://gsbapps.stanford.edu/researchpapers/library/BankEquityNotExpensive.pdf>.

90. See, e.g., McDonald, *supra* note 78; DUFFIE, *supra* note 74 (short-term trading can manipulate conversions).

91. However, it has been argued that such an incentive is less severe than that which exists on the issuance of subordinated debt. See George Pennacchi, *A Structural Model of Contingent Bank Capital*

The Case Against the Dodd-Frank Act's Living Wills

potentially force conversion at any time, rating agencies find the CoCos' risk difficult to quantify, which limits marketability.⁹³

Another sensible, efficient method to help SIFIs built capital is to bar equity payouts and dividends for all SIFIs for a specified amount of time.⁹⁴ If this prevention of payouts is the result of an installed regulation, it would not damage the financial health of any SIFI.⁹⁵ Regulators can also remove the stigma associated with equity issuance and debt overhang related frictions by making SIFIs issue equity on a predetermined schedule.⁹⁶

Yet another model to help SIFIs raise capital without endangering taxpayer money would give SIFIs' shareholders two options:⁹⁷ either to accept a bailout exception to their limited liability status, so that authorities can recoup taxpayer bailouts' funds directly from the SIFI's shareholders, or to dramatically increasing the leverage requirements.⁹⁸

(b) Liquidity Buffers

According to the Basel Committee, liquidity is the ability of a financial institution to fund increases in assets and meet its obligations as they come due, without incurring unacceptable losses.⁹⁹ Liquidity corresponds to a financial institution's ability to make punctual payments to its customers, and SIFIs actively manage their liquidity risks to make sure that they have the ability to pay their obligations with sufficient funding, once such obligations become

(Fed. Reserve Bank of Cleveland, Working Paper 10-04, 2010), available at <http://ssrn.com/abstract=1595080>.

92. See Pennacchi et al., *supra* note 88 (suggesting a method to deal with the problematic aspects of CoCos and the incentive to manipulate, a version of CoCos called COERCs, which is structured to avoid some of the complexities and incentives for manipulation that can arise; COERCs include a feature that enables the equity to have the option to repay the debt in order to avoid dilutive conversion).

93. *Id.*

94. See Admati et al., *supra* note 89.

95. *Id.*

96. *Id.*

97. See Peter Conti-Brown, *Elective Shareholder Liability for Systemically Important Financial Institutions* 1 (Rock Ctr. for Corporate Governance at Stanford Univ., Working Paper No. 97, 2011), available at <http://ssrn.com/abstract=1762986>.

98. This is known as the "capital adequacy" option, a position that was highly advocated by Professor Anat Admati, who also advocated that arguments stating that "equity is expensive," which led to claims that mandating high capital thresholds would impact credit markets adversely, are fallacious, and weak. Admati argues that better capitalized banks would perform better, and that setting equity requirements at a significantly higher level than the current practice, would entail large social benefits and possibly no social costs. See *id.* Supporting this position, Swiss and UK bank regulators have recently adopted an aggressive stance, which calls for much higher standards than the new internationally agreed capital ratios – the Basel III rules, which are to be phased in by 2019. See, e.g., John Plender, *UK's Banking Climate Is Making the US Look Attractive*, FIN. TIMES, Apr. 5, 2011, available at <http://www.ft.com/cms/s/0/f11d61cc-5f9f-11e0-a718-00144feab49a.html?ftcamp=rss#axzz1lhPkd6z11>; Patrick Jenkins & Brooke Masters, *UK Watchdogs' Stance on Bank Capital Attacked*, FIN. TIMES, Mar. 27 2011, available at <http://www.ft.com/cms/s/0/7d77a9d0-589c-11e0-9b8a-00144feab49a.html#ixzz1lhR3u2Mm>.

99. APOSTOLIK ET AL., *supra* note 59, at 40.

due.¹⁰⁰ Therefore, any reorganization and resolution plan must include carefully prepared procedures concerning how a SIFI would generate additional liquidity while in crisis when liquidity is the lifeblood of a business.¹⁰¹ Banks are already required to develop a contingency funding plan as part of their standard liquidity management, and the living will resolution aspects should be built on these existing normal procedures.¹⁰² Therefore, each SIFI's plan should be based on a careful examination, consideration, and implementation of the following issues: (i) the existence and reliability of each SIFI's back-up sources of liquidity from the private market, as well as the commitment level and reliability of the counterparties that are to counteract with the relevant SIFI; (ii) the SIFI's ability to maintain a collateral budget that indicates what types of collateral liquidity providers require; (iii) the existence and availability of collateral that the SIFI can use to secure additional funding or pledge to existing business counterparties, if need be;¹⁰³ (iv) the existence of a monitoring mechanism to conduct periodic evaluations of when the SIFI might need to access routine sources of central bank funding; (v) the preparation of legal agreements that will be required in order for a SIFI to borrow from a central bank, if need be; (vi) the preparation of potential agreements among the SIFI and central banks concerning unencumbered eligible assets' transfer or pledge; and (v) the SIFI's different options concerning repaying central banks in case the SIFI will be required to borrow from them.¹⁰⁴

(c) Leverage Ratio Limitations

Financial institutions, especially banks, are inherently highly leveraged in comparison to other businesses.¹⁰⁵ The higher the debt to equity ratio, the faster the equity disappears when the financial institution needs to take losses if it defaults. Losses in the financial institution's equity levels can have dire consequences, and so regulators around the world focus on the leverage ratio.¹⁰⁶ Put another way, the level of the leverage of a financial institution indicates how much the owners of that financial institution have put themselves at risk.¹⁰⁷ Thus, any recovery plan must set leverage ratio guidelines that will force SIFIs to check their abilities to fund all their commitments under different

100. *Id.*

101. Huertas Speech, *supra* note 31, at 5.

102. *Id.*

103. For example, if a bank is downgraded it needs to pledge additional collateral to its existing market counterparties.

104. Huertas Speech, *supra* note 31, at 5.

105. APOSTOLIK ET AL., *supra* note 59, at 36-37, 124.

106. *Id.*

107. *Id.*

The Case Against the Dodd-Frank Act's Living Wills

scenarios.¹⁰⁸

(d) Organizational Measures

A carefully devised reorganization or resolution plan must detail how a SIFI intends to organizationally maintain its systemically relevant functions in an insolvency scenario. Such planning, which will be based on data obtained from the SIFI's properly installed and updated MIS, must focus on how each SIFI should best try to: (i) identify its main systemic functions, assets and liabilities, while focusing on the activities or units that are systemically important and demonstrating how they could continue to operate during a resolution process;¹⁰⁹ (ii) sort and balance its assets and liabilities, based on the place of jurisdiction and choice of applicable law;¹¹⁰ (iii) align its different legal structures and business entities; (iv) reduce personal, structural, contractual, financial, and operative interdependencies between its different entities; (v) have the ability to legally and structurally execute a transfer to a bridge financial institutions or bank, if need be;¹¹¹ (vi) unify business processes, standardize contracts, and register the assets and liabilities of each relevant counterparty; (vii) promote a business structure that better facilitates resolution, if need be;¹¹² (viii) reduce operating costs, expenditure, staff costs and bonuses related expenses;¹¹³ and (ix) replace bonuses with dividends or

108. See *Lehman Examiner Report*, *supra* note 44, at 66.

109. This will often normally require that such activities or units be separately incorporated and made bankruptcy-remote in order to easily detach them from the SIFI's group of entities, if need be, in order to keep those systemically important functions in operation while other parts of the SIFI's group of entities are being resolved. See *GENEVA REPORT*, *supra* note 42, at 63.

110. There can be great benefit to choosing one legal system over another, or even the SIFI's headquarter location according to what is the most attractive legal and judicial system. *See id.* at 85.

111. Institute of International Finance, *A Global Approach to Resolving Failing Financial Firms: An Industry Perspective*, May 2010, at 30-31, available at <http://www.commodities-now.com/component/attachments/download/217.html>.

112. Different business structures can fit different business approaches. For example, a SIFI incorporated in one jurisdiction and operating one international network composed of branch offices, might better facilitate handling stress because it permits liquidity to flow freely from one office to another. Differently, a stand-alone subsidiary model where each subsidiary is functionally independent enables institutions to more easily resolve their operations in each jurisdiction without necessarily linking the resolutions to other entities in the SIFI's group for critical functions. Nevertheless, the stand-alone units model also increases the costs of providing cost-border financial services by preventing synergy gains resulting from economies of scope and scale, and leads to a more fragmented global banking system. Additionally, it could also result in trapped pools of capital and liquidity, which may increase systemic risk. *See id.* at 86-87, 91; Zdenek Kudrna, *Cross Border Resolution of Failed Banks in the EU: Search for the Second-Best Policies* 22-23 (Austrian Acad. of Scis., Inst. for European Integration Research, Working Paper, 2010), available at <http://ssrn.com/abstract=1604402>.

113. A successful reorganization normally involves a reduction in a business's expenses. *See e.g.* Anne J. McClain, *Bankruptcy Code Section 1113 and the Simple Rejection of Collective Bargaining Agreements: Labor Loses Again*, 80 GEO. L.J. 191, 196 (1991); Ralph C. Anzivino, *Reorganization of the Professional Sports Franchise*, 12 MARQ. SPORTS L. REV. 9, 45 (2001). Accordingly, courts have considered cost reductions to be required to facilitate successful reorganizations. *See e.g.* *In re Royal Composing Room*, 848 F.2d 345, 349 (2d Cir. 1988); *In re Walway Co.*, 69 B.R. 967, 973 (Bankr. E.D. Mich. 1987).

create a different employee-rewarding method that discourages excessive risk taking and focus on long-term goals.¹¹⁴

Additionally, using frequently updated corporate organization charts, SIFIs could better examine their different entities in order to make business decisions regarding the reorganization or liquidation of those entities, including the best suited venues for those endeavors. To better make such decisions, each SIFI should also analyze its group's entities and create a cross-default chart, which is a master list of all major debt instruments that reflects how a default on one obligation triggers a default on another obligation. Indeed, each SIFI would be required to determine which entities or operations may need protection, which entities are liable on key debt, and which entities are holding companies versus the ones that are wholly owned operating companies.

Finally, options for disposing certain aspects of the SIFIs' businesses must be considered in the reorganization and resolution plan,¹¹⁵ as well as whether the entire business could be sold to a third party.¹¹⁶ Accordingly, attractive-to-third-parties healthy business units of the SIFI, which are readily separately saleable,¹¹⁷ without the need for shareholders and regulatory long-waited-for approvals,¹¹⁸ should be identified by the SIFI as such.

C. Resolution Plans

If a SIFI's condition deteriorated to such a degree that governmental authorities must intervene because the recovery or reorganization plan failed, a resolution process should then begin. Pursuant to the Dodd-Frank Act, a special

114. See generally Victoria McGrane, *Big Banks Confront New Bonus Onus*, WALL ST. J., February 8, 2011, available at <http://online.wsj.com/article/SB1000142405274870442204576130402335971020.html>.

115. This can entail, for example, conducting diligence regarding the role of the business within the corporate enterprise and what the probable proceeds will be, preparing separation arrangements and potential transitional services, creating a pool of potential buyers, and preparing timetables for negotiations, and approvals procedures.

116. In this context, however, two main themes are worth commenting about – antitrust and completion risk. First, commonly, the most probable potential candidate to purchase a large, complex financial institution at a short notice is a different large, complex financial institution. Consequently, this can raise some antitrust issues, which will need to be taken under consideration in reaching an evaluation regarding if such a transaction could be contemplated in the reorganization stage, at a later stage or not at all. Second, typically completion risk is higher with respect to the sale of an entire financial institution and the closer a financial institution being sold is to resolution, the more probable it is that such an institution's transactions will require backstopping or a guarantee to be offered by the purchasing party. However, such a commitment of the purchasing party may necessitate a formal consent of the purchasing party's shareholders and often even of the regulators from the purchasing party's home country. Therefore, such a possibility can be a viable option only if the preparation for such a sale commences early enough.

117. This would be the case, for example, if a business unit is organized under a separate subsidiary, which is operationally separable from the rest of the SIFI, is self-sufficient and its ownership can simply be transferred by a sale of the stock in the subsidiary. Huertas Speech, *supra* note 31, at 6.

118. In the Lehman Brother's case, the company needed approval without which such a transaction could not go through.

The Case Against the Dodd-Frank Act's Living Wills

resolution regime will deal with the failure of each SIFI.¹¹⁹ That resolution will be administered by the FDIC and follow the basic values of a Chapter 11 bankruptcy proceeding, including: (i) wiping out the SIFI's shareholders' investments; (ii) dismissing the SIFI's senior directors and officers, and (iii) forcing the SIFI's creditors to accept less-than-full payment of their claims, whether those were converted to equity interests or not, in a successor institution.¹²⁰ Although the Dodd-Frank Act's resolution plan requirement contemplates that the FDIC will create and maintain a separate plan for resolving such SIFIs under the Orderly Liquidation Authority, nothing prevents a SIFI from also including in its plan different strategies that could be available under non-bankruptcy resolution regimes. Indeed, independent of the new rule, there are several reasons for SIFIs to prepare resolution plans before a crisis starts.¹²¹ First, such plans can assure that a SIFI is able to produce, at the point of intervention, all of the information that the government would need.¹²² Second, such plans can highlight the obstacles that would occur, if a resolution were to be required. The diligence that will be done in order to prepare the resolution plan will be a good indicator as to which legal changes or infrastructure-related changes would be needed so as to enable the government to pick the resolution method that will not be based on taxpayers' funds.¹²³ Third, the mere preparation of such resolution plans can highlight whether a SIFI has a corporate, business, or financial structure that does not permit using certain resolution methods or makes such methods extremely expensive. Such a revelation may require a SIFI to amend its structure or adopt additional liquidity and capital requirements in order to lower the probability that resolution would indeed be required.¹²⁴ Lastly, it is hoped that by having SIFIs outline possible plan options and have the required information be readily available, the government might be able to eliminate, or at least drastically reduce, the likelihood that the resolution of a SIFI in distress would necessitate the extension of government guarantees or the injection of taxpayer funds.¹²⁵

Therefore, under a resolution plan a SIFI must primarily prepare for how it would quickly and efficiently supply the government with the information necessary to intelligently decide which resolution method should be used.¹²⁶

119. See Dodd-Frank Act tit. II §§ 201-207 (Orderly Liquidation Authority) (creates a new failure procedure whereby the Secretary of the Treasury could institute the takeover of any SIFI outside of the bankruptcy law with the FDIC becoming the receiver).

120. *Reforming Too-Big-To-Fail*, *supra* note 10, at 757.

121. See Dodd-Frank Act tit. I.

122. Huertas Speech, *supra* note 31, at 2.

123. *Id.*

124. *Id.*

125. *Id.* at 8.

126. “The important feature of resolution planning will therefore be the provision of information in advance and during a period of stress, along with a thorough analysis of the connections within different parts of a group.” GANS, *supra* note 29, at 588-89 (quoting speech by FSA Chief Executive,

The resolution plan analysis builds on the work performed to document and understand the structure of the SIFI. The SIFIs' process of planning concerning how to provide such information would make it possible for the government to allocate some efforts in advance toward the planning of resolution methods, and their feasibility. Such governmental resources would also assist both the SIFI's management and the government itself in identifying potential difficulties in potential resolution plans that could be removed before a crisis starts.

i. The Framework for the Authorities' Decision

Currently, there appears to be a consensus that some type of cost-benefit analysis consideration should provide the framework for the choice of a SIFI's resolution method.¹²⁷ However, this approach should not be limited to narrow considerations relating to the deposit guarantee scheme, but should instead focus on the costs and benefits for society in general.¹²⁸ As for who should make the resolution method decision, there is a consensus that decisions regarding SIFIs should ultimately be made by governments, in their highest level of authorities.¹²⁹ Further, central banks and supervisors should be welcome to provide advice with respect to such decisions.¹³⁰ Nevertheless, because the largest SIFIs are active in several jurisdictions, it is not always clear which government—the home country or a host country—should lead the resolution process and determine what resolution method should be used. The complexities surrounding a genuinely international SIFI's resolution are great, because such resolutions entail several countries coordinating how to share the burden of supporting a failed SIFI. Thus, living wills should include a clear strategy outlining in advance how the home and host countries will share the responsibility for the principal entities or parts of the SIFI, if such a SIFI were to fail.¹³¹

Hector Sants).

127. Huertas Speech, *supra* note 31, at 14.

128. *Id.*

129. *Id.*

130. *Id.*

131. A first attempt to set rules regarding this type of responsibility sharing can be seen in the Cross Border Stability Groups ("CBSGs"), which were established under the guidance of the Financial Stability Board. The CBSGs were scheduled to be established by mid-2011 accompanied by a signature of a Cross Border Cooperation Agreement ("CBCA"), which was defined in a new EU-wide 2008 Memorandum of Understanding ("MoU") in 2008 that was formally adopted on June 1, 2008. The Memorandum of Understanding on Cooperation Between the Financial Supervisory Authorities, Central Banks and Finance Ministries of the European Union on Cross-Border Financial Stability is *available at* <http://www.ecb.int/pub/pdf/other/mou-financialstability2008en.pdf>.

The Case Against the Dodd-Frank Act's Living Wills

ii. The Different Resolution Methods

In its living will, each SIFI must plan internally which resolution method could work best for it. The more commonly used financial institutions' resolution methods thus far include measures to resolve: (i) insured depository institutions and banks; (ii) insurance companies, which in the U.S. are mainly governed by state laws; (iii) and broker-dealers.¹³² In addition, in the U.S. many different types of businesses can become debtors under the Bankruptcy Code and liquidate or reorganize its operations pursuant to Chapter 7 or Chapter 11.¹³³ However, SIFIs should not be limited to only using the existing legal measures if they can creatively devise other resolution options, so any planned resolution scheme is a viable one, which can pass muster under the authorities' supervision and provide the authorities with all the information they need.

Methods traditionally used for failing depository institutions and banks include: (i) deposit transfer/bridge bank; (ii) share transfer order; and (iii) liquidation/deposit pay-off.¹³⁴ Under a deposit transfer technique, the authorities sell a failed bank's deposit book to a third party, by matching the deposit liabilities with cash or good assets, for which the bank purchasing the deposit book may often pay a premium.¹³⁵ Under a bridge bank, a new institution, such as a temporary national bank,¹³⁶ takes over and maintains the banking services of a troubled bank for a certain amount of time, while other assets and liabilities are left behind and are eventually liquidated.¹³⁷ This procedure bridges the gap between the failure of a bank and a final resolution, and can begin without first moving the failed bank through the intermediate stage of a non-permanent public ownership. And although the government may need to supply the failed bank with the liquidity needed to match the deposit

132. See 12 U.S.C. 1813(c) for the definition of an insured depository institution under the Federal Depository Insurance Act (FDIA); see Dodd-Frank Act tit. II, §201(a)(13), which defines insurance company as any entity that is engaged in the business of insurance, "covered by a State law that is designed to specifically deal with the rehabilitation, liquidation, or insolvency of an insurance company," and subject to regulation of state regulators; and 15 U.S.C. §78aaa-111, which defines the rules for insolvent brokers and dealers' liquidations under the Securities Investors Protection Act of 1970 (SIPA).

133. See 11 U.S.C. §101(41), which defines the word "person," and §109, which defines who can become a debtor. Note, however, that §109(b)(2) details which financial entities are excluded from becoming debtors under the Bankruptcy Code, and are subject to separate insolvency regimes.

134. Huertas Speech, *supra* note 31, at 13-14.

135. *Id.* at 13.

136. In the US the FDIC is tasked with ensuring that depositors can get immediate access to insured deposit and containing systemic threats to the financial system. As part of this role the FDIC has been using, as a last resort, the bridge bank technique, however, until now, this technique has only used to help failing banks, not SIFIs. Similarly, in other countries, such as Japan, national insurance corporations exist and are authorized to set up bridge banks in order to handle bank failure when no immediate prospect of a different SIFI purchasing the failed bank exists. *See GENEVA REPORT*, *supra* note 42, at 79.

137. *Id.*

liabilities, or extend credit to the failed bank, the government is not required to invest in the failed bank or supply any guarantee to the deposits or liabilities transferred into the bridge bank.¹³⁸ These techniques, however, are not risk-free, because if liabilities to different counterparties become frozen, the liabilities can negatively impact the liquidity or capital of the failed bank's counterparties and result in a domino effect leading to the failure of multiple banks.¹³⁹ Additionally, if a failed bank has large shares of the market for unsecured consumer credit or credit to smaller sized businesses and operations, then a speedy shutting-off of such credit facilities can result in shutting down large parts of the credit market, and disrupting global finance.¹⁴⁰

In contrast, using a share transfer order,¹⁴¹ governments may order that a failed SIFI's shares be transferred to its home government—the only party that can, typically receive a large failed institution's shares on short notice at a predetermined typically very low price, which will be specified in the order.¹⁴² Theoretically, the shares can also be transferred to a third party or different governments; however, because the purchasing party would typically need both shareholders and regulatory approval for that transaction, it is normally the government that acquires the failed institution's shares.¹⁴³ Once the shares are transferred, the failed institution remains, at least for some time, a going concern.¹⁴⁴ And unlike injecting new equity in a failed institution, shares transfer does not require an instantaneous taxpayer expenditure.¹⁴⁵ But a government guarantee of certain liabilities of the failed institution may be required, at least for a certain amount of time, to continue the business and avoid a run-on-the-bank scenario.¹⁴⁶

Finally, under the liquidation approach all of the businesses of the failed institution stop, and a deposit-guarantee fund urgently works to pay off the insured depositors. This can lead to widespread panic if the deposit-guarantee fund is not in a position to immediately pay out the depositors—a not uncommon situation because to promptly pay the depositors, the fund must first gather information about them and their insured deposits.¹⁴⁷ Additionally, other financial institutions must be able to serve these depositors as new customers as soon as possible.¹⁴⁸ Moreover, the deposit-guarantee fund must have proper

138. Huertas Speech, *supra* note 31, at 13.

139. *Id.*

140. *Id.*

141. See, e.g., Banking Act, c. 1 (2009) (U.K.).

142. Huertas Speech, *supra* note 31, at 13-14.

143. *Id.*

144. *Id.*

145. *Id.*

146. *Id.*

147. *Id.*

148. *Id.*

The Case Against the Dodd-Frank Act's Living Wills

and sufficient funding, a situation which can be very difficult to financially sustain, if the failing institution had an extremely high number of customers with large insured deposits.¹⁴⁹

Insurance companies' resolution measures in the U.S. are based on the various states statutes.¹⁵⁰ These liquidation and dissolution proceedings traditionally entail the appointment of a receiver, or a state official—such as the commissioner of insurance or superintendent—as a liquidator or statutory receiver.¹⁵¹ The appointed officer then can become the successor of the liquidating insurance company,¹⁵² which has no additional corporate power.¹⁵³ Accordingly, all corporate activity stops—with the exception of the company's efforts to wind-up its operations—and the title to the company's property passes to the appointed receiver.¹⁵⁴ Moreover, once an insolvency proceeding of an insurance company commences or a decree of dissolution is entered, all of company's outstanding policies are automatically canceled, and no recovery for losses that occur subsequently is permitted,¹⁵⁵ unless specific law provide for such recovery,¹⁵⁶ or the company's rehabilitation method does not preclude it.¹⁵⁷ The receiver acting as a liquidator has a fiduciary obligation to the liquidating company's creditors, and may take steps to retain possession of the company's property, but the receiver has no greater right to demand or recover property or additional premiums than the insurer had.¹⁵⁸ Finally, under several states' laws, special funds—referred to as insolvency-funds, security-funds or guaranty-funds—are established, or security is deposited with state officials, in order to protect the insurance companies' policyholders, creditors, or

149. *Id.*

150. See 44 C.J.S. *Insurance* § 226 (2011) ("Under statutes in the various states, provision has been made for the liquidation of insurance companies, including local branches of foreign companies.").

151. See 43 AM. JUR. 2D *Insurance* §103 (2011).

152. See *Clark v. Williard*, 292 U.S. 112 (1934).

153. See *In re American Reserve Ins. Co.*, 138 Cal. App. 3d 906 (2d Dist. 1983); D.R. Mertens, Inc. v. State *ex rel.* Dept. of Ins., 478 So. 2d 1132 (Fla. Dist. Ct. App. 1st Dist. 1985); Matter of Liquidation of Integrity Ins. Co., 685 A.2d 1286 (1996); *People ex rel. Palmer v. Peoria Life Ins. Co.*, 34 N.E.2d 829, 136 A.L.R. 151 (1941).

154. *Id.* Under certain states' laws, the passage of the company's property's title is the result of the succession established for the company by the law that created it, and is not the consequence of a judicial proceeding mandating the company to assign its assets, but under other laws, the title to the company's property passes to the receiver only following court order. See *Clark v. Williard*, 292 U.S. 112 (1934); cf. *Farrimond v. State ex rel. Fisher*, 8 P.3d 872 (Okla. 2000).

155. See *Matter of Liquidation of Integrity Ins.*, 685 A.2d 1286 (1996).

156. See *Foster v. Colonial Assur. Co.*, 668 A.2d 174 (Pa. Commw. Ct. 1995), *aff'd*, 673 A.2d 922 (1996).

157. See 43 AM. JUR. 2D *Insurance* §93-101 (2011).

158. See e.g. *In re Title U.S.A. Ins. Corp.*, 42 Cal. Rptr. 2d 498 (4th Dist. 1995); *In re Liquidation of Integrity Ins. Co.*, 754 A.2d 1177 (N.J. 2000); *In re Rehabilitation of Centaur Ins. Co.*, 632 N.E.2d 1015 (Ill. 1994); *In re Liquidation of Union Indem. Ins. Co. of New York*, 651 N.Y.S.2d 436 (N.Y. App. Div. 1996); *Webb v. Reynolds Transp., Inc.*, 949 S.W.2d 364 (Tex. App. San Antonio 1997); *In re Rehabilitation of National Heritage Life Ins. Co.*, 656 A.2d 252 (Del. Ch. 1994); *Nova Ins. Group, Inc. v. Florida Dept. of Ins.*, 606 So. 2d 429 (Fla. Dist. Ct. App. 1992).

individuals with tort claims against insureds.¹⁵⁹ The priority and compensability of claims against such funds, which are held in trust by states and may be administered by the liquidating companies' receivers, is determined by the state's laws.¹⁶⁰

Finally, the resolutions of U.S. broker-dealers can be performed pursuant to the Bankruptcy Code, although this process is normally administered under a different Act—the SIPA—and entails the transfer of the failed securities broker-dealer's accounts to another broker-dealer by the Securities Investor Protection Corporation (SIPC).¹⁶¹ If such a transfer is not possible, the failed broker-dealer is liquidated: the SIPC either sends investors certificates for the stocks that were lost or, if preserving the investors' portfolios as those were not possible, the SIPC sends investors checks for the market-value of their shares.¹⁶²

iii. Financial Institutions Fund

In addition to the methods outlined above, other creative courses of actions should be considered to assist SIFIs in case a resolution is warranted. For example, a SIFI could create a systemic emergency insurance fund, which would be funded by risk-adjusted assessments on all financial institutions that benefit from systemic stability.¹⁶³ Such a fund would also give financial institutions new incentives to caution regulators of increasing systemic risk.¹⁶⁴ The rationale behind this solution is that the ultimate cost of any government assistance—which will be supplied to a SIFI in its resolution proceedings in order to minimize interferences with the financial system—should not be borne by taxpayers, but by the financial services industry. Moreover, the financial services industry and the different SIFIs are the ones most likely to benefit, directly or indirectly, from any governmental assistance that would help to avoid or mitigate threats to financial stability. And because the most interconnected and biggest SIFIs would probably benefit more than other financial institutions, it has been argued that it is only fair that such SIFIs would be responsible for a bigger part of a failed SIFI's unpaid costs in the event that the failed SIFI's costs cannot be recouped.¹⁶⁵ Additionally, it has

159. See 43 AM. JUR. 2D *Insurance* §115 (2011).

160. See 43 AM. JUR. 2D *Insurance* §115-19 (2011).

161. See Securities Investor Protection Act of 1970, 15 U.S.C. §§ 78aaa-111 (2006), available at <http://www.uscourts.gov/FederalCourts/Bankruptcy/BankruptcyBasics/SIPA.aspx>.

162. *Id.*

163. See generally Jeffrey N. Gordon & Christopher Muller, *Confronting Financial Crisis: Dodd-Frank's Dangers and the Case for a Systemic Emergency Insurance Fund*, 28 YALE J. ON REG. 1 (forthcoming 2011).

164. *Id.*

165. Karl S. Okamoto, *After the Bailout: Regulating Systemic Moral Hazard*, 57 UCLA L. REV. 183, 195-96 (2009).

The Case Against the Dodd-Frank Act's Living Wills

been suggested that such assessments should be collected over a long period of time, in order to avoid pro-cyclical effects.¹⁶⁶

III. PREPARING FOR UNKNOWN HAZARDS AND STRESS TESTS

A. *Risk Management and Preparing for Potential Hazards*

Risk management is the practice of reviewing, evaluating, and identifying the different types of risks that an institution is exposed to because of its activities and environment.¹⁶⁷ Risk managers must monitor the risks to which their company is exposed, determine the plausibility level of losses and other effects resulting from such risks, decide what actions will be taken to deal with these risks, and reduce the likelihood of any negative consequences.¹⁶⁸ In financial institutions, risk-management departments or groups are typically charged with reviewing, evaluating, and identifying the risks to which the financial institutions are exposed as part of their activities and the business environment in which they operate.¹⁶⁹ If conducted properly, risk management could give a SIFI a competitive advantage over other SIFIs and could become a profit center for the SIFI. Indeed, risk management: allows a SIFI to monitor the risks affiliated with any change; determines if a SIFI has the ability and infrastructure to handle different risks; keeps alert senior managers and directors to possible risks and their status; and suggests alternative routes of action for a SIFI to adopt when dealing with the risks.¹⁷⁰

Therefore, risk managers should focus on identifying potential threats before such threats materialize. Once identified, risk managers must assess the potential effect of those threats on the SIFI's business and operations, assign different priorities to the threats, and develop appropriate responses to handle them. The identified threats will then be classified on a scale based on the

166. *Id.*

167. See generally R.S. Raghavan, *Risk Management in Banks*, CHARTERED ACCT., Feb. 2003, at 841, available at http://www.icai.org/resource_file/11490p841-851.pdf.

168. See James Fanto, *Anticipating the Unthinkable: The Adequacy of Risk Management in Finance and Environmental Studies*, 44 WAKE FOREST L. REV. 731, 735-36 (2009).

[D]ecision making in business has much in common with military strategy and can thus be profitably analyzed using game theory.... Peacock points out that throughout history, military conflicts have produced a set of basic Darwinian principles that can serve as an excellent guideline to business managers about how to compete in the marketplace. Neglecting these principles can make the difference between business success and failure More than ever before, today's business leaders must learn how to . . . muster the courage to steer the firm in radical new directions when necessary. Above all, firms must think and act strategically in a world of increasing global competition. Game theory can be particularly useful and can offer important insights in the analysis of oligopolistic interdependence. Indeed, more and more firms are making use of war-games simulations in their decision making.

DOMINICK SALVATORE, MICROECONOMICS: THEORY AND APPLICATIONS 391 (5th ed. 2009).

169. See Fanto, *supra* note 168, at 735-36, 739.

170. *Id.*

likelihood that they will materialize as well as their potential impact on the business and operations of a SIFI.¹⁷¹ The main classification criterion, however, should not be the source of the threat or its probability, but the level of the impact that the threat could have on the SIFI's business and operation.¹⁷² Thus, every single threat that can potentially cause a high adverse effect will typically warrant additional consideration even if its probability of actually occurring is extremely low.

As for the potential impact of each threat, immense literature covering the different aspects and concepts of risks valuation exists,¹⁷³ which is relevant to areas ranging from national security risks¹⁷⁴ to pricing natural disaster insurance.¹⁷⁵ Risk management entails using mathematical models to analyze the likelihood of losing on different investments and financial or business exposures and to quantify such losses based on the prior success or loss rates and statistics on similar investments and exposures.¹⁷⁶ A central concept in the finance literature is the Value at Risk measure (VAR), a statistical measure of the possible downsides of assets.¹⁷⁷ VAR is meant to assist risk management teams to identify the risks to which a financial institution is exposed from investments and activities. VAR gives an estimate for the worst-case scenario concern, by assessing, at various confidence levels, the lowest value assets can have at a future point in time,¹⁷⁸ and providing a snapshot of how much money can be lost in a single day. VAR assumes that historical data can be used to determine asset-price volatility, and that variations follow a "bell curve" and are therefore normally distributed around a mean.¹⁷⁹ VAR is easy to calculate and is fairly simple in its application; once the value is found, a financial institution can decide if it is comfortable with the risk it faces, and if not, it can make modifications to its trading strategies and positions accordingly.¹⁸⁰ VAR is also endorsed by regulators and governmental agencies,¹⁸¹ and is considered

171. See *Lessons Learned*, *supra* note 56, at 6.

172. *Id.*

173. See, e.g., CROUHY ET AL., *supra* note 66; APOSTOLIK ET AL., *supra* note 59.

174. See, e.g., 2 INTERNATIONAL POLITICAL RISK MANAGEMENT: THE BRAVE NEW WORLD (Theodore H. Moran ed., 2004).

175. See Okamoto, *supra* note 165, at 214.

176. See generally Anette Mikes, *Risk Management and Calculative Cultures*, 20 MGMT. ACCT. RES. 18 (March 2009).

177. See generally Duffie & Pan, *supra* note 66, at 7; FOX, *supra* note 65, at 238; CROUHY ET AL., *supra* note 66, at 149-79.

178. See Okamoto, *supra* note 165, at 214.

179. See *The Risks of Financial Modeling: VaR and the Economic Meltdown: Hearing Before the Subcomm. on Investigations and Oversight of the H. Comm. on Science and Technology*, 111th Cong. (2009) (statement of Richard Bookstaber), available at http://democrats.science.house.gov/Media/file/Commdocs/hearings/2009/Oversight/10sep/Bookstaber_Testimony.pdf.

180. See Peter Conti-Brown, *A Proposed Fat-Tail Risk Metric: Disclosures, Derivatives, and the Measurement of Financial Risk*, 87 WASH. U. L. REV. 1461, 1461-62 (2010).

181. It is used by the U.S. Securities and Exchange Commission (SEC), the U.S. Federal Reserve, the UK Financial Supervisory Authority, and even the Basel Committee on Banking Supervision. See,

The Case Against the Dodd-Frank Act's Living Wills

to be a useful efficient measurement for determining appropriate banking capital requirements, and for adequate risk disclosures to shareholders.¹⁸² Then, once different risks are identified, prioritized, and evaluated, each SIFI's board and executive personnel must use the risk analyses conducted to determine what the appropriate risk profile for the SIFI should be. It is also a SIFI's board and executives' role to ensure that the SIFI does indeed keep within its pre-determined risk boundaries and actively operate to minimize and address any losses associated with such risk.¹⁸³

The recently increased awareness to, and focus on, risk management is greatly connected to capital regulation, because it is globally accepted that financial institutions should have a fixed amount of capital in relation to their total assets amount, which is referred to as a leverage ratio.¹⁸⁴ Indeed, as emphasized by the Basel Committee on Banking Supervision,¹⁸⁵ risk management is crucial for financial institutions because the capital levels of the institutions are based on the institutions' assets and operations' risk assessment.¹⁸⁶ Moreover, ensuring that financial institutions actually adhere to a fixed leverage ratio is the preferred method to monitor financial institutions' risk. And the riskier an institution is, or its assets and operations are, the more capital the financial institution is required to have, and therefore the less funds it will be able to borrow for its investments. This risk-based capital model creates guidelines for each SIFI's management to assess and determine what they would like the risks of their institution's assets and business operations to be, and based on that the SIFI's basic capital amounts are set. Financial regulators enable SIFIs to develop their risk assessments using the SIFIs' own risk-analyzing tools and financials models instead of the risk-analyzing tools and models developed by the regulators.¹⁸⁷ Currently in the U.S., the Federal Reserve and other financial regulators review and monitor such risk assessments and risk management operations of the financial institutions and

e.g., SEC Accounting Policies for Certain Derivative Instruments, 17 C.F.R. § 210.4-08(n) (2011); SEC Financial Statements, 17 C.F.R. § 228.310 (2011); RICHARD DALE, RISK AND REGULATION IN GLOBAL SECURITIES MARKETS 78 (1996); Capital Requirements for Market Risk, 60 Fed. Reg. 38,142 (proposed July 25, 1995) (to be codified at 12 C.F.R. ch. 2); Sec. & Futures Auth., Board Notice 249: Implementation by SFA of the Capital Adequacy Directive (1995); BASEL COMM. ON BANKING SUPERVISION, AN INTERNAL MODEL-BASED APPROACH TO MARKET RISK CAPITAL REQUIREMENTS 6 (1995).

182. See Conti-Brown, *supra* note 180, at 1462.

183. See generally PETER S. ROSE & SYLVIA C. HUDGINS, BANK MANAGEMENT & FINANCIAL SERVICES 32 (7th ed. 2008).

184. See, e.g., 12 C.F.R. § 3.6(b) (2011).

185. See ROSE & HUDGINS, *supra* note 183, at 30, 483-84.

186. See Risk-Based Capital Standards: Advanced Capital Adequacy Framework--Basel II, 72 Fed. Reg. 69,288, 69294-98 (Dec. 7, 2007) (describing how the internal model approach, which was used to measure market risk, is now broader and includes credit and operational risk as well).

187. See *id.* (explaining how the internal model approach, which was used to measure market risk, is now extended to credit and operational risk).

companies that are subject to their regulatory authority.¹⁸⁸

As described in this Article, as part of the Dodd-Frank Act's living wills regulations, SIFIs must better analyze their risks and prepare reorganization and liquidation plans in order to be able to deal with sudden shocks and implausible scenarios. This is largely because risk management in SIFIs is being blamed as one of the factors that led to the creation of the recent financial crisis.¹⁸⁹ Therefore, the hope is that by preparing living wills, SIFIs will improve their risk management systems, as well as their day-to-day operations, business structure, and MIS, and will have the ability to deal with any potential risks or threats. Indeed, by setting clear and transparent guidelines regarding risk limits in the living wills, which include the maximum amounts that can be expected to be lost without undermining the SIFI's stability, SIFIs could better monitor their potential risks.¹⁹⁰ Such guidelines should also mandate that the establishment of a senior management risk committee, which should/will meet regularly in order to discuss the SIFI's significant risks—including credit, market, and operational risks. The guidelines should/will further mandate that diligent minutes of these meetings be taken.¹⁹¹ In addition, the reorganization and liquidation plans should include transparent guidelines concerning single transaction limits, which will limit the large financial positions¹⁹² that the SIFI's aggregate risk constraints might not otherwise limit.¹⁹³ Finally, SIFIs should determine guidelines concerning counterparty risk concentration.

But, even with an optimal risk management system in place, it is not clear how SIFIs could be ready for the worst case scenario, as it has been long argued that "no plan of operations extends with certainty beyond the first

188. See DIV. OF BANKING SUPERVISION & REG., FED. RESERVE BD., BANK HOLDING COMPANY SUPERVISION MANUAL supp. 28, § 4070 (2005) (discussing the Bank Holding Company Rating System that includes a rating on an "R" component, which represents risk management).

189. See, e.g., *The Financial Crisis and the Role of Federal Regulators Hearing Before the H. Comm. on Oversight and Gov't Reform*, 110th Cong. 3-4 (2008) (testimony of Alan Greenspan, former Chairman, Bd. of Governors of the Fed. Reserve Sys.); *Financial Regulation: Review of Regulators' Oversight of Risk Management Systems at a Limited Number of Large, Complex Financial Institutions Hearing Before Subcomm. on Sec., Ins., and Inv., Sen. Comm. on Banking, Hous., and Urban Affairs*, 111th Cong. 20-22, 24 (2009) (testimony of Orice M. Williams, Dir., Fin. Markets and Cnty. Inv., U.S. Gov't Accountability Office); Fanto, *supra* note 168, at 740-42.

190. Risk appetite is an integrated measurement of the financial institution's market, event risk and counterparty credit. It often, as was in Lehman's case, represents the maximum amount of risk that a financial institution can take and still be able to return an acceptable profit, even if it suffers a severe loss. See Lehman Examiner Report, *supra* note 44, tab 8, at 9.

191. See *id.*, tab 8, at 33-34.

192. Financial positions are organizations' status of their assets, liabilities and owners' equity, as reflected in their financial statement. See Carmen Martinez-Carrascal & Annalisa Ferrando, *The Impact of Financial Position on Investment: An Analysis for Non-Financial Corporations in the Euro Area* (Banco de Espana, Working Paper No. 0820, 2008), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1273546.

193. See Lehman Examiner Report, *supra* note 44, at 66. It is important to apply this measure universally and not only to specific types of transactions. For example, Lehman Brothers applied it only to leveraged loans originations. *Id.*

The Case Against the Dodd-Frank Act's Living Wills

encounter with the enemy's main strength."¹⁹⁴ Similarly, officials have admitted that "a firm's planning for its own demise will be a challenge."¹⁹⁵ Nonetheless, SIFIs are still required to prepare for all possible scenarios and plan for their own reorganization and liquidation, because, as one commentator has argued, "The sad truth we have learned is that this is absolutely necessary."¹⁹⁶

B. Stress-Testing and Scenario Planning

The need to be prepared for all possible scenarios, which is one of the lessons from the recent financial crisis, has placed the issue of stress-testing—a specific procedure of risk-management¹⁹⁷—in the spotlight.¹⁹⁸ Stress tests are designed to discover weak points in the financial institutions system at an early stage, and to assist banks, financial institutions, and their supervising regulators with the decision as to what preventive actions must be taken. Stress tests are "a procedure for evaluating the potential loss of a portfolio due to shocks to its underlying risk factors over a wide range of scenarios, however unlikely the probability of the occurrence may be."¹⁹⁹ Therefore, stress tests are essentially forward-looking economic assessments that check whether financial institutions are strong enough to endure pessimistic economic conditions scenarios or extreme emergencies.²⁰⁰ The Dodd-Frank Act requires financial regulatory authorities to conduct annual analyses of SIFIs as part of the Act's enhanced supervision provisions. Pursuant to this requirement, the authorities will evaluate whether SIFIs "have the capital, on a total consolidated basis, necessary to absorb losses as a result of adverse economic conditions."²⁰¹ In

194. See HELMUTH VON MOLTKE, MOLTKE ON THE ART OF WAR: SELECTED WRITINGS 45-47 (Daniel J. Hughes ed. 1993).

195. See Huw Jones, *FSA Says Clashes Over Bank Living Wills Inevitable*, FORBES, Nov. 2, 2009 (quoting Hector Sants, FSA Chief Exec.), available at <http://www.forbes.com/feeds/afx/2009/11/02/afx7073507.html>.

196. "We know from previous experience of stress testing that firms find it difficult to construct plausibly severe stress tests, and planning for their own resolution will be yet more challenging." *Id.*

197. See Fanto, *supra* note 168, at 736.

198. See, e.g., Li Lian Ong, Rodolfo Maino,& Nombulelo Duma, *Into the Great Unknown, Stress Testing With Weak Data* 4 (IMF Working Paper WP/10/282, 2010), available at <http://www.imf.org/external/pubs/ft/wp/2010/wp10282.pdf>; Li Lian Ong & Martin Cihák, *Of Runes and Sagas: Perspectives on Liquidity Stress Testing Using an Iceland Example* (IMF Working Paper WP/10/156, 2010), available at <http://ssrn.com/abstract=1641007> (presenting discussions on the weaknesses of the different stress test methods); and Fanto, *supra* note 168, at 731 ("risk management in systemically important financial institutions failed, which contributed to the recent collapse of the financial system.").

199. Jared Pedowitz, Ernst & Young LLP, *Market Risk Management Walkthrough Template*, (Nov. 20, 2007), at 6, available at <http://lehmanreport.jenner.com/docs/ERNST%20&%20YOUNG/EY-SEC-LBHI-EED-GAMX-07-007515-007530.pdf>.

200. See generally BASEL COMM. ON BANKING SUPERVISION, PRINCIPLES FOR SOUND STRESS TESTING PRACTICES AND SUPERVISION 9-11 (2009), available at <http://www.bis.org/publ/bcbs147.pdf>.

201. Dodd-Frank Act tit. I, § 165(i)(1)(A).

addition, the Dodd-Frank Act requires all SIFIs to conduct internal stress tests and mandates that all other regulated financial companies with assets equal to or greater than \$10 billion conduct internal annual stress tests, and report these results back to the authorities.²⁰² A summary of such reports will also be published by the SIFIs and the other tested financial companies.²⁰³ Thus, it appears that in addition to using stress tests as a tool to increase financial stability, the Dodd-Frank Act also seeks to promote transparency and increase public confidence in the financial markets. Indeed, the stress tests are meant to shed more light on the SIFIs financial condition so that high-level important conclusions can be made based on the tests' results.²⁰⁴ This means that both the tests and the assumptions concerning the tests' underlying scenarios must be carefully designed. Further, any changes in a financial institution's positions needs to be continually updated, and the stress tests themselves must be updated periodically to address the institution's evolving business practices and strategies.²⁰⁵

The stress tests should focus mainly on the SIFIs': (i) credit; (ii) market; (iii) operational; and (iv) liquidity risks, because if these risks are not carefully monitored and managed, they can jeopardize the entire financial system's health. SIFIs should also be encouraged to internally require that all major business decisions be made in consideration of the stress tests' results relating to the type of risk being undertaken, and that prior to entering into any series of risky transactions, the specific transactions be tested and general stress tests be administered.

Credit risks are the possible losses from defaults on loans' payments of principal and interest.²⁰⁶ Stress tests for this type of risk review the effect that increasing loan defaults, or non-performing loans, have on the financial

202. *Id.* § 165(i)(2).

203. *Id.*

204. The Federal Reserve will approve dividend increases or other capital distributions only for companies whose capital plans are approved by supervisors and are able to demonstrate sufficient financial strength to operate as successful financial intermediaries under stressed macroeconomic and financial market scenarios, even after making the desired capital distributions. *See* Press Release, Board of Governors of the Federal Reserve System, Federal Reserve Board Issues Final Rule on Annual Capital Plans, Launches 2012 Review (Nov. 22, 2011), available at <http://federalreserve.gov/newsreleases/press/bcreg/2011bcreg.htm>.

205. Indeed, excluding certain positions from its stress tests and the tests' assumptions was one of Lehman Brother's risk-assessing mistakes, as Lehman had real-estate and private equity positions, which initially were not traded freely, and therefore, were assumed to not be susceptible to stress testing over a short period of time; despite the fact that the investments in these areas grew, they were not properly reflected in the stress test. *See* Lehman Examiner Report, *supra* note 44, at 181.

206. *See* Fanto, *supra* note 168, at 736. Initially, the Basel guidelines, which were known as "Basel I," dealt only with credit risk. *Id.* Eventually, however, banking rule-makers have adopted guidelines concerning credit and operational risk modeling according to the "Basel II" standards. *See* Risk-Based Capital Standards: Advanced Capital Adequacy Framework--Basel II, 72 Fed. Reg. 69,288 (Dec. 7, 2007).

The Case Against the Dodd-Frank Act's Living Wills

institution's profit and capital.²⁰⁷

Market risks are the possible losses from the change in the value of securities' prices due to changes in interests or default rates.²⁰⁸ Such risks are typically linked to a pessimistic economic scenario in which, for example, economic growth drops and unemployment rises. Market risk stress tests measure how modifications in the prices of different financial assets—such as equities and bonds—as well as various rates—such as exchange rates and interest rates—impact a financial institution's profits, capital, and portfolio assets' value. Stress tests for market risk examine the impact of a drop in the value of the different assets in the financial institution's portfolio, using macroeconomic assumptions to predict such drops.

Operational risks are the risks of loss resulting from failed or inadequate internal procedures, from human or systems errors, or from external events.²⁰⁹ Such risks include legal risks, but not reputational or strategic risks.²¹⁰ Operational risks are inherent in business and are the most challenging risks to deal with, measure, and monitor because they are the least understood risks.

Liquidity risks concern the situation in which financial institutions fall short of cash and are not easily able to find alternative sources either through borrowing money from other financial institutions or by selling assets.²¹¹ In order to avoid such a situation, the BIS has established rules concerning liquidity risk management.²¹² Nevertheless, in the recent financial crisis the

207. See generally Antonella Foglia, *Stress Test Credit Risk: A Survey of Authorities; Approaches*, 5 Int'l J. Cent. Banking 9 (2009).

208. See ANTHONY SAUNDERS & MARCIA MILLON CORNETT, FINANCIAL INSTITUTIONS MANAGEMENT: A RISK MANAGEMENT APPROACH 266 (6th ed. 2008). Financial institutions engage in securities-market activities, which entail buying securities and debt as part of investment or trading strategies, and therefore any determined capital standards must take account of market risk. See Fanto, *supra* note 168, at 736. Similarly to the credit-risk regulation, guidelines concerning market-risk measurement rules were determined as well. See 12 C.F.R. § 225 app. D (2011) (rules for U.S. bank holding companies).

209. The Basel II Accord identifies five different types of operational risks: internal process risks, people risks, legal risks, systemic risks and external risks. It also provides three different approaches to calculating such risks: the Basic Indicator Approach, the Standardized Approach, and the Advanced Measurement Approach. APOSTOLIK ET AL., *supra* note 59, at 179-200.

210. *Id.* at 18, 179-200.

211. See for example, the risk for a “run on the bank,” which is a risk the SIFIs face and results from the fact that depositors can demand the return of their funds at any given point in time, so if at one point in time there is mass-demand of depositors to get their deposits back, the SIFI may not be able to accommodate these requests. And if the SIFI or bank cannot liquidate its different investments fast enough to obtain the money needed to repay the depositors, as well as to pay down leverage, it is in trouble. Indeed, a mass-demand of depositors to get their funds back usually paves the way to drops in asset values and reduces the number of possible liquidity sources. This can start a vicious cycle of drops in asset values and panic. As asset values drop, depositors start to worry about the stability of the SIFI with which they deposited their funds and start to withdraw deposits. And the more depositors pull back their funds, the more the SIFI from which they withdraw the deposits must liquidate more assets – which results in additional drops in values of assets – and withdraw liquidity from different financial institutions. Such other financial institutions then also need to liquidate their positions, which once more causes asset values’ drops, and this cycle dangerously continues. See Okamoto, *supra* note 165, at 193.

212. See, e.g., BASEL COMMITTEE ON BANKING SUPERVISION, PRINCIPLES FOR SOUND LIQUIDITY

liquidity shocks that the financial industry dealt with were so radical²¹³ that governments had no choice but to inject great amounts of cash into liquidity-strapped financial institutions that were in trouble. Stress tests for liquidity risks must simulate the range of potential liquidity shortages and examine the impact that the shortages would have on the financial institutions.

Insufficient stress-testing and the inability to properly estimate losses in the risk models that were used both contributed to the recent financial crisis.²¹⁴ Consequently, it is now clear that financial institutions should improve their existing stress testing abilities. Accordingly, it has also been argued that SIFIs should use, in addition to other risk-management techniques, reverse stress-testing—stress tests that start from the assumption of business failure and then identify the circumstances where this result might take place. Therefore, unlike in regular stress tests, which test for outcomes resulting from changes in circumstances, reverse stress tests require SIFIs to analyze different conditions and circumstances that would make their business model not feasible—a process that helps SIFIs identify possible weaknesses.²¹⁵ But even without focusing on reverse stress-testing, the weaknesses exposed in the recent financial crisis show that not only were not enough resources devoted to stress-testing in general, but that there was also a failure to test against severe macroeconomic results, and that SIFIs failed to properly consider system-wide results of tests.

Since it is now believed that the successful implementation of proper stress tests is viable as part of their living wills' planning, great efforts should be focused on devising creative, successful, and efficient stress tests. Such tests should aim to evaluate even the most radical and extreme scenarios in order to enable financial institutions to discover what obstacles may exist.

i. Scenario Planning

Scenario analysis attempts to answer the same questions as VAR, but only from a more qualitative perspective—namely, what are the possible outcomes a SIFI faces, and what is the likelihood of each outcome actually happening?²¹⁶

RISK MANAGEMENT AND SUPERVISION (BANK FOR INT'L SETTLEMENTS, SEPT. 2008), available at <http://www.bis.org/publ/bcbs144.htm> (final document).

213. See, e.g., Robin Sidel, David Enrich & Dan Fitzpatrick, *WaMu Is Seized, Sold Off to J.P. Morgan*, in *Largest Failure in U.S. Banking History*, WALL ST. J., Sept. 26, 2008, at A1 ("The collapse . . . was triggered by a wave of deposit withdrawals . . .").

214. See Fanto, *supra* note 168, at 740-41.

215. See *Reverse Stress Testing*, FINANCIAL SERVICES AUTHORITY (Apr. 24, 2010), available at http://www.fsa.gov.uk/pages/About/What/International/stress_testing/firm_s/reverse_stress_testing/index.shtml.

216. See Kabir K. Dutta & David F. Babbel, *Scenario Analysis in the Measurement of Operational Risk Capital: A Change of Measure Approach* (Wharton School Finance and Insurance Departments, Working Paper, 2010), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1565805 ("Scenario analysis is an important tool in decision making. It has been in existence for several decades

The Case Against the Dodd-Frank Act's Living Wills

Risk managers are tasked with identifying potential harms and accordingly developing possible downside scenarios, assessing their likelihood, analyzing the sources of the problems in these scenarios, and developing different plans to contain them. Therefore, risk managers work on developing scenarios that cover as many different situations, events, and malfunctions as possible. Their work may range from examining the resilience of backup communications systems to extremely sophisticated hi-tech modeling of portfolio performance.²¹⁷ Further, the tests developed must examine the worst-case scenarios and test the SIFIs' businesses under different burdening, nearly unimaginable conditions to prepare for all possible scenarios. Additionally, risk managers need to be alert to any systemic weaknesses, such as moral hazard, which might cause problems or create negative incentives, and develop internal regulations that will ameliorate these weaknesses.²¹⁸ Finally, risk managers must also create methods and policies to guarantee compliance with the internal regulations and policies they create, in order to not only predict harm, but also to successfully prevent it where possible.²¹⁹

ii. War Games and Simulations

Rules alone cannot protect a system from systemic risk.²²⁰ Systemic risk is formed when the actions of one party may be rational and promote that party's interests, but if everyone adopted the same approach as that one party, the system may collapse.²²¹ War games,²²² coupled with broader use of simulated stress tests, could be a great tool to help financial institutions analyze how they should act, given that all SIFIs are operating in one system and interacting with

and has been used in various disciplines, including management, engineering, defense, medicine, finance and economics ... It is a tool that, when properly and systematically used, can bring to light many important aspects of a situation that would otherwise be missed. Scenario analysis tries to navigate the possible situations and events that can impact an entity in the future, with respect to the characteristics we are trying to measure and given the state of the entity at the present time.”).

217. For an explanation of how to value portfolio performances, see CHRISTOPHERSON ET AL., PORTFOLIO PERFORMANCE MEASUREMENT AND BENCHMARKING (2009).

218. See, e.g., CROUHY, ET AL. *supra* note 66, at 325-45. An example for such a hazard and a policy that will be developed to avoid such risk are the personal trading rules, which were created in order to prevent the creation of any incentives to front run client trading. *Id.*

219. See Okamoto, *supra* note 165, at 214-15.

220. See Michael R. Gadbow, *Systemic Regulation of Global Trade and Finance: A Tale of Two Systems*, 13 J. INT'L ECON. L. 551, 568 (2010).

221. *Id.*

222. A war game is a special and specific simulation of combat. Corporations adopted this exercise and use it as a business improvement technique – a simulation of competition in a marketplace. This tool has become popular, as it offers strategists new ways to analyze their businesses, their competitors, and their business decisions. The main purpose of most war games is to increase companies' probability and success in the face of competition and a series of uncontrollable trends and occurrences. See generally BENJAMIN GILAD, BUSINESS WAR GAMES: HOW LARGE, SMALL, AND NEW COMPANIES CAN VASTLY IMPROVE THEIR STRATEGIES AND OUTMANEUVER THE COMPETITION (2009); MARK L. HERMAN, MARK D. FROST AND ROBERT KURZ, WARGAMING FOR LEADERS: STRATEGIC DECISION MAKING FROM THE BATTLEFIELD TO THE BOARDROOM (2008).

each other.²²³ Moreover, war games, used together with international regulations, promise a much more efficient way to plan for potential economic crises. Indeed, one of the risks to predict is the connection between financial institutions, and the potential that risks and threats impacting an individual financial institution, or a group of institutions, may spread to other institutions and possibly threaten the stability of the entire global financial system. This is especially true given the global scale of financial institutions' operations, which create the potential to pass on shocks from one geographic area to another on such a large scale, as seen in the last few years.

The use of war games and multi-participant simulations can provide guidance on the risks that SIFIs face from the remainder of the highly interconnected international banking system. Vigorous stress tests conducted on the international level will help identify the weakest links of the global financial system and enable regulators to prepare for an international emergency response.²²⁴ This is extremely important because the internationalization of the financial system, as demonstrated by the 2008 financial meltdown, makes it impossible for individual or national-coverage stress tests to be satisfactory. Therefore, although the U.S. and the U.K. simulated scenarios in joint stress-testing and conducted war games together even prior to the recent financial crisis, there was no effort to conduct similar exercises at a global level²²⁵ and this failure should not be repeated; war games should be expanded to include many international aspects and participants. Consequently, SIFIs should allocate resources to focus on global crisis planning and develop better global financial war-gaming testing abilities.

Simulation and war games are one of many methods to obtain information about the potential weaknesses of financial systems, but they greatly differ from traditional, conventional quantity oriented models by enabling a number of participants to interact with a mathematical model.²²⁶ Indeed, simulation games can help obtain more meaningful results by including in the mathematical models more complex aspects of real human behavior. Mathematical algorithms cannot simulate human responses and behavior the

223. *Id.*

224. It was recently argued that secret "war games" held by the Financial Services Authority ("FSA"), the Bank of England and the British Treasury showed that Northern Rock, which eventually was nationalized by British Government in 2008, was at risk and that its troubles would affect HBOS, a big U.K.'s mortgage lender, which as a result had to be rescued and was later sold to Lloyds TSB (Lloyds Banking Group). See Catherine Boyle, *Secret 'War Games' Identified Northern Rock's Weakness*, THE TIMES, May 30, 2009, http://business.timesonline.co.uk/tol/business/industry_sectors/banking_and_finance/article6391083.ece.

225. CONGRESSIONAL OVERSIGHT PANEL, AUGUST OVERSIGHT REPORT: THE GLOBAL CONTEXT AND INTERNATIONAL EFFECTS OF THE TARP, Aug. 12, 2010, at 112, available at <http://cop.senate.gov/documents/cop-081210-report.pdf>.

226. G. ORCUTT, M. GREENBERGER, J. KORBEL, & A. RIVLIN, MICROANALYSIS OF SOCIOECONOMIC SYSTEMS: A SIMULATION STUDY 3-281 (1961) (simulations of activity of the nation's economy).

The Case Against the Dodd-Frank Act's Living Wills

same way that humans can. Thus, simulation games are becoming an extremely important tool in the study of human systems.²²⁷ And, since simulation games involve conflicting interests, which are reflected by the different players' agendas and decisions that play an integral part in the simulations, the human responses to these conflicting interests, although not always Pareto efficient, are vital and cannot easily be substituted by a programmed simulation model.²²⁸ After all, gaming is a research tool,²²⁹ and since one of the biggest problems of computer simulation is the inability to properly represent and program human attributes, it was suggested that computer gaming, where humans participate in the simulation, could be used to alleviate this problem.²³⁰ But, because simulation games entail "unique limitations in addition to those inherent in computer simulation,"²³¹—for example, institutions might not make the same decisions that individual players would²³²—it has been argued that thus far, simulation games have not been conducted via computers as much as they could have been.²³³ Nevertheless, simulation games have been efficiently used in many different contexts, from war games²³⁴ to modeling building fires²³⁵ to simulations of collaborative work,²³⁶ to political elections.²³⁷ Economic simulations—a well-accepted tool dating back to the 1950s²³⁸—are relatively easy to conduct, because theories used in economic simulations can generally be expressed by equations and graphs, and thus involve economic relationships can easily be translated into computer-friendly terms. Thus, economic simulations have been put into widespread use since the 1970s, when they were considered to be a useful tool in trying to predict economic circumstances and for policy planning purposes.²³⁹ Then, as time passed,

227. *Id.*

228. Margaret M. Hazen & Thomas Lee Hazen, *Simulation of Legal Analysis and Instruction on the Computer*, 59 IND. L.J. 195, 202 (1984) (citations omitted).

229. John N. Drobak, *Computer Simulation and Gaming: An Interdisciplinary Survey with a View Toward Legal Applications*, 24 STAN. L. REV. 712, 719 (1972).

230. *Id.* at 719-20.

231. *Id.*

232. *Id.*

233. See PATENTOPOLIS, <http://cps.q42.net/projects/10> (last visited Feb. 1, 2009).

234. Robert C. Rubel, *The Epistemology of War Gaming*, NAVAL WAR C. REV. 108 (Spring 2006), available at <http://www.usnwc.edu/getattachment/5fce9410-594b-47bf-af57-4cf5e406e634/Epistemology-of-War-Gaming,-The---Rubel,-Robert-C.->.

235. Richard Bukowski & Carlo Séquin, *Interactive Simulation of Fire in Virtual Building Environments*, 24 SIGGRAPH Conf. on Computer Graphics & Interactive Tech. 35 (1997), available at <http://doi.acm.org/10.1145/258734.258757>.

236. Nathan Bos, et al., *In-group/Out-group Effects in Distributed Teams: An Experimental Simulation*, 2004 ACM Conf. on Computer Supported Cooperative Work 429, available at <http://doi.acm.org/10.1145/1031607.1031679>.

237. Edward B. Foley, *Democracy in the United States, 2020 and Beyond, in Race, Reform, and Regulation of the Electoral Process* (manuscript at 11-13) (Heather Gerken, Guy Charles & Michael Kang, eds., forthcoming 2010).

238. ORCUTT ET AL., *supra* note 226, at 3-281 (simulations of activity of the nation's economy).

239. John N. Drobak, *Computer Simulation and Gaming: An Interdisciplinary Survey with a View*

economic simulations were used more and more by government agencies, private businesses, and even universities.²⁴⁰ These simulations even included various aspects of human decision-making elements, such as government spending.²⁴¹ Such elements were added because, by including human functions, behavior-aspects, and relationships' patterns that cause certain human factors to respond to other elements of the model, the economic simulations can also take into consideration human cultural influences,²⁴² and that enables investigating broader issues.²⁴³

In the context of the living wills and improving stress tests, in order to create a viable interactive simulation that could shed light on the role of SIFIs in the real world, it is necessary to consider how aspects of the real world could be mapped onto structures in the simulation.²⁴⁴ Ideally, the impact that regulation has on corporate enterprises, the historical analysis of prior financial crises, the cultural and economic effects of corporate enterprises,²⁴⁵ the compatibility of federal and state controls, the structure of corporate governance, and the structure of corporate decision-making could all be represented by an economic simulation of a corporate world model. A model like this can be created by grouping together different models of corporate entities, such as shareholders, boards of directors, markets, and capital. Moreover, linking a money market into such a model would enable analysts to study corporate finance, including the influence of lending institutions and the security market.²⁴⁶ Similarly, researchers could model antitrust related issues, and the effects of government policies for certain industries could be further reviewed, as well as the various industries' effects on the competition's volume and structure. Such an economic simulation model would enhance risk management and add qualitative aspects to the quantitative modeling. It would also enable other professionals—such as psychologists, neuro-economists and historians, for example—to contribute to the risk analysis, and enrich it with different perspectives²⁴⁷

Toward Legal Applications, 24 STAN. L. REV. 712, 716-17 (1972).

240. J. RASER, SIMULATION AND SOCIETY 55 (1969).

241. ORCUTT ET AL., *supra* note 226, at 237-55.

242. Drobak, *supra* note 239, at 716-17.

243. *Id.*

244. Andrew W. Torrance & Bill Tomlinson, *Patents and the Regress of Useful Arts*, 10 COLUM. SCI. & TECH. L. REV. 130, 155 (2009).

245. Drobak, *supra* note 239, at 728.

246. *Id.*

247. René M. Stultz, *Risk Management Failures: What Are They and When Do They Happen?* 18-19, 22 (Dice Center, Working Paper No. 2008-18, 2008), available at <http://ideas.repec.org/p/ecl/ohidc/2008-18.html>.

The Case Against the Dodd-Frank Act's Living Wills

C. Black Swans and Tail Risk

Will sophisticated risk management—which includes scenario planning, interactive simulation, and war games—be able to predict potential risks and threats and keep SIFIs apprised of future hazards? Much of this depends on the reliability of the risk models that are being used by the SIFIs. Carefully designed models should be able to detect the probability of negative outcomes using assumptions of symmetric and—more importantly—asymmetric distribution of gains and losses. But using only incorrect symmetric distribution assumptions will not prevent possible losses from occurring with greater probability, which is commonly referred to as the “fat tail” issue.²⁴⁸ Therefore, risk management models need to assist SIFIs to become aware of, monitor, and assess how to best deal with “tail dependence,” which is the risk that a loss in one sphere will cause losses in other spheres, despite the fact that the initial loss can be at the tail of the probability distribution.²⁴⁹

But such tail dependence risk is not the only radical scenario of which the SIFIs’ risk management systems must be wary. Destructive and disastrous events can occur in a random way that cannot be modeled or calculated in advance.²⁵⁰ Indeed, pursuant to Professor Nassim Taleb, disastrous events are “black swans”—always new and unthinkable.²⁵¹ And preparing in advance to deal with black swans or trying to prevent black swans from happening entails a logical problem. Even if proper risk management measures were put in place in advance to prevent black swans and were indeed successful in doing so—preventing a new and unthinkable specific event from ever happening—no one would know that the newly installed measures were the cause of the success, as the unthinkable event never happened.²⁵² Nevertheless, when the same newly installed measures will not be successful in preventing a second, different, also new and unthinkable event from happening, public rage will take place arguing that wasteful unsuccessful risk management procedures were installed, which

248. See, e.g., Barry Eichengreen, *Ten Questions About the Subprime Crisis*, FIN. STABILITY REV. Feb. 2008, at 19, 21-22 (2008) (Special Issue on Liquidity), available at http://www.banque-france.fr/gb/publications/telechar/rsf/2008/etud4_0208.pdf; see also Susan Pulliam, et al., *Merrill Upped Ante as Boom in Mortgage Bonds Fizzled*, WALL ST. J., Apr. 16, 2008, at A1.

249. See Fanto, *supra* note 168, at 742; see also BASEL COMM. ON BANKING SUPERVISION, PRINCIPLES FOR SOUND STRESS TESTING PRACTICES AND SUPERVISION 9-10 (2009), available at <http://www.bis.org/publ/bcbs147.pdf>.

250. NASSIM NICHOLAS TALEB, THE BLACK SWAN: THE IMPACT OF THE HIGHLY IMPROBABLE 274-85 (2007).

251. *Id.* see also Joe Nocera, *Risk Mismanagement: Were the Measures Used to Evaluate Wall Street Trades Flawed?*, N.Y. TIMES MAG., Jan. 4, 2009, at 27-31, available at <http://www.crss.ucsb.edu/courses/ChEMEE124/RefMat/R1NYTimes.pdf>.

252. “If risks are well prevented, we’ll never know how much value was preserved because we will never experience the loss. All we will have to measure is the cost of prevention . . . It is a problem because while we can identify the value of a ‘no’ decision in theory, in the real world ‘no’ decisions will be evaluated routinely only in hindsight. In hindsight, they tend to not look very good unless we are already facing a disaster.” Okamoto *supra* note 165, at 217.

failed to detect and prevent an unthinkable [second] event from happening. And since it is impossible to predict every single new and unthinkable event and prevent it in advance, this outcome is inevitable. Moreover, in the process of trying to amend the risk management measures after existing measures failed to detect an unthinkable event from happening, damaging changes can be made, which will prevent the potential ability to predict and prepare for a different kind of event.²⁵³ Therefore, the SIFIs, the governmental agencies, and the public must understand that any attempt to create a bulletproof risk management model is doomed to fail.

IV. SUPERVISION

Pursuant to the new rules, all SIFIs must submit their living wills plans to regulators on a staggered basis, starting on or before July 1, 2012, but no later than December 31, 2013.²⁵⁴ Additionally, SIFIs will be required to file updated plans annually, and following the occurrence of a material event SIFIs will need to submit notices concerning the material event within forty-five days.²⁵⁵ The Dodd-Frank Act also authorizes regulators to impose different liquidity and capital requirements on SIFIs as they see fit, and to restrict SIFIs' activities if the SIFIs do not submit credible reorganization and liquidation plans in a timely manner.²⁵⁶

The broad powers given to the regulators should be used to advance the Dodd-Frank Act's objective—to try to achieve an orderly resolution in a time of crisis—which will often necessitate reorganizing or winding down an insolvent SIFI in such a way that might result in wiping out shareholders' interests. The management of each SIFI, much like any other company, can be expected to try to keep as much value as possible in the SIFI's reorganization or liquidation plans for its shareholders. Thus, given this conflict of interests, regulators should not overly rely on the reorganization or liquidation plans developed by SIFIs; instead, they should take an active part in reviewing and designing all plans. Indeed, regulators should be actively involved in living will drafting and not blindly trust a last resort plan drawn up by executives who mismanaged their company and caused it to fail, especially because relying on SIFI management plans might place other SIFIs at peril as well.²⁵⁷

253. “[I]f financial-market complexities produce new situations of risk that may have little to do with model outcomes, risk assessment and measurement may aggravate the situations because they change the conduct of parties who believe that they have already prepared for the worst.” Fanto, *supra* note 168, at 752-53; *see also* GEORGE COOPER, THE ORIGIN OF FINANCIAL CRISES: CENTRAL BANKS, CREDIT BUBBLES AND THE EFFICIENT MARKET FALLACY 144-48 (2008).

254. *See* the Final Rule, *supra* note 7.

255. *Id.* The Final Rule requires such notices to summarize why the event, occurrence, or change may require changes to the resolution plans. *Id.*

256. *See* Dodd-Frank Act tit. I, § 165; FDIC's NPR, *supra* note 7.

257. *See* Supervising and Resolving, *supra* note 38.

The Case Against the Dodd-Frank Act's Living Wills

Therefore, the supervisory requirements, which were included in the Dodd-Frank Act, are critical; the success of a SIFI's living will directly correlates with the level of supervision and regulator involvement. Without tight supervision and regulatory involvement, SIFIs and the financial industry will always under-invest in predictive prevention—analyzing possible downside scenarios, identifying possible causes, and devising policies and procedures to avoid their occurrence—because it appears less valuable the more effective it is.²⁵⁸ If a risk manager flags a somewhat risky position with a low probability—arguing that something adverse will happen—and the more likely positive result ends up taking place, the risk manager will in hindsight have cost the SIFI whatever the upside that materialized. Only if the unlikely negative result or a disaster materializes—for which the risk manager flagged a position as risky—does the risk manager's decision have value in hindsight.²⁵⁹

Similarly, the installment of proper MIS in SIFIs, which will provide all the necessary information for the SIFIs' reorganization and liquidation plans, must be carefully reviewed and supervised. And the reorganization and liquidation plans themselves must be constantly updated by the SIFIs, and routinely reviewed by the regulators, in order to guarantee that SIFIs actually simplify their structures, properly prepare for the unknown, and are kept at par with the rationales underlying the living will regulations.²⁶⁰ Moreover, regulators should apply different standards in reviewing SIFIs and require updates based on their observations. For example, capital requirements should be higher for SIFIs that will require more time to restructure and liquidate, unless those SIFIs can demonstrate that they have a larger fraction of liabilities that can be converted to equity without invoking bankruptcy.²⁶¹ Otherwise, the Dodd-Frank Act enables the regulators to subject SIFIs to various sanctions, capital charges, and even divestments if the plans they submit for review will be found to be deficient.²⁶² And the regulators should not hesitate to use these powers when needed, because while such powers might seem too broad, imposing similar sanctions on size and different business operations have long been effectively used when imposing antitrust rules and in the competition law context.²⁶³ Thus, the expectation is that SIFIs will draft well-prepared and carefully devised

258. See Okamoto, *supra* note 165, at 216.

259. *Id.*

260. See MONETARY AND CAPITAL MARKETS & WESTERN HEMISPHERE DEPARTMENTS, INTERNATIONAL MONETARY FUND, UNITED STATES FINANCIAL SYSTEM STABILITY ASSESSMENT 37 (July 2010), available at <http://www.imf.org/external/pubs/ft/scr/2010/cr10247.pdf> [hereinafter IMF STABILITY REPORT 2010].

261. KENNETH R. FRENCH, ET AL., THE SQUAM LAKE REPORT: FIXING THE FINANCIAL SYSTEM 104-06 (2010).

262. See Dodd-Frank Act tit. I, § 165(d)(5).

263. See GENEVA REPORT, *supra* note 42, at 65.

institution-specific reorganization and liquidity plans.²⁶⁴

Additionally, if a SIFI has diverse and complex business relationships with clients, suppliers, and investors at a national and international levels—such that in the event of default it would have serious consequences for other involved parties, as well as knock-on effects that could severely damage the entire economy—it appears that the supervising regulators can and should impose a limitation of interconnectedness and interdependences.²⁶⁵ Moreover, the supervising regulators, in such situations, must interact with the other relevant supervising regulators, which are overseeing the SIFI's activities in the other jurisdictions in which the SIFI operates, and figure out the best way to oversee the SIFI's operations and business activities.

Finally, financial regulators must improve their overview and monitoring of SIFIs' risk management. Regulators already have the authority to supervise corporations' risk models and to require the corporations to improve their models,²⁶⁶ but must also exercise their power, and severely penalize financial institutions that do not completely comply with the living wills' requirements.²⁶⁷ Indeed, severe "punishments," as described in the Dodd-Frank Act should be inflicted in order to create a business norm: no deviations from the rules will be accepted and the safety of the financial stability is in the top priority. Similarly, U.S. regulators already have the ability to set a deposit insurance premium—an annual levy that banks pay on their deposits in return for receiving deposit insurance coverage—based on each SIFI's risk level.²⁶⁸ Thus, undercapitalized SIFIs that have high supervisory risk-ratings pay many more basis points of deposits for insurance coverage per year, than what well-capitalized SIFIs with low supervisory risk-rating are paying.²⁶⁹ But, regulators must make the standards stricter, to incentivize SIFIs that want to get coverage to be well-capitalized in order to be able to afford the insurance premium payments. And most importantly, regulators should focus their efforts on being involved in creating the SIFIs' stress tests, because stress tests created by financial institutions can be based on assumptions that are neither prudent nor reasonable. Such assumptions can severely impact the stress tests' results, which will then provide the basis to systemic risk analyses that will help determine what type of financial decisions should be made. Indeed, courts have

264. See IMF STABILITY REPORT 2010, *supra* note 260, at 37.

265. See Dodd-Frank Act tit. I, § 165(d)(5). Note that this interconnectedness is the result of the financial integration, which has increased dramatically and as a consequence, the total cross-border claims between banks stood at \$5.9 trillion in the third quarter 2009, much more than the \$4.7 trillion at the end of 2005. And in addition to interbank claims, connectedness is also reflected in different linkages, such as capital market transactions. See GENEVA REPORT, *supra* note 42, at 8.

266. See Fanto, *supra* note 168, at 748.

267. *Id.*

268. APOSTOLIK ET AL., *supra* note 59, at 76.

269. *Id.*

The Case Against the Dodd-Frank Act's Living Wills

long held that companies' projections tend to be overly optimistic and positive.²⁷⁰ Therefore, fact-finders should not rely on SIFIs' self-projections as accurate, without further inquiring into the reasonableness and cautiousness of the projections' underlying assumptions.²⁷¹ For example, in the Lehman Brother's bankruptcy case, the alteration of merely two assumptions that were used by the company when conducting a stress-test in May 2008, resulted in a \$26.7 billion negative effect, as well as in the company's failure by \$6 billion in the very same stress-test, which it passed before altering those two assumptions.²⁷² Thus, regulators should also constantly check and approve the models and scenarios that SIFIs use in their stress tests, and make sure that different SIFIs use different stress tests, because stress tests should not be "one size fits all," but based upon the SIFIs' assets quality.²⁷³

V. DIFFICULTIES IN THE IMPLEMENTATION OF LIVING WILLS

Many perceive living wills as the best solution to the problems highlighted by the recent financial crisis. Nevertheless, living wills entail many different problematic aspects, which can cause even the most ideally planned living wills to fail. And while living wills do offer some advantages, they simply cannot do all the things their proponents claim.

A. The Difficulty in Identifying and Predicting Risk

Risks change as global economic conditions shift and as the financial environment develops. Consequently, it is difficult to identify too-big-to-fail financial institutions before an actual crisis starts, and the VAR is not always a helpful tool in doing so. The more complicated the valued assets are, the less reliable the predictions of the distribution of the possible results and values become.²⁷⁴ Additionally, VAR relies on specific assumptions concerning the distribution of possible outcomes; those assumptions often undervalue the effect of outlier distributions and therefore can lead to overly optimistic valuations.²⁷⁵ These weaknesses highlight one of the most obvious limitations of living wills: the extreme difficulty to predict in advance and, therefore, to prepare accordingly. Indeed, it is difficult to predict prior to a distress which

270. Moody v. Sec. Pac. Bus. Credit, 971 F.2d 1056, 1073 (3d Cir. 1992).

271. MFS/Sun Life Trust-High Yield Series v. Van Dusen Airport. Servs. Co., 910 F. Supp. 913, 937 (S.D.N.Y. 1995).

272. See Lehman Examiner Report, *supra* note 44, at 1679-80.

273. Moreover, stress tests are especially multifaceted, individualized processes when a great part of the relevant assets are financial derivatives because assessing counter-party risk is extraordinarily difficult. *Grading the Banks' Stress Test*, May 6, 2009, N.Y. TIMES, available at <http://roomfordebate.blogs.nytimes.com/2009/05/06/grading-the-banks-stress-test/>.

274. See Duffie & Pan, *supra* note 66, at 9 ("[VAR] captures only one aspect of market risk, and is too narrowly defined to be used on its own as a sufficient measure of capital adequacy.").

275. See TALEB, *supra* note 250.

geographical areas will be affected the most, which parts of a SIFI will be under the most stress, and what the situation in different markets will be, in addition to the financial standing of each SIFI's counterparties and other financial institutions.²⁷⁶ But, since to some extent, the Dodd-Frank Act's living wills solution is a typical reaction to a financial crisis—a post-crisis regulation, which is intended to steer clear from the causes that led to the crisis in a specific industry²⁷⁷—the problem is that while it is possible that a future crisis will happen again in the same specific industry, it is not probable that the causes of a future crisis will be the same as those of the late 2000's crisis.²⁷⁸ Moreover, post-crisis regulation is frequently more reactionary rather than anticipatory, and thus may not be helpful in resolving future different crises.²⁷⁹ In fact, it might limit society's ability to deal with potential future crises.²⁸⁰

Additionally, while it can be argued that stress-testing can help with predicting distress in advance, just like simulation and war games often do not work well for the military when trying to identify future concerns, these methods might fail to identify specific risks in the financial environment too. Those who set up the simulations models and the tests' scenarios typically use past experiences to determine what is likely to happen in the future.²⁸¹ But, since financial calamities are typically unexpected, planning in advance reorganization and liquidation plans, in order to be ready to face the unknown, is virtually impossible.²⁸² Moreover, there are several constraints that must be

276. See *Supervising and Resolving*, *supra* note 38; see also BASEL COMM. ON BANKING SUPERVISION, REPORT AND RECOMMENDATIONS OF THE CROSS-BORDER BANK RESOLUTION GROUP (Sept. 2009), available at <http://www.bis.org/publ/bcbs162.pdf?noframes=1>; FINANCIAL STABILITY FORUM, FSF PRINCIPLES FOR CROSS-BORDER COOPERATION ON CRISIS MANAGEMENT (Apr. 2, 2009), available at http://www.financialstabilityboard.org/publications/r_0904c.pdf.

277. See, e.g., Dodd-Frank Act, Pub. L. No. 111-203, 124 Stat. 1376; Kathleen A. Lacey et al., *Assessing the Deterrent Effect of the Sarbanes-Oxley Act's Certification Provisions: A Comparative Analysis Using the Foreign Corrupt Practices Act*, 38 VAND. J. TRANSNAT'L L. 397 (2005) (post-Enron regulations); Elias Mossos, *Sarbanes-Oxley Goes to Europe: A Comparative Analysis of United States and European Union Reforms After Enron*, 13 CURRENTS: INT'L TRADE L.J. 9, 10-11 (Summer 2004).

278. Darren Bush & Carrie Mayne, *In (Reluctant) Defense of Enron: Why Bad Regulation Is to Blame for California's Power Woes (or Why Antitrust Law Fails to Protect Against Market Power When the Market Rules Encourage Its Use)*, 83 OR. L. REV. 207 (2004).

279. See Darren Bush, *Too Big to Bail: The Role of Antitrust in Distressed Industries*, 77 ANTITRUST L.J. 277, 279 (2010).

280. See Bradley J. Bondi, *Facilitating Economic Recovery and Sustainable Growth Through Reform of the Securities Class-Action System: Exploring Arbitration as an Alternative to Litigation*, 33 HARV. J.L. & PUB. POL'Y 607, 608 (2010).

281. This lack of a sufficiently historical or imaginative perspective in creating stress tests can be demonstrated, for example, by the fact the risk managers mainly used scenarios that were based on events that previously occurred. See Gunter Löffler, *Caught in the Housing Crash: Model Failure or Management Failure* 5-7 (Univ. of Ulm, Working Paper, 2008), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1326427.

282. Commentators agree that "catastrophic risks are difficult to identify and their consequences in the complex financial institutions are almost impossible to predict." See James A. Fanto, *Financial Regulation Reform: Maintaining The Status Quo*, 35 BROOK. J. INT'L L. 635, 653 (2010) [hereinafter Fanto, *Financial Regulation Reform*].

The Case Against the Dodd-Frank Act's Living Wills

taken into consideration when designing an interactive simulation. For example, simulations, by their nature, must commence and end at pre-determined points in time. However, in the real world, things are more dynamic and there are no specific noticeable starting or ending points in business processes. Each participant, whether a company or an individual, is limited by different resources that vary over time; each will be exposed to different business opportunities, and have various advantages and weaknesses. Therefore, when planning a simulation with the intention to use its results in the real world, it is vital to decide if all the participants should begin the simulation at the same time, if all participants should be given instructions and if the all should get the same instructions, and if the participants should know in advance how and when the simulation will conclude.²⁸³

B. The Too-Big-To-Fail Problem Has Not Been Solved

The Dodd-Frank Act in general, and specifically its living wills provisions, does not solve the too-big-to-fail problem.²⁸⁴ And the too-big-to-fail problem was further exacerbated, following the recent financial crisis' round of bailouts, which encouraged mergers between commercial banks and investment banks. As a result, the post-crisis market is much more consolidated.²⁸⁵ Currently, the five biggest financial institutions are approximately twenty percent bigger than what they were prior to 2008. Moreover, these enlarged financial institutions control about \$8.6 trillion in financial assets, which equals approximately sixty percent of the U.S.'s gross domestic product. Thus, these institutions remain too-big-to-fail,²⁸⁶ and it has been argued that they do not even offer any scale or

283. Torrance & Tomlinson, *supra* note 244, at 158.

284. “[W]hile Dodd-Frank makes many significant and substantial changes to American banking and securities laws, it will not end taxpayer bailouts.” See Peter Conti-Brown, *Solving the Problem of Bailouts: A Theory of Elective Shareholder Liability*, Rock Ctr. for Corporate Governance at Stanford Univ. Working Paper No. 97, Stanford Law and Economics Olin Working Paper No. 48, forthcoming Stanford Law Rev. Feb. 16, 2011, at 110, available at <http://ssrn.com/abstract=1762986>.

285. See Michael W. Boyer, *Financial Regulatory Reform: A New Foundation or More of the Same?*, 22 LOY. CONSUMER L. REV. 233 (2009) (discussing post-bailout consolidation of banks); Tara Branum & Susanna Dokupil, *Security Takeovers and Bailouts: Aviation and the Return of Big Government*, 6 TEX. REV. L. & POL. 431 (2002) (discussing post-9/11 airline bailout); Stanley I. Langbein, *The Thrift Crisis and the Constitution*, 53 WASH. & LEE L. REV. 159 (1996).

286. See Thomas M. Hoenig, President Fed. Reserve Bank of Kan. City, The William Taylor Memorial Lecture: It’s Not Over ‘Til It’s Over: Leadership and Financial Regulation (Oct. 10, 2010), available at <http://www.kansascityfed.org/speechbio/hoenigpdf/william-taylor-hoenig-10-10-10.pdf>. Similarly, Sens. Sherrod Brown and Ted Kaufman, have stated that “too big to fail” is not just the United States’ problem, but the entire world’s, and have argued that by itself the Dodd-Frank Act “cannot provide the global regulatory framework required to resolve incredibly complex mega-banks operating in scores of countries.” A similar opinion was expressed by Massachusetts Institute of Technology Professor Simon Johnson argued in September 2010. See THE OFFICE OF SIGTARP 2011 QUARTERLY REPORT TO CONGRESS 6-7 (Jan. 26, 2011) [hereinafter SIGTARP REPORT], available at http://www.sigtarp.gov/reports/congress/2011/January2011_Quarterly_Report_to_Congress.pdf; Committee on Financial Services, *What’s REALLY in the Dodd-Frank Financial Reform Bill? Lots of Bailouts*, <http://financialservices.house.gov/Issues/reallydoddfrank.htm>.

scope economy advantages.²⁸⁷ This is especially alarming, as it is not clear whether the U.S. deposit insurance system was intended to deal with such a highly concentrated banking industry.²⁸⁸ The U.S. deposit insurance system is designed to follow insurance rules, which means that single loss exposures must be independent and spread over a great number of standardized units in order for that single loss not to be catastrophic to the insurer.²⁸⁹

A living wills requirement cannot solve this too-big-to-fail problem, because it is essentially a disclosure requirement and not a substantial regulation that alters negative market incentives or undesired economic incentives. Thus, any solution to the problem must be more expansive and aggressive than the mandating and implementation of living wills alone. Moreover, any advantage that the implementation of living wills might result in depends on how the regulators tasked with supervising the living wills succeed in their work. However, it is doubtful whether it would be wise to delegate, under the living wills framework, great responsibility, in a supervision capacity, to the very same regulators who failed to identify the recent financial crisis prior to its commencement.²⁹⁰ Additionally, the fundamental regulatory framework, which existed prior to the commencement of the crisis featuring bank-debtor guarantees and bare minimum levels of bank capital and liquidity, has been kept for the most part under the Dodd-Frank Act, with slightly changed parameters. Thus, it is not clear that under these circumstances living wills can even make any difference. Finally, there is nothing in the Dodd-Frank Act that ensures that banks and financial institutions will not demand a bailout again, even if they comply with the living wills preparation requirements. Moreover, the ultimate success of the Dodd-Frank Act depends on market perception. As long as the relevant different counterparties all trust that there will be a bailout—the SIFIs' executives, the ratings agencies, different

287. "First, most economic studies have concluded that U.S. banks stop producing increasing returns to scale as they grow beyond the \$10-\$25 billion size range. Studies of foreign banks, including large universal banks, have reached similar results. In addition, FDIC data show that banks in the \$1-\$10 billion size range operate with better efficiency ratios than those registered by bigger banks." Wilmart, *supra* note 2, at 279-280; see also Markus M. Schmid & Ingo Walter, *Do Financial Conglomerates Create or Destroy Economic Value?*, 18 J. FIN. INTERMEDIATION 193, 214 (2009) (not finding favorable economies of scale in banks with assets that are worth more than \$100 billion); Luc Laeven & Ross Levine, *Is There a Diversification Discount in Financial Conglomerates?*, 85 J. FIN. ECON. 331, 333-35 (finding that "the market values of banks that engage in multiple activities are much lower than if those banks were broken up into financial intermediaries that specialized in the individual activities.").

288. Kenneth D. Jones & Chau Nguyen, *Increased Concentration in Banking: Megabanks and Their Implications for Deposit Insurance*, 14 FIN. MARKETS, INSTITUTIONS & INSTRUMENTS 1, 2 (2005).

289. *Id.*

290. Indeed, even the chairman of Barclays Capital, Hans-Joerg Rudloff, stated that living wills should not be prepared by banks because insiders do not have the distance required to accurately assess the situation. Instead, the living wills should be prepared by someone outside the bank. GENEVA REPORT, *supra* note 42, at 136.

The Case Against the Dodd-Frank Act's Living Wills

creditors,²⁹¹ and other market participants—the too-big-to-fail problem will continue, regardless of whether SIFIs create living wills or not, and whether such plans are useful or not.²⁹² If an institution appears to be too big, too interconnected, or systemically too important for the authorities to allow it to fail, its relevant actors ‘have less incentive to evaluate the quality of the firm’s business model, its management, and its risk-taking behavior. As a result, such institutions face limited market discipline, allowing them to obtain funding on better terms than the quality or riskiness of their business would merit, and giving them incentives to take on excessive risks.’²⁹³ Indeed, when smaller banks and financial institutions borrow funds, they pay a higher interest rate than the too-big-to-fail institutions, because they do not have the same implicit federal government guarantee that is given to the too-big-to-fail SIFIs, and are thus viewed by lenders as riskier. Consequently, it was estimated that a cost-of-funds differential of an annual subsidy of \$6.3 billion is given to the too-big-to-fail banks.²⁹⁴ This annual subsidy can also be viewed as a redistribution from taxpayers to the too-big-to-fail banks,²⁹⁵ which as a result are more profitable. And the mere fact that federal deposit insurance even exists undercuts market discipline,²⁹⁶ which causes a financial services market distortion.²⁹⁷ Indeed, recently one of the global leading credit rating agencies, Standard & Poor’s (S&P), publicized its intention to make the projection of government assistance a permanent factor in forming a bank’s credit. Moreover, S&P stated that it believed that “banking crises will happen again. . . [and] expect this pattern of banking sector boom and bust and government support to repeat itself in some

291. “Unlike traditional lenders, consumer creditors – such as depositors – are unable to effectively monitor a financial intermediary’s credit quality. They tend to have limited information (and, with government-sponsored insurance, less incentive) to assess whether a firm is investing their capital profitably. To date, an important function of financial regulation has been to bridge that gap.” Whitehead, *supra* note 87, at 14.

292. “This, ‘heads I win, tails the Government bails me out’ mentally promotes behavior that . . . increases the likelihood of failure and, therefore, the likelihood of another taxpayer-funded bailout.” SIGTARP REPORT, *supra* note 286, at 6-7.

293. See Ben S. Bernanke, Chairman of the Board of Governors of the Federal Reserve System, Speech at the Independent Community Bankers of America National Convention, Orlando, Florida: Preserving a Central Role for Community Banking (Mar. 20, 2010), available at <http://www.federalreserve.gov/news/events/speech/bernanke20100320a.htm>; Block, *supra* note 12, at 957-58; Jones, *supra* note 4, at 392.

294. Dean Baker & Travis McArthur, Ctr. for Econ. & Policy Research, *The Value of the “Too Big to Fail” Big Bank Subsidy* 2 (Sept. 2009), available at <http://www.cepr.net/documents/publications/too-big-to-fail-2009-09.pdf>.

295. *Id.* at 4.

296. But see Jean Pierre Sabourin, President and Chief Executive Officer Canada Deposit Insurance Corp., Speech at the Chicago Reserve Conference: The Deposit Insurer’s Role in Maintaining Financial Stability, in Systemic Financial Crises 59, 61-62 (Sept. 30, 2004) (stating that a deposit insurer can also assist in systemic risk mitigation by taking assuring in advance that large banks are “too-good-to-fail”), available at <http://www.iadi.org/speeches/0903004.pdf>.

297. See Vasso P. Ioannidou & María Fabiana Penas, *Deposit Insurance and Bank Risk-Taking: Evidence from Internal Loan Ratings*, (FDIC Ctr. for Fin. Research, Working Paper No. 2008-07, 2008), available at http://www.fdic.gov/bank/analytical/cfr/2008/wp2008/CFR_WP_2008_07_vasso.pdf.

fashion, regardless of governments' recent and emerging policy response." S&P also described the U.S. government's likelihood of support for a SIFI as "moderately high."²⁹⁸ Thus, it can be argued that the Dodd-Frank Act's provisions, de facto, only further "institutionalize" government bailouts,²⁹⁹ and that given the discounts that various financial institutions continue to obtain, the market does not trust that the Dodd-Frank Act will actually ever end the too-big-to-fail problem.³⁰⁰ Consequently, any solution to the problem is going to require much more than living wills alone.

C. The Cross-Border Insolvency Issue Has Not Been Solved

There is no clear framework as to what procedures should be followed in order to better coordinate—between the home and host countries' authorities—the resolution of a failed SIFI.³⁰¹ Although a well-prepared SIFI could potentially resolve some of the cross-border coordination issues in its living will, by reaching out in advance to the different authorities of the countries in which it operates, this is unlikely to work in most cases. Indeed, different countries have different financial rules—including rules concerning living wills—and while SIFIs operate all over the world, neither the Dodd-Frank Act by itself, nor any other financial law, provides an all-inclusive international regulatory framework for winding them down.³⁰² Moreover, the Dodd-Frank Act actually complicates issues even more, because it enables the FDIC and the Federal Reserve to jointly impose sanctions for not fully complying with the US's living wills requirements not only on U.S.-based SIFIs, but also on the U.S. operations of foreign companies, without mandating consultations with their home country regulators.³⁰³ This can result in great inefficiency for complex, multinational SIFIs, which might be required to create multiple, inconsistent, and overlapping living wills for their major operating subsidiaries, rather than one master plan with subparts for the SIFIs' major relevant subsidiaries, in relevant jurisdictions, under the relevant insolvency regimes.³⁰⁴

298. See Standard & Poor's, Criteria/Financial Institutions/Request for Comment: Banks: Credit Methodology, Jan. 6, 2011, at 16, available at <http://www2.standardandpoors.com/spf/pdf/media/CriteriaFinancialInstitutionsRequestforCommentBanksRatingMethodology.pdf>.

299. See Supervising and Resolving, *supra* note 38. Such commentators include Rep. Spencer Bachus and Speaker of the House John Boehner.

300. "The Plan preserves the status quo of large financial conglomerates and arguably even enhances their importance in the United States." Fanto, *Financial Regulation Reform*, *supra* note 282, at 642.

301. See UNDERSTANDING THE DODD-FRANK, *supra* note 25, at 183.

302. See *id.*

303. Davis Polk & Wardwell LLP, *FDIC Releases Joint Notice of Proposed Rulemaking on Resolution Plans and Credit Exposure Reports* (Apr. 5, 2011) [hereinafter *FDIC Releases Joint Notice of Proposed Rulemaking*], http://www.davispolk.com/files/Publication/c46d3612-578c-4706-9487-01144c479a32/Presentation/PublicationAttachment/9df66ece-09fa-4dd4-b73e-031278f4e668/050411_S165d_NPR_Summary.pdf.

304. *Id.*

The Case Against the Dodd-Frank Act's Living Wills

Furthermore, while the initial relevant legal scholarship and most of the harmonization attempts do not focus on financial institutions,³⁰⁵ but on general international corporations, “[i]t is a well-known paradox of globalization that while it has led to increasing uniformization of social life around the world, it has also led to its increasing fragmentation.”³⁰⁶ And this fragmentation—which was recently portrayed by the international side of Lehman’s bankruptcy, resulting in more than seventy-five separate proceedings³⁰⁷—is an inevitability that is not sufficiently addressed by international law. Indeed, given the current global financial environment, the notion that corporations live globally but die nationally is no longer relevant.³⁰⁸ Companies expand their operations globally, and as financial markets continue to integrate, cross-border insolvencies will only increase in volume and complexity. Consequently, the collapse of one worldwide corporation can severely impact the finances and economies of multiple countries and companies around the globe. Such multinational corporations may be entitled to file for insolvency in any jurisdiction in which

305. See *id.* at 181. In addition, the provisions of the United Nations Commission on International Trade Law (UNCITRAL) model law for international insolvencies, and the U.S. Bankruptcy Code, specifically exempt banks. See Robert R. Bliss & George G. Kaufman, *A Comparison of U.S. Corporate and Bank Insolvency Resolution, Economic Perspectives*, J. ECON. PERSP. (2d quarter 2006), available at <http://www.wfu.edu/~blissrr/PDFs/Bliss-Kaufman%20-%202006,%20FRB-C%20EP%20-%20Insolvency%20Regime%20Comparison.pdf>.

306. Fragmentation of International Law: Difficulties Arising From the Diversification and Expansion of International Law, Rep. of the Int’l Law Comm. Fifty-eighth Sess. May 1 to June 9 and July 3 to August 11 2006, A/CN 4/L 682, Apr. 13, 2006, at 403 ¶ 242. Modern International Law is full of new and fast developing fragmented areas of specialization, however “globalisation and fragmentation, appear to be mutually exclusive. At face value, globalisation is linked to universal application of rules which seek the lowest possible common denominator and thus favour a wide and general content. Fragmentation, which is a consequence of specialisation, on the other hand, denotes an exclusivity and limited but specific scope.” M. Olivier, *Globalisation or Fragmentation of International Law: Challenges for Harmonisation*, at 428 (2008), available at [http://www.up.ac.za/dspace/bitstream/2263/10055/1/Olivier_Globalisation\(2008\).pdf](http://www.up.ac.za/dspace/bitstream/2263/10055/1/Olivier_Globalisation(2008).pdf). For more background and legal scholarship about fragmentation see Wouter Werner, *Constitutionalisation, Fragmentation, Politicization, the Constitutionalisation of International Law as Janus-faced Phenomenon* GRIFFIN’S VIEW ON INT’L COMP. LAW 17-30 (2007); Andreas Fischer-Lescano & Gunther Teuber, *Regime-Collisions: The Vain Search for Legal Unity in the Fragmentation of Global Law*, 25 MICH. J. INT’L. L. 999, 999-1046 (2004); Lapaš, *Some Remarks on Fragmentation of International Laws*, CILSA 1-29 (2007); Marti Koskenniemi & Päivi Leino *Fragmentation of International Law? Postmodern Anxieties*, 15 LEIDEN J. OF INT’L L. 553-79 (2002).

307. Lehman Brothers, a US based financial services company, existed as over 7,000 legal entities in more than 40 different jurisdictions around the world. See Price Waterhouse Coopers, *Lehman Brothers’ Bankruptcy: Lessons Learned for the Survivors*, Aug. 2009, available at <http://www.pwc.com/jg/en/events/Lessons-learned-for-the-survivors.pdf> (informational client presentation).

308. Until the late 1970s, international bankruptcies were still considered to be a very complex academic subject with very little practical significance. Paulo Fernando Campana Filho, *The Legal Framework for Cross-Border Insolvency in Brazil*, 32 Hous. J. INT’L L. 97, 102 (2010). However, today it is believed that “by its very nature bankruptcy law must be symmetrical with the market. If the market is becoming global, bankruptcy law must become global as well.” Jay Lawrence Westbrook, *Global Development: The Transnational Insolvency Project of the American Law*, 17 CONN. J. INT’L L. 99, 100 (2001).

they have establishments or businesses. Simultaneous proceedings, therefore, can be opened in multiple jurisdictions, each with its own laws, and debtors can decide among three options: filing a single plenary proceeding in one jurisdiction,³⁰⁹ filing parallel plenary proceedings in multiple jurisdictions,³¹⁰ and even filing ancillary proceedings in foreign jurisdictions.³¹¹ Accordingly, issues related to forum-shopping,³¹² through which international debtors³¹³ attempt to exercise control over the bankruptcy process and the rights of their creditors and other constituents, also become relevant.³¹⁴ Additionally, there is

309. See for example, the restructuring proceedings of LyondellBasel Industries, which filed for Chapter 11 in the US, in order to prevent foreign creditors from enforcing their remedies and commencing European insolvency proceedings against the non-debtor parent entity. *See* Lyondell Chemical Co., Case No. 09-10023 (Bankr. S.D.N.Y. 2009). Similarly, Yukos Oil Company, a Russian corporation, filed for chapter 11 in the US in order to obtain an automatic stay, which enjoined a foreclosure auction of its largest assets that was scheduled to take place after the government bought tax evasion charges against it. But, based on Section 1112(b), the US court eventually dismissed the chapter 11 case holding that the totality of the circumstances weighted in favor of resolving the case in a forum Russian state's participation would be guaranteed. *See* Yukos Oil Co., Case No. 04-47742 (Bankr. S.D. Tex. 2004); Matteo, M. Winkler, *Arbitration Without Privity And Russian Oil: The Yukos Case Before The Houston Court*, 27:1 U. Pa. J. Int'l Econ. L. (2006). Additionally, the Almatis Group, a German and Netherlands based consortium, filed a prepackaged chapter 11, in an attempt to avoid insolvency proceedings in Germany. *See* Almatis B.V., Case No. 10-12308 (Bankr. S.D.N.Y. 2010).

310. See for example, the restructuring proceedings of Nortel Networks Corporation, a Canadian company, which with its Canadian subsidiaries, filed for protection under the Companies' Creditors Arrangement Act in Canada on January 14, 2009. Nortel's US subsidiaries filed for chapter 11 and its European, African and Middle Eastern subsidiaries filed under the UK's Insolvency Act. *See* Nortel Networks Inc., Case No. 09-10138 (Bankr. S.D.N.Y. 2009).

311. In the US, ancillary proceedings can be commenced pursuant to chapter 15 of the US Bankruptcy Code. See for example, the restructuring proceedings of Tri-Continental Exchange Ltd., which sold fraudulent insurance policies in the US and Canada, and began a plenary insolvency proceeding in St. Vincent and the Grenadines. On July 20, 2006, Tri-Continental Exchange Ltd. filed a chapter 15 for recognition as a "foreign main proceeding." *In re Tri-Continental Exchange, Ltd.*, 349 B.R. 627, 638 (Bankr. E.D. Cal. 2006).

312. *See* LYNN M. LOPUCKI, COURTING FAILURE: HOW COMPETITION FOR BIG CASES IS CORRUPTING THE BANKRUPTCY COURTS 200 (2005), *reprinted in* Lynn LoPucki, *Global and Out of Control?*, 79 AM. BANKR. L.J. 79, 79 (2005) (warning that international forum shopping is worse than a domestic one). Additionally, many expressed the concern that increasing the number of international courts will lead to forum shopping, create inconsistency within case law, and "may jeopardize the unity of international law and, as a consequence, its role in inter-State relations." Koskenniemi & Leino, *supra* note 306, at 555 (citing H.E. Judge Gilbert Buillaume, President of the Int'l Court of Justice, Speech to the General Assembly of the United Nations (Oct. 30, 2001)); *cf.* John A.E. Pottow, *The Myth (and Realities) of Forum-shopping in Transnational Insolvency*, 32 BROOK. J. INT'L L. 785, 814-16 (2007) (stating that is not clear whether forum shopping has non-positive effects on the market).

313. Neil Desai compares the multinational firm to an octopus that can strategically spread its tentacles and conduct business through its subsidiaries. Subsidiaries are located around the world to accumulate market share, generate revenue, target demographics, develop product lines, and gain brand recognition. With the added layer of e-commerce, multinationals and their subsidiaries are operating in a global arena that collapses commerce into one marketplace. Neil Desai, *How Insolvent Multinational Businesses Should Adjust to Congress's Creation: Chapter 15*, 7 HOUS. BUS. & TAX L.J. 138, 139-40 (2006).

314. For example, creditors of one Bear Stearns hedge fund were alarmed when in 2007 it filed for bankruptcy not in the United States, where it did practically all its business, but in the Cayman Islands, where the fund was nominally registered. *See* Scott C. Mund, 11 U.S.C. 1506: U.S. Courts Keep A Tight Rein On The Public Policy Exception, But The Potential To Undermine International Cooperation In Insolvency Proceedings Remains, 28 WIS. INT'L L.J. 325, 328 (2010); Daniel Glosband, *Bankruptcy Court Rejects Cayman Proceedings of Bear Stearns Hedge Funds*, 26-8 AM. BANKR. INST. J. 38, 64 (2006).

The Case Against the Dodd-Frank Act's Living Wills

an increased risk that regulators will be primarily focused on protecting their national interests, a very alarming possibility, as such gamesmanship would have a negative effect on reducing global systemic risk.

In general, principles of national sovereignty prevent bankruptcy courts in one jurisdiction from forcefully applying their law in other jurisdictions. Therefore, courts rely on international law theory and on international comity³¹⁵ to give effect to their decisions outside their jurisdiction.³¹⁶ Currently, there are a number of leading approaches in the international insolvency legal scholarship for the resolution of international institutions' insolvency: the universalism model, the territoriality model, and the contractual approach.³¹⁷ Pursuant to the universalism approach, courts support conduct in international insolvency proceedings that manage the multiple insolvency proceedings as one case. Under this approach, the case may be chiefly administered in a single forum; however, foreign and domestic creditors are entitled to equal rights.³¹⁸ Differently, under the territoriality approach, each jurisdiction conducts its own bankruptcy proceeding, in which the rights of the local creditors and parties in interest are superior to their foreign counterparts.³¹⁹ Pursuant to this theory, local bankruptcy regulations, private law values and notions of due process continue to prevail regardless to the cross-border aspects of the insolvency proceeding. Finally, under the contractual approach, each international organization will, based on a menu selection, make its decisions concerning how it will like for its insolvency proceedings to be conducted.³²⁰ Pursuant to this theory, these selections will be part of the organization's corporate governance organizational documents.

(2007) (referring to *In re Bear Stearns High-Grade Structured Credit Strategies Master Fund*, 374 B.R. 122 (Bankr. S.D.N.Y. 2007)). Similarly, in *In re Sphinx, Ltd.*, 371 B.R.10 (S.D.N.Y. 2007) and in *In re Basis Yield*, 381 B.R. 37 (Bankr. S.D.N.Y 2008), US bankruptcy court refused to grant chapter 15 cases foreign main proceeding recognition to hedge funds registered in the Cayman Islands, because even though they were registered there, they did not conduct any actual operations there. Therefore, until national insolvency laws are uniform, there will be an incentive for debtors to forum shop. Evelyn Biery et al., *A Look at Transnational Insolvencies and Chapter 15 of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005*, 47 B.C. L. REV. 23, 57 (2005). Moreover, to the extent directors and officers have discretion to do this, it could be argued that they actually have a fiduciary duty to the equity holders to forum shop. Mod. Bus. Corp. Act §§ 8.30(a), 8.42(a) (1984).

315. Comity is “[a] practice among political entities (as nations, states, or courts of different jurisdictions), involving esp. mutual recognition of legislative, executive, and judicial acts.” BLACK’S LAW DICTIONARY (8th ed. 2004).

316. See Hannah L Buxbaum, *Rethinking International Insolvency: The Neglected Role of Choice-of-Law Rules and Theory* 36 STAN. J. OF INT’L L. 23, 30 (2000).

317. See e.g. Jay Lawrence Westbrook, *A Global Solution to Multinational Default*, 98 MICH. L. REV. 2276 (2000); Lynn M. LoPucki, *Cooperation in International Bankruptcy: A Post Universalist Approach*, 84 CORNELL L. REV. 696 (1999); and Robert K. Rasmussen, *Resolving Transnational Insolvencies through Private Ordering*, 98 MICH. L. REV. 2252 (2000).

318. Jay Lawrence Westbrook, *A Global Solution to Multinational Default*, 98 MICH. L. REV. 2276 (2000).

319. See LoPucki, *supra* note 317.

320. See Rasmussen, *supra* note 317.

Despite focusing on the issue of how to best conduct cross-border insolvency proceedings, and despite attempting to create an international treaty that would harmonize the different insolvency regimes, global regulators did not make much progress. In the living wills context, any such solution would also require agreements concerning both losses sharing³²¹ and potential special assistance regarding SIFIs' insolvency. However, currently, no such agreements exist, although the US's recently enacted Dodd-Frank Act does call for cooperation with foreign regulators in dealing with SIFIs' insolvencies.³²² Additionally, unlike the US's Bankruptcy Code, the Dodd-Frank Act also enables the FDIC to provide operating capital to keep such SIFIs afloat while a SIFI's liquidation takes place, in order to avoid the quakes that can result from a Lehman-like fall down. But the Dodd-Frank Act fails to address the complete absence of a feasible cross-border solution for the resolution of international institutions' insolvency, and their potential inevitable breakdown. Moreover, it calls for a FDIC receivership—which replaces the bankruptcy of large companies as the only route for assistance—without considering any potential destabilizing impacts on the international financial legal system.³²³ Finally, the Dodd-Frank Act fails to include any guidelines concerning burden-sharing mechanisms between SIFIs regarding financial support and between ministers of finance regarding capital support.³²⁴

D. The Costs Associated with the Living Wills Might Outweigh the Benefits

Voicing what many commentators believe regarding the practicality of living wills, Michael H. Krimminger, deputy to the Federal Deposit Insurance Corp. chairman for policy, has argued that “[i]t is going to be really hard, but think about it this way: what’s the alternative? The alternative is not to throw up your hands and say we can’t do this . . . We do not want to end up in the situation that we were in the fall of 2008.”³²⁵ And, while it is true that there are many rationales justifying using living wills, it is not clear whether living wills

321. See Zdenek Kudrna, *Cross Border Resolution of Failed Banks in the EU: Search for the Second-Best Policies* 22-23 (Austrian Acad. of Scis., Inst. for European Integration Research, Working Paper, 2010), available at <http://ssrn.com/abstract=1604402>.

322. See UNDERSTANDING THE DODD-FRANK, *supra* note 25, at 183.

323. Pursuant to the legislation, the FDIC would be enabled as receiver to resolve insolvency under Sections 11 and 13 of the Federal Deposit Insurance Act, 12 U.S.C. 1821 and 1823. 77 Fed. Reg. 3075 (Jan. 23, 2012).

324. For a discussion of the advantages of establishing such agreements *ex ante* see in general Emilios Avgouleas et al., *Living Wills as a Catalyst for Action* (Duisenberg Sch. of Fin. Policy Paper No. 4, 2010), available at <http://ssrn.com/abstract=1533808>.

325. Barbara A. Rehm, *The Dodd-Frank Act's Curious Bequest: The Living Will*, AM. BANKER (2010) [hereinafter *The Dodd-Frank Act's Curious Bequest*], available at <http://www.bankinvestmentconsultant.com/news/lehman-dodd-frank-2668908-1.html>. Additional commentators argued that living wills are useless and referred to them as “nothing more than a fig leaf for too big to fail.” *Id.*

The Case Against the Dodd-Frank Act's Living Wills

are the best, most feasible solution. At the end of the day, living wills are just plans and have no binding power or effect, which means that SIFIs can spend a great deal of money on plans that will never be used, even if actually needed.³²⁶ Moreover, given the arguments stated above, not only is it not clear if such plans will work at all, but even if they do work, the costs associated with creating such plans and keeping them current and updated might outweigh the benefits. First, on the regulatory side, requiring SIFIs to get approval by a couple of agencies—the FDIC and the Federal Reserve—is going to add greatly to the expenses of both of these agencies. Additionally, each agency will have to add an additional massive regulatory task force to its existing personnel. Second, as far as administration concerns, requiring both of the governmental agencies to work with the SIFIs and together with each other, in order to review the SIFIs' plans, will surely cause delays, confusion, and coordination problems between the agencies themselves as well as with the SIFIs. Third, in addition to the data architecture expenses associated with establishing a proper MIS, the SIFIs will have to spend a great deal of resources on retaining specialized legal and financial restructuring professionals, communication advisors, and many more. These professionals will assist the SIFIs to clarify their legal structures, which can take years given the highly complex and unusual subsidiary and branch organizational structures that were designed by the SIFIs for regulatory purposes and tax arbitrage. And doing so will probably result in the SIFIs being less tax-efficient and would therefore be extremely pricey for the SIFIs.³²⁷ Finally, despite the efforts dedicated to the work on the living wills' reorganization and liquidation plans, it is doubtful that the SIFIs, with the help of the retained professionals, will be able to successfully predict and prevent, or prepare for, the next crisis.³²⁸

E. Confidentiality Issues

The living wills requirements mandate that SIFIs disclose highly sensitive information about their operations to various parties. Such parties include the FDIC, the Federal Reserve, restructuring professionals, claims agents, and communication companies, as the SIFIs will need these parties' input on any reorganization and liquidation plans devised. Thus, each SIFI must collect and provide information regarding its financials, economic positions, trading books, counterparty exposures, business strategies, corporate governance,

326. "A resolution plan submitted in accordance with this subsection shall not be binding on a bankruptcy court, a receiver appointed under title II, or any other authority that is authorized or required to resolve the nonbank financial company supervised by the Board, any bank holding company, or any subsidiary or affiliate of the foregoing." Dodd-Frank tit. I, § 165(d)(6).

327. Roshni Bunker, Note, *Glass-Steagall Through the Back Door: Creating a Divide in Banking Functions Through the Use of Corporate Living Wills*, 2010 COLUM. BUS. L. REV. 424, 467.

328. See *Dodd-Frank Act's Curious Bequest*, *supra* note 325.

organization, and risk analyses. But, such information can expose SIFIs to serious political, competitive, or other harm, and can even result in handicapping the financial markets if improperly disclosed to the public or undesired parties. Therefore, prior to implementing the living wills concept, it is necessary to understand how such information, which is to be included in each SIFI's living will, will be handled and protected.³²⁹ In the business world, information regarding any company's financials—and particularly information on potential insolvency scenarios—is highly confidential, especially when the information relates to a high-profile financial institution. This makes it unlikely that SIFIs will be comfortable sharing such confidential information with so many different parties—when not even in a financial distress—merely to comply with a procedural requirement. Indeed, unlike firms in a Chapter 11 reorganization proceedings—which, in order to be meaningful, must entail giving the reorganized company's key creditor-constituencies full access to the debtor's financial and other information³³⁰—not all SIFIs creating living wills are in any financial difficulties. And at least some of the SIFIs that will be required to devise living wills might never end up in such financial distress, which requires filing for reorganization under the Bankruptcy Code. Therefore, if no special confidentiality measures are arranged, SIFIs should be rightfully concerned about the possibility that such information will be not be kept confidential. For example, if the information is not treated as confidential supervisory information, multiple regulatory agencies could share it, which can increase chances that certain undesired individuals will be exposed to the information or that it will be eventually leaked.³³¹ This is especially so since no penalties for unauthorized disclosures of information have been mentioned so far in the Dodd-Frank Act or by regulators discussing the new living wills requirements. And while any leak can potentially result in a run on a bank or a sharp drop in a SIFI's stock price,³³² the extreme scenarios contained in living wills can be not only highly damaging to a specific SIFI, but can also have a

329. See *id.* And although under section 112(d)(5)(A) of the Dodd-Frank Act, the Federal Reserve and the FDIC “shall maintain the confidentiality of any data, information, and reports submitted under” Title I of the Dodd-Frank Act, in July 2012, following the first submission of plans, the FDIC and the Federal Reserve released the submitted plans’ public sections, which identified key business lines, executives and financial information. The confidential sections, which are protected under the Freedom of Information Act, are to be reviewed by the FDIC and the Federal Reserve, and detail more precisely how the financial institutions plan to resolve themselves in the wake of a crisis. See Steve Goldstein, *Living-Will Plans Released by Big Banks*, MARKETWATCH, July 03, 2012, available at http://articles.marketwatch.com/2012-07-03/economy/32518331_1_deutsche-bank-foreign-banks-fdic.

330. See generally Brad B. Erens & Kelly M. Neff, *Confidentiality in Chapter 11*, 22 EMORY BANKR. DEV. J. 47 (2005).

331. See *FDIC Releases Joint Notice of Proposed Rulemaking*, *supra* note 303 (In the US, information provided to government agencies is normally subject to FOIA, which requires federal agencies to make their records available to the public unless a specific exception applies, particularly in light of the disclosure requirements of 5 U.S.C. 552(b)).

332. See Okamoto, *supra* note 165, at 193.

The Case Against the Dodd-Frank Act's Living Wills

continuing hazardous effects on the financial system and the economy.

Moreover, in connection to the difficulty associated with the cross-border insolvency issue in implementing living wills, it is also unclear how confidential information will be shared with foreign regulators, or how the Dodd-Frank Act will make foreign regulators comfortable sharing any foreign SIFIs' sensitive information with U.S. regulators.³³³

Finally, given the importance of keeping SIFIs' living wills confidential, it will be even more difficult for a limited number of regulators to gather all the information provided by different SIFIs and incorporate it into a cross-market analysis. But, since the success of the living wills concept greatly depends on the regulators' ability to link different institutions' information and conduct industry-wide exposure analyses in order to understand the complete picture of the interactions between the different SIFIs,³³⁴ a method for doing this without widely exposing highly confidential information is needed.

F. The Failure of the Living Wills in a Market-Wide Crisis

If the expectation is that SIFIs' execution of living wills will save each SIFI from failing in the event of a market-wide crisis or even prevent the crisis from happening, then the expectation is an unreal one. Indeed, despite the difficulties identified with the living wills solution, a living will can still be helpful, especially as a response to a single-SIFI-specific-crisis rather than in a situation where there is a market-wide crisis. In a strong market, a SIFI in financial difficulties will have a far greater probability of recovery and a far simpler navigation through the resolution process than it will have in a weak troubled market. Living wills are targeted at solving SIFI-particular problems and focus on reducing the likelihood that the failure of one SIFI will start a domino effect that will make other SIFIs fail too. But, living wills cannot impact or resolve systemic problems that affect all SIFIs, market-wide, such as an unexpected, quick change in exchange rates, interest rates, or even sovereign defaults.³³⁵

G. Overconfidence and a False Sense of Security

It has been argued that risk management increases risk as it makes analysts and investors think that risk is under control—which is an impossibility—and creates a sense of confidence to engage in riskier business activities, which result in altering the original situation that had been previously modeled.³³⁶ This phenomenon is not unique to financial and risk analysis; providing a false

333. See FDIC Releases Joint Notice of Proposed Rulemaking, *supra* note 303.

334. FRENCH ET AL., *supra* note 261, at 48.

335. Huertas Speech, *supra* note 31, at 3.

336. TALEB, *supra* note 250, at 288-89.

sense of security often encourages more risk taking and overconfidence in other industries too. For example, in the environmental area, the common method used to prevent disasters from taking place has been to contain or control the danger itself. Thus, for many years, governmental agencies have guarded people's houses and businesses in hazard areas by constructing various structures that will hold back natural disasters and prevent them from destroying property. These structures included different engineered solutions meant to protect people from the potential natural hazards, such as breaking waves and rising floods. Nevertheless, in some instances the protective measurements taken have actually resulted in a higher likelihood of potential disaster, because these measures provided a false sense of security that made people feel more comfortable to settle in or invest in hazardous areas than they would have otherwise. This led to a higher concentration of people and property when the measures failed than might have been otherwise.³³⁷

Moreover, since financial models and economic theories—unlike models in other, more accurate sciences such as mathematics, physics or chemistry—result only in educated guesses based on interpretations of relationships between data and future outcomes, potential overconfidence that risk is “mitigated” is even more troubling.³³⁸ Additionally, unlike in “hard sciences,” financial models should factor in uncertainty resulting from the unpredictability of human behavior, which makes these models’ predictive abilities even weaker. Therefore, these models must be constantly reviewed and revised according to any changes and updates that might be relevant and never be fully relied on, but always be regarded with some skepticism.³³⁹

H. Contingency Planning in a Vacuum

Living wills are similar to traditional plans designed pursuant to the Bankruptcy Code; however, they are not regular contingency plans, but a mere exercise in contingency planning, because unlike traditional plans they are not the result of multi-party planning and negotiations that result in a deal.³⁴⁰ As demonstrated in virtually all of the big corporate enterprise bankruptcy cases,

337. Anna K. Schwab & David J. Brower, *Increasing Resilience to Natural Hazards: Obstacles and Opportunities for Local Governments Under the Disaster Mitigation Act of 2000*, 38 ENVTL. L. REP. NEWS & ANALYSIS 10171, 10172 (2008).

338. Emanuel Derman, *Models*, FIN. ANALYSTS J. 28, 32-33 (Jan./Feb. 2009).

339. *Id.*

340. It has been argued that in 84% of all large Chapter 11s from 2002, the investors entered bankruptcy with a deal in hand or used it to sell the assets of the business. See Douglas G. Baird & Robert K. Rasmussen, *The End of Bankruptcy*, 55 STAN. L. REV. 751 (2002). For traditional reorganization planning, see Barry E. Adler, *Financial and Political Theories of American Corporate Bankruptcy*, 45 STAN. L. REV. 311, 315-15 (1993); Fayez A. Elayan & Thomas O. Meyer, *The Impact of Receiving Debtor-in-Possession Financing on the Probability of Successful Emergence and Time Spent under Chapter 11 Bankruptcy*, 28 J. BUS. FIN. & ACCT. 905 (2001).

The Case Against the Dodd-Frank Act's Living Wills

reorganization and liquidation plans concerning funding, capital, liquidity, and disposition of assets and properties are never developed in vacuum. Such plans mandate the input of key creditors, different government agencies, and main stakeholders, based on each case's circumstances. Therefore, it would be extremely difficult to prepare such plans without knowing, at least to some extent, which capital markets can or will provide funding to the planning SIFI, if need be, and if so, on what terms they will do so, or which purchasers will be willing and able to consummate a purchase of assets.³⁴¹

I. The Regulator's Intervention and Its Impact

Pursuant to the living wills requirements, regulators have an active role in supervising SIFIs and their businesses. However, it is not clear to what extent regulators should intervene if they believe an intervention in a SIFI's business is justified. It is obvious that a balance needs to be struck between guarding the legal and rightful interests of a SIFI's shareholders and permitting regulators to rapidly intervene to reduce any instability in the financial system. Indeed, there is a fine line that needs to be carefully considered, because the regulators are also tasked with protecting the rights of the public and the SIFI's creditors. For example, pursuant to the Bankruptcy Code, any intervention or an attempt to impose a fair plan should follow the proposition that creditors of a reorganized company should be no worse off than they would have been had the reorganized SIFI been liquidated pursuant to the applicable Bankruptcy law.³⁴² Thus, carefully designed guidelines must be created to instruct the regulators as to when to actually intervene and to what extent. Moreover, consideration must be given to whether SIFIs should be able to appeal on the regulators decision, and if so, whether such proceedings need to be administrative or judicial proceedings, and if they will be final or not. Otherwise, it will not be fair to require SIFIs to design living wills without informing them of their rights, but only imposing duties and additional requirements.

Such carefully designed guidelines should also provide specific criteria concerning when and to what extent to impose structural or operational changes on SIFIs, if the supervising regulators reviewed, but did not approve a SIFI's living will plans. If the use of such powers is not carefully defined in clear and transparent guidelines, it can result in unequal or even arbitrary treatment of SIFIs, or even in an excessive use of the governmental agencies' powers toward certain SIFIs, when such use of powers is not required. Moreover, an early intervention of the authorities in a certain SIFI's business

341. Jay M. Goffman, et al., *Proposed Dodd-Frank Rule Would Require Covered Financial Companies to Develop Detailed Bankruptcy Contingency Plans*, SKADDEN (Apr. 6, 2011), <http://www.skadden.com/Index.cfm?contentID=51&itemID=2392>.

342. See 11 U.S.C. § 1129.

and operations can be interpreted by the public as a premature signal that the resolution phase of that specific SIFI has begun, which can lead to a significant loss of market confidence. Thus, it has been argued that interventions should only be made if a SIFI is certain to fail.³⁴³ Similarly, some commentators have argued that if the authorities were to demand that structural or operational changes be made at a certain SIFI, “there is a real danger that any imposed changes could effectively ring-fence individual group companies and interfere with a firm’s integrated risk management across the group.”³⁴⁴

J. The Issue of Liability and the Difficulty of Obtaining SIFI Board Approvals

Finally, an additional difficulty in the implementation of living wills is associated with a SIFI board’s compliance with the living wills requirement. Each SIFI’s initial living will needs to be approved by the SIFI’s board of directors. But requiring SIFI board approval can be interpreted to extend liability to a SIFI’s board for the credibility of its living will, despite some of the unrealistic assumptions used when drafting living wills. Living wills are assumed to work even though they are just plans containing last resort options which are drafted in a vacuum. Therefore, unless such liability issues are handled in advance, it is unlikely that any responsible SIFI board will approve its institution’s living will, as required by the Dodd-Frank Act.³⁴⁵

VI. CONCLUSION

Despite the advantages that the living wills concept entails—and the high expectations from it—the implementation of that Dodd-Frank Act requirement remains riddled with difficulties. Given those difficulties and the associated dilemmas, a living wills solution is not likely to be generally effective. Such dilemmas include, *inter alia*, how to handle the confidentiality issue, as it is unrealistic to expect SIFIs to provide full information regarding their financials, economic positions, exposures, business strategies, and corporate and organizational governance. Indeed, sharing such information can greatly disadvantage competitive SIFIs and expose them to political harm, or even result in severely destroying the financial markets if improperly disclosed to the public, competitors, or even foreign regulators. Similarly, the difficulties associated with implementing living wills, include, *inter alia*, the inability of living wills to work in circumstances that resemble the 2008-2009 panic, in which financial markets essentially closed down, especially since the Dodd Frank Act bars helping institutions the way the government did in 2008-2009.

343. Will Henley, *AFME Joins Critique of EU Resolution Plans*, GFS NEWS (Mar. 11, 2011), http://www.gfsnews.com/article/1332/1/AFME_joins_attack_on_EU_resolution_plans.

344. *Id.*

345. See FDIC Releases Joint Notice of Proposed Rulemaking, *supra* note 303.

The Case Against the Dodd-Frank Act's Living Wills

And what makes things even worse is not only the false sense of security that living wills provide, but also that few, if any, SIFIs have the ability to support the purchase of other SIFIs' businesses in good times; this means that during a crisis it is quite possible that no SIFI will be able to support such purchases unless the FDIC provides support with equity and debt financing. Consequently, it is unlikely that the living wills requirement will prevent future bailouts or drastically modify the fashion in which regulators will deal with future crises.³⁴⁶

Moreover, mandating the preparation of living wills is only a procedural response to the problems that were manifested in the recent financial crisis, and will not succeed in isolation. Indeed, living wills are not a substantive regulatory solution.³⁴⁷ Accordingly, they will not work unless globally active institutions are subject to effective, consolidated, external, and constant supervision, and unless information-sharing agreements between home and host countries supervisors are properly planned and implemented.³⁴⁸ Thus, a feasible cross-border solution for the resolution of international institutions' insolvency is needed; such a solution will bridge between the different countries' resolution rules, whether those are focused on living wills, or proposals for special bonds or contingent capital. And relying on the living wills concept also requires regulatory authorities to fully comprehend the connections between various financial product markets,³⁴⁹ and to have an extremely wide range of tools, skills, and resources, because the more complex a SIFI's business operations become the more opaque they become to regulators.³⁵⁰

Thus, even if SIFIs are warned that failure to provide acceptable living will plans to regulators, could result in: (i) stricter capital, liquidity, or leverage standards; and (ii) regulatory limitations on their growth, operations, or

346. See David Skeel, *Magical Thinking at the FDIC*, LESS THAN THE LEAST (Apr. 20, 2011 11:08 AM), <http://www.law.upenn.edu/blogs/dskeel/>.

347. See UNDERSTANDING THE DODD-FRANK, *supra* note 25, at 185.

348. Even with the best policies and regulation in place, "there will inevitably be cases where SIFIs run into trouble, and governments need to provide working capital and some risks. In cases of cross-border financial institutions, differences in burden sharing will then arise, and this will lead to coordination problems, unless arrangement has been agreed upon and beforehand. When possible, these issues are better resolved ex ante rather than attempting to improvise an ex post solutions." GENEVA REPORT, *supra* note 42, at 26, 86.

349. See Peter Fox-Penner, *Too Big to Regulate?*, THE BASELINE SCENARIO (Jan. 16, 2010), available at <http://baselinescenario.com/2010/01/16/too-big-to-regulate>.

350. For example, see the investigative staff of the U.S. Federal Energy Regulatory Commission (FERC) findings concerning Enron: "The complexity of the issues confronting Staff and the agencies cooperating with the Commission is such that more time would be required to fully understand Enron's and other market participants' activities in the energy markets." Initial Report on Company-Specific Separate Proceedings and General Reevaluations; Published Natural Gas Price Data; and Enron Trading Strategies, Docket No. PA02-2-000, Federal Energy Regulatory Commission, Aug. 2002, at 9, available at http://www.ucei.berkeley.edu/Restructuring%20Archive/FERC_Enron_investigation.pdf.

activities,³⁵¹ those threats might not be enough to substantially solve the problem posed by SIFIs. Currently, SIFIs have too much exposure to risk with minimal limitations. That has the side effect of enabling speedier growth of banks and financial intuitions without enough capital cushion in place to prevent failures.

The currently existing living wills requirement simply bypasses the too-big-to-fail problem rather than solve it. Given the severe economic and social consequences resulting from the failure of a mega-bank or financial institution, many commentators argue that the best way to deal with the too-big-to-fail problem is to break up those institutions.³⁵² Indeed, Alan Greenspan said in October 2009, that “[i]f they’re too big to fail, they’re too big.”³⁵³ The Dodd-Frank Act imposes no size requirements at all. Instead, it attempts to solve the problem in a different way: by mandating that SIFIs prepare living wills, which in theory should better enable regulators to monitor and supervise SIFIs and prevent crises, such as the Lehman collapse. Based on that solution the Dodd-Frank Act superficially advances the notion that no bailouts should ever be given to financial institutions at the expense of the taxpayers.

Alternative solutions to break-up are also available. If not broken down, mega-banks and financial institutions could be forced to segregate their federally-insured-deposit operations from risky business operations, similarly to what the Glass-Steagall Act required for many decades. Additionally, such SIFIs could be forced to raise much more capital, as recommended in Basel III, decrease their risk profile, and unload problematic businesses. But cutting back the size of such gigantic financial businesses, or forcing such strict requirements on their operations, will not be easy as a practical or political matter, although it was done in the past, to some extent, by Theodore Roosevelt³⁵⁴ and Franklin Delano Roosevelt.³⁵⁵ And, indeed, the institutions that were considered too-big-to-fail in 2008 and had to be saved by TARP and the Federal Reserve have never been forced to slim down.

Therefore, the threats posed by the too-complex-to-succeed, international

351. See Victoria McGrane & Alan Zibel, *FDIC Drafts Rule on ‘Living Wills’ for Banks*, WALL ST. J., Mar. 29, 2011, available at http://online.wsj.com/article/SB10001424052748704559904576230842703099306.html?mod=googlenews_wsj.

352. See Fanto, *Financial Regulation Reform*, *supra* note 282, at 658.

353. Michael McKee & Scott Lanman, *Greenspan Says U.S. Should Consider Breaking Up Large Banks*, BLOOMBERG NEWS, Oct. 15, 2009, available at <http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aJ8HPmNUfchg>.

354. See generally LEWIS L. GOULD, THE PRESIDENCY OF THEODORE ROOSEVELT 24, 27-32, 49-53, 64, 142-43, 212-18, 223, 279-81 (1991); EDMUND MORRIS, THEODORE REX 88-94, 194-96, 206-09, 426-48 (2001).

355. *Keep Consumers Safe by Bringing Back Glass-Steagall Act*, SEATTLE TIMES, Nov. 2, 2009, at A11 (Editorial), available at http://seattletimes.nwsource.com/html/editorials/2010171846_edit02wamu3.html.

The Case Against the Dodd-Frank Act's Living Wills

SIFIs,³⁵⁶ whose collapse can threaten the stability of the financial system, remain unresolved. And what is even worse is that despite their advantages, if the dilemmas and difficulties associated with the implementation of living wills are not properly resolved, living wills may not only become costly, but also have the perverse effect of increasing systemic risk and instability.³⁵⁷

356. See Ron Ashkenas, *Too Big to Fail — Or Too Complex to Succeed?*, FORBES, Mar. 2011, available at <http://blogs.forbes.com/ronashkenas/2011/03/01/too-big-to-fail-or-too-complex-to-succeed/> (arguing that uncontrolled growth without continual pruning and streamlining is a potential recipe for disaster).

357. John L. Douglas, et al., Davis Polk & Wardwell & McKinsey, *Credible Living Wills: The First Generation* (Apr. 25, 2011) http://www.davispolk.com/files/Publication/37a3a804-6a6c-4e10-a628-7a1dbbaece7c/Presentation/PublicationAttachment/c621815c-9413-436b-91ea-3451b2b4cf32/042611_DavisPolkMcKinsey_LivingWills_Whitepaper.pdf.