Equity for Intermediaries: The Resolution of Financial Firms in Bankruptcy and Bank Resolution

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This Essay considers the role of bankruptcy law in the legal ecosystem that regulates banks and other financial intermediaries. It uses the recent spate of bank and crypto intermediary failures to consider the role of bankruptcy courts (and other resolution institutions) in protecting both customers, and the stability of the financial system when the instability of a financial intermediary threatens to spread contagion throughout the financial system. It expands the definition of bankruptcy to comprise the various regimes for resolving the debts of financial intermediaries, and identifies common themes that operate (and should operate symmetrically) across those resolution regimes. The Essay develops three concepts—"equitable realization," "constitutive priority" and "fiat priority"—that together instantiate an affirmative and complementary role for bankruptcy courts in the regulation of financial intermediaries that I call "constitutive equity." These principles seek to balance the imperatives of financial system stability, value preservation, and fair treatment of competing stakeholders.

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Introduction

This Essay considers the role of bankruptcy law in the legal ecosystem[1] that regulates banks and other financial intermediaries. It uses the recent spate of bank and crypto intermediary failures to consider the role of bankruptcy courts (and other resolution institutions) in protecting both customers, and the stability of the financial system when the instability of a financial intermediary threatens to spread contagion throughout the financial system. It expands the definition of bankruptcy to comprise the various regimes for resolving the debts of financial intermediaries. In so doing, it seeks to identify the common themes that operate (and should operate symmetrically) across those resolution regimes. This Essay builds on the "functional approach" to financial institution resolution developed in earlier work, and develops three value allocation concepts—"equitable realization," "constitutive priority" and "fiat priority"—that together instantiate an affirmative and complementary role for bankruptcy courts in the regulation of financial intermediaries that I call "constitutive equity." These principles seek to balance the imperatives of financial system stability, value preservation, and fair treatment of competing stakeholders.

The recent collapse of Silicon Valley Bank, First Republic, and Signature Bank, along with the melting down of various crypto-intermediaries like Celsius and FTX are the first tests of the protective architecture that was put in place for so-called "too big to fail" banks after the financial crisis of 2007-08 through the enactment of the Dodd-Frank Act in 2010.[2] The primary lesson of 2023 is that the Dodd-Frank architecture is incomplete due to its laser-like focus on systematically important financial institutions (sometimes called a SIFI or G-SIFI, for global SIFI, or G-SIB for global systemically important bank)[3]. The failures of SVB and the various crypto-intermediaries demonstrate that financial contagion, and hence systemic risk, can emerge from smaller institutions as well as larger ones. The failures of SVB and the others have occurred outside of, and without the help of, the Dodd-Frank Architec-

1. In referring to a legal "ecosystem," or "ecological" approach to legal interactions, this essay draws on the work of Liu and Emirbayer. *See* Sida Liu & Mustafa Emirbayer, *Field and Ecology*, 34 SOCIO. THEORY 62, 62 (2016) ("[F]ield theory conceptualizes society as structured spaces in which agents with habitus and capital struggle for dominant positions. The ecological approach . . . theorizes society as interactional spaces with competing actors and fluid locations."). For a more extensive use of the "ecological" approach in connection with international commercial law reform, see generally SUSAN BLOCK-LIEB & TERRENCE C. HALLIDAY, GLOBAL LAWMAKERS: INTERNATIONAL ORGANIZATIONS IN THE CRAFTING OF WORLD MARKETS (2017).

2. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

3. *See* FIN. STABILITY BD., KEY ATTRIBUTES OF EFFECTIVE RESOLUTION REGIMES FOR FINANCIAL INSTITUTIONS 5 (Oct. 15, 2014), https://www.fsb.org/wp-content/uploads/r_141015.pdf [https://perma.cc/PD8M-Z9CT].

ture. As a result, the solutions, while effective, have been ad hoc. Indeed, banks like SVB lobbied extensively after the enactment of Dodd-Frank to raise the $50 billion threshold for designation as a systemically important financial institution to $250 billion. This increase ensured that they would not be subject to the resolution planning requirements of Dodd Frank, to ensure that they would not be subjected to its strictures.[4]

The recent failures teach two lessons. First, the Dodd-Frank legislation has created a workable architecture for regulating the safety and soundness of, and resolving financial intermediaries, whether or not they are too big to fail. However, the architecture was not used because none of the entities that failed were within its scope. In a previous article, I warned that the decision to limit the scope of the Dodd-Frank reforms to so-called "too big to fail" institutions was a mistake—that forest fires can be started by campfires as well as large explosions.[5] Accordingly, it argued for a functional approach to financial institution failure. This Essay extends the argument and calls for a regulatory regime that considers financial intermediaries of all shapes and sizes and manages systemic risk across the financial system. It then seeks to instantiate that approach, at least with regard to the resolution of failed institutions ("bankruptcy") and develops a set of principles for allocating the value of failed institutions.

The Dodd-Frank Act responded to the crisis that followed the failure of Lehman.[6] The 2008 crisis demonstrated that the New Deal institutions designed to protect the stability of the banking system were insufficient to protect a financial system that included large financial "conglomerates" that might house a bank, an investment bank, and an insurance company within the same corporate group. This consolidation was accelerated in 1998 by the dismantling of the Glass-Steagall Act, through the enactment of the Gramm-Leach-Bliley Act that permitted "universal banking"—eliminating the regulatory boundaries that separated banks, investment banks and insurance companies.[7] The recent fail-

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4. *See* Sahil Kapur, *Silicon Valley Bank Puts New Spotlight on a 2018 bank deregulation law,* NBC NEWS (Mar. 13, 2023, 4:33 PM EDT), https://www.nbcnews.com/politics/congress/silicon-valley-bank-collapse-puts-new-spotlight-2018-bank-deregulation-rcna74655 [https://perma.cc/MZ7B-W2SZ]; Erin Mansfield, *SVB lobbied Congress for years to loosen bank regulations. Lawmakers knew the risks*, USA TODAY (Apr. 13, 2023, 5:00 AM ET), https://www.usatoday.com/story/news/politics/2023/04/13/svb-lobbying-bank-regulations/11555491002 [https://perma.cc/4JTJ-FJEG].

5. Edward J. Janger, *Baby Lehman: A Functional Approach to non-SIFI Resolution*, 27 NORTON J. BANKR. L. & PRAC. NL Art. 7, at 6-8 (2018).

6. Indeed, the FDIC has published a study of how an orderly liquidation of Lehman could have been accomplished had Dodd-Frank been in effect at the time. FDIC, *The Orderly Liquidation of Lehman Brothers Holdings under the Dodd-Frank Act*, 5 FDIC Q. 1, 11-18 (2011).

7. Pub. L. No. 106-102, 113 Stat. 1338, codified in relevant part primarily at 15 U.S.C. §§ 6801-09, 6821-27 (1999).

ures show both the success and failure of that architecture. On the one hand, the entities covered by Dodd-Frank—the "too big to fail" banks—weathered the recent crisis, and provided a buffer of sufficient size such that the failures that did occur did not become systemic.[8] But a government bailout was not avoided entirely. To prevent contagion the FDIC was forced to guarantee deposits above the usual $250,000 threshold.

The recent failures also show that the regulatory architecture for a "universal" banking system needs to be comprehensive as well. The term "bank" comprises traditional government-chartered banks, but also investment banks, and so-called "crypto-banks," all of which hold customer deposits of money, securities, or digital assets, and all of which reinvest those funds in the hope of making a profit on the interest rate spread. These common features mean that these firms raise common regulatory concerns, even though they may not be regulated by the same regulator: (1) depositor protection, (2) institutional safety and soundness, (3) systemic risk, and (4) fiscal policy. This is true, even though the various institutions may operate within, or fall between the cracks of the various regulatory regimes. When the regulation of financial intermediaries is viewed functionally, the spate of near systemic "bank" failures in 2022-23 demonstrates that the Dodd-Frank regime made a fundamental error when it limited its regulatory focus to institutions that were deemed systemically significant—too big to fail.

A second lesson emerges from this analysis as well. The financial institution resolution regimes take the regulatory landscape as they find it. Resolution is where the policy failures come home to roost. Failures of regulation play out in resolution, and the costs of those failures must be balanced amongst the various stakeholders, while minimizing consequential harm. Just as the regulatory regimes must consider the financial intermediary ecosystem as a whole, so must the resolution regime. Failed financial institutions may use bankruptcy courts in different ways depending on the governing regulatory regime. But, generally speaking, bankruptcy courts provide a generic forum for minimizing disruption to business enterprises, maximizing value, and distributing that value fairly to the failed firm's various stakeholders. This is an essential function of any effective regime for regulating and resolving financial intermediaries, but it is only one piece of a larger architecture. As such, there are a set of common principles that should govern the various resolution regimes.

To understand the role of bankruptcy courts, one must understand the central goal of bankruptcy law (built into the structure of the Bank-

8. Though it is important to note that this was possible only because the FDIC expanded deposit insurance to cover all depositors, even those whose deposits exceeded the insurance limit. Press Release, FDIC, FDIC Acts to Protect All Depositors of the former Silicon Valley Bank, Santa Clara, California (Mar. 13, 2023), https://www.fdic.gov/news/press-releases/2023/pr23019.html [https://perma.cc/9L4B-M7L9].

ruptcy Code)—to stop runs on a firm, and thereby preserve value and then to distribute it equitably. Value preservation is accomplished through the creation of a comprehensive estate and the automatic stay, along with powers to obtain financing, continue operations and preserve contracts.[9] Equitable value allocation is accomplished through the claims allowance and plan confirmation process.[10] Each of these functions—value realization and equitable allocation—require certain tailored adaptations where financial institutions are involved.

A second-order effect of stabilizing the firm is limiting systemic contagion. In this respect, bankruptcy (when accompanied by a properly implemented bail-in structure) can function as a complement to the regulatory structure. To accomplish this function, however, it is essential to realize that financial institution resolution is a two-step process of (1) stabilization, and (2) realization and allocation. These two moments are separated in time. Essential to the process of stabilization is a process that is understood to respect the claims of entitlement upon realization of value —the process must treat claims of entitlement equitably.

As financial firms fail, investors run, and policy imperatives collide. Fear that there will not be enough to go around leads investors to try to grab "what is theirs" first, ahead of others—equity be damned. Policies of consumer and investor protection, institutional survival, market stability, and monetary policy collide as well. Resolution regimes take entitlements and policy failures as they find them. However, an effective stabilization requires a regime that can make a credible promise at the beginning of the resolution process that entitlements will be respected to the extent possible, and that any adjustments will be handled equitably. This Essay argues that to fulfill this complementary role in the broader regulatory structure, bankruptcy courts must commit to following three fundamental principles of value allocation (defined below): (1) giving effect to "equitable realization" and (2) "constitutive priority," while rejecting (3) "fiat priority."

These three principles are developed and described in prior work with Melissa Jacoby. In "*Tracing Equity: Realizing and Allocating Value in Chapter 11*", we developed the concept of "equitable realization." We showed that under the Bankruptcy Code, when a bankruptcy case is opened, the relative position of creditors to each other is fixed, even

9. 11 U.S.C. § 362 (stay); 11 U.S.C. § 541 (estate); 11 U.S.C. § 502(b) (claims allowance and disallowance of post-petition interest); and 11 U.S.C. § 552 (limiting the property subject to an allowed secured claim to property owned on the petition date and its proceeds).

10. 11 U.S.C. § 502(b) (claims allowance and disallowance of post-petition interest); 11 U.S.C. § 552 (limiting the property subject to an allowed secured claim to property owned on the petition date and its proceeds); 11 U.S.C. § 1129 (plan confirmation).

though the amount of recovery may still be uncertain.[11] Value is then realized and distributed in a manner that gives effect to those pre-bankruptcy entitlements. Equitable realization is related to the concept of priority and raises the question of when and why one creditor should be given priority over another. In this Essay I go further, to develop a second related concept—"constitutive priority"—the principle that a priority should be recognized only if it meets the requirements for a property right or a fully implemented policy-based priority that meets the requirements for subordinating third parties[12] In the absence of such a clearly established priority or property right, the creditors should share with others pro-rata. Third, and finally, in "*Ice Cube Bonds: Allocating the Price of Process in Chapter 11 Bankruptcy*," we raised a second concern that we refer to as a "melting ice cube" or "crisis leverage."[13] As a normative matter, priorities should be based on entitlement rather than leverage, and, to give effect to this principle, the scope of priority claims must be fixed on the date of equitable realization. As discussed below, the Bankruptcy Code effectuates this principle. However, crisis leverage can give rise to "fiat priorities" that operate by using control over a particular asset or transaction to distort the priority scheme through the exercise of situational leverage. Fiat priorities should be avoided (as with the safe harbors), closely scrutinized (as with critical vendors or financing orders), or clawed back. Further, these lessons should apply, by analogy, to administrative receivers and other resolution fora.[14]

This Essay will proceed in four steps. Part I defines terms. What is bank regulation and what is bankruptcy? It lays out a functional approach

11. Melissa B. Jacoby & Edward J. Janger, *Tracing Equity: Realizing and Allocating Value in Chapter 11*, 96 TEX. L. REV. 673, 734 (2018) ("Equitable Realization locks in the relative positions of creditors as of the petition date, taking an Equitable Snapshot that freezes the relationship between asset-based claims and those with claims against the estate more generally. Value Realization happens upon disposition of the collateral or the estate.").

12. In works with Jacoby and others, I have also discussed the concept of "realizable priority" as a way of determining the entitlements of creditors claiming priority through property rights, corporate structure or jurisdiction. *See, e.g.*, Edward J. Janger & Stephan Madaus, *Value Tracing and Priority in Cross-Border Group Bankruptcies: Solving the* Nortel *Problem from the Bottom Up*, 27 U. MIA. INT'L & COMPAR. L. REV. 331, 334 (2020) ("claims of priority should be limited to their demonstrable realizable value."). Constitutive priority is related, but addresses the governance effects of priority, rather than the creditor entitlement. I hope, but don't assume that Professors Jacoby and Madaus would agree with my extension of the underlying concept.

13. Melissa B. Jacoby & Edward J. Janger, *Ice Cube Bonds: Allocating the Price of Process in Chapter 11 Bankruptcy*, 123 YALE L.J. 862, 866 (2014) ("Pleas for quick 363 sales frequently feature the melting ice cube argument—a "strong assertion of nonviability" because of an alleged rapid wasting of assets—as a justification for short-circuiting the Chapter 11 plan process."); Melissa B. Jacoby, *Shocking Bankruptcy Law*, 131 YALE L.J. F. 409, 411 (2021) ("This Essay considers how a shock fuels problematic models of business bankruptcy, particularly the practices I label 'bankruptcy à la carte' and 'off-label bankruptcy.'").

14. John Pottow and I have previously argued for symmetry between the bankruptcy and bank resolution regimes, when financial institutions and financial instruments are involved. Edward J. Janger & John A.E. Pottow, *Implementing Symmetric Treatment of Financial Contracts in Bankruptcy and Bank Resolution*, 10 BROOK. J. CORP. FIN. & COM. L. 155, 160 (2015).

to these terms and establishes the contours of the legal landscape. Part II explores the interaction between the regulatory regime and the resolution regime when one takes such a functional approach. Part III considers the specific lessons of the failures of 2022-23. Part IV draws conclusions and develops the three concepts mentioned above—"equitable realization," "constitutive priority" and "fiat priority"—that together instantiate an affirmative and complementary role for bankruptcy courts in the regulation of financial intermediaries—"constitutive equity."

I. Defining Terms: "Banks," "Bank Regulation," and "Bankruptcy"

Before embarking on an evaluation of the role of bankruptcy in bank regulation, it is necessary to define terms. What do we mean when we use the term bank regulation? What is a bank? And, how are we using the term bankruptcy?

A. Bank Regulation: Regulation of Banks and Financial Intermediaries

The principles of "bank regulation" apply beyond the narrow category of chartered banking institutions. As will be discussed below, financial intermediaries come in many flavors, big banks, little banks, broker-dealers, and novel crypto-intermediaries. All share a similar set of features. They take deposits of liquid customer assets, and use those assets or their value to invest in more profitable but less liquid investments. The reasons for regulating banks and other financial intermediaries point in four interrelated policy directions, each of which operates from within a different regulatory silo—(1) protection of depositors, (2) protection of the stability of the financial institution, (3) protection of the safety and soundness of the financial system, and (4) regulation of the money supply. All four of these concerns are implicated when regulating banks, but they also come into play when regulating other intermediaries whose business model involves reinvesting the money or other assets deposited by (borrowed from) customers or property held for customers.

Protecting Depositors. With regard to depositors, banks are understood to constitute safe repositories for personal savings—a functional equivalent to holding specie, readily available to pay for transactions, on-demand at par. This is the logic behind federal and state insurance of bank deposits up to a threshold.[15] To the extent that consumers wish to take risks with their money by investing in uninsured or risky investments, regulation is also directed toward honesty and transparency to encourage informed decision-making about risk.[16]

15. Federal Deposit Insurance Act, 12 U.S.C. § 1828 *et seq*. (FDIA); Securities Investor Protection Act, 15 U.S.C. § 78aaa *et seq*.

16. *Mission*, SEC, https://www.sec.gov/about/mission [https://perma.cc/3P3C-TWJ6].

Institutional Safety and Soundness. The idea of banks as risk-free places to store one's money requires a bit of collective cognitive dissonance. The business model of banks is built on the fact that they are highly leveraged. They borrow demand deposits from customers and relend or otherwise invest those funds in less liquid investments.[17] The result is that banks are always facing the risk of a "run." If customers lose trust and seek to withdraw their money in large numbers, the bank will not have sufficient cash on hand. It will therefore either default on its obligations or be forced to liquidate assets at fire sale prices.[18] The insurance backstop reinforces depositors' trust. So-called prudential regulation, therefore seeks to assure the safety and soundness of the institution, and to limit the exposure of the insurance fund.

Financial System Stability. Runs are not just an issue at a single institution. The financial system faces the risk of contagion.[19] Banks and other financial institutions are tightly intertwined. Failure of a single bank can have consequences for the financial system as a whole. Lehman is the most recent example of a single bank failure with systemic consequences. But, as we shall discuss below, the failures of smaller banks, like Silicon Valley, Signature, First Republic, and so on, could also have had systemic consequences had the Federal Reserve not stepped in.

Fiscal Policy. Finally, in modern finance, money and debt go hand in hand. Indeed, much of what economists consider "money," for the purposes of monetary policy is not actual specie, but consumer deposits (bank debt) sitting in a customer's bank account. The money supply as measured by the Federal Reserve includes more than just currency in circulation. The M1 measure of the money supply includes currency and demand deposits in banks—money owed by banks to their depositors. M2 the broader measures of the money supply incorporate even more forms of debt such as CDs and other types of deposits that can readily be converted to cash. M3 incorporates large institutional deposits.[20] The point here is that banks create money. They borrow from depositors and reinvest those deposits. If the return on their investments is greater than the cost of the borrowed money, they are profitable. If not, they lose money.

17. *Financial Stability Report - November 2022*, FED. RSRV. (Nov. 2022), https://www.federalreserve.gov/publications/2022-november-financial-stability-report-leverage.htm [https://perma.cc/LPY3-QGDH] (publishing data on leverage in the banking system).

18. Silicon Valley Bank, discussed below, provides an example of this problem. *See, e.g.*, Christopher G. Neely & Michelle Clark Neely, *Internet Rate Risk, Bank Runs, and Silicon Valley Bank*, FED. RSRV. BANK OF ST. LOUIS (May 11, 2023), https://www.stlouisfed.org/publications/regional-economist/2023/may/interest-rate-risk-bank-runs [https://perma.cc/UTA3-MJBB].

19. Mark J. Roe, *The Derivatives Market's Payment Priorities as Financial Crisis Accelerator*, 63 STAN. L. REV. 539, 564-69(2011).

20. *Money Stock Measures*, FED. RSRV. (Apr. 23, 2024), https://www.federalreserve.gov/releases/h6/current/default.htm [https://perma.cc/C99F-BY32].

This overlap between debt and money creates three regulatory imperatives : first, assuring that instruments that are used like money (as a medium of exchange) act like money, in that they trade at par and clear immediately;[21] and, second, assuring that financial innovations do not distort monetary policy by inflating the money supply; and third, assuring that financial innovations do not make "safe" assets less safe.[22]

Thus, when we talk about "bank regulation," we are really talking about four different things: (1) depositor protection—insurance; (2) safety and soundness of the institution—adequacy of capital; (3) stability of the financial system—limiting contagion risk; and (4) monetary policy—safety of currency and regulation of the money supply. Note, however, that these "regulatory silos" that apply to operating financial intermediaries are somewhat distinct from the "resolution" of failed financial intermediaries (bankruptcy). Regulation seeks to prevent the failure of financial institutions, and to assure that where they do occur the failures will not disrupt the economy. Bank resolution is where regulatory failures come home to roost. Instead, bank resolution describes the process of and forum for managing the failures that do occur, for minimizing their consequences and allocating the costs of failure.

B. Banks: (and) Similar Financial Intermediaries

Banks, chartered by states and the federal government, are just one form of financial intermediary that takes those deposits and reinvests the invested funds in the economy The characteristics of a bank exist along a continuum from safe to risky, liquid to illiquid, interlinked or not. It may seem a bit odd to suggest that a G-SIFI like Citi or Chase is in any way similar to FTX, or the local credit union, but the hallmarks of a bank are that the customer has ready access to the deposited funds or other assets, can use them to pay for things, and, most importantly, does not need to worry about the solvency of the depository institution. The various regulatory regimes, discussed below, each address the consequences when a financial intermediary deviates from those assumptions. The regulated institutions may look different, but the regulatory regimes and resolution fora have a variety of broad, functional similarities that must be appreciated.

21. Anna Gelpern & Erik F. Gerding, *Inside Safe Assets*, 33 YALE J. ON REGUL. 363, 365 (2016) ("Multi-trillion dollar global markets depend on participants' ability to treat entire categories of financial contracts as if they were risk-free. 'Safe assets' is a catch-all term to describe such contracts").

22. Morgan Ricks, *Regulating Money Creation After the Crisis*, 1 HARV. BUS. L. REV. 75 (2011).

1. Banks

In the narrow sense, banks are institutions that take deposits, and are regulated by one of the banking industry's prudential regulators—the FDIC, the OCC, etc. They may be chartered by a state or by the federal government.[23] Deposits are insured up to a cap, and the institutions are subject to regulation of both capital reserves and types of investment.[24] The basic architecture of bank regulation was put in place as part of the New Deal, in the wake of the Great Depression. Initially, it was characterized by a strict separation between banks that take customer deposits, and other institutions, like investment banks and insurance companies that were thought to carry more risk. Under the Glass-Steagall Act of 1933, banks that took customer deposits were not allowed to invest in or sell securities, while investment banks that sold and held securities could not be affiliated with a bank.[25] That strict separation was eliminated by the Gramm-Leach-Bliley Act of 1999.[26] After 1999, a single holding company could own a bank, an investment bank and an insurance company, for example. Each would be regulated by the relevant prudential regulator. So, for example, at one point, Citigroup owned Citibank (the bank), Citi Global Investment and Capital (an investment bank), and Travelers Insurance (an insurance company that it later sold).[27] Thus, it is necessary to distinguish between a "bank," which is regulated as a depository institution, and a "bank holding company," which may own a bank as well as other financial services intermediaries.

2. Non-bank financial intermediaries

Chartered and regulated banks are not, however, the only institutions with a business model that relies on taking customer deposits, reinvesting the money and, hopefully, profiting on the spread. This family of businesses can broadly be referred to as financial intermediaries. They are a heterogenous lot, ranging from large investment banks and broker-dealers to crypto-intermediaries to hedge funds and private equity firms. They all share the characteristic that the depositor is (rightly or wrongly)

23. Andrew P. Scott, *An Analysis of Bank Charters and Selected Policy Issues*, CONG. RSCH. SERV. 2 (Jan. 21, 2022) https://crsreports.congress.gov/product/pdf/R/R47014 [https://perma.cc/3NBV-FKBJ].

24. *Understanding Deposit Insurance*, FDIC (Apr. 1, 2024), https://www.fdic.gov/resources/deposit-insurance/understanding-deposit-insurance [https://perma.cc/375Q-9YK3].

25. Julia Maues, *Banking Act of 1933 (Glass-Steagall)*, FED. RSRV. HIST., https://www.federalreservehistory.org/essays/glass-steagall-act [https://perma.cc/KSU3-Q5EJ].

26. Pub. L. No. 106-102, 113 Stat. 1338, codified in relevant part primarily at 15 U.S.C. §§ 6801-09, 6821-27 (1999).

27. *Momentous Encounter Leads to Merger*, CITIGROUP, https://www.citigroup.com/global/about-us/heritage/1998/momentous-encounter-leads-to-merger [https://perma.cc/DS2D-BH2F].

generally assuming that they face the risk of any investment that they make through the intermediary, but they are not facing the risk that the intermediary itself will become insolvent. Nonetheless, intermediaries do fail, and the implications for customers and the financial system have ranged from locally painful (see, for example, Bernie Madoff),[28] to possible systemic consequences narrowly averted by a quiet Federal Reserve-orchestrated bailout (see Long Term Capital Management),[29] to catastrophic (Lehman).[30] Recently, in addition to the failures of mid-sized banks, such as Silicon Valley, First Republic, Signature; crypto winter (and a healthy dose of fraud) has led to the collapse of congeries of crypto-intermediaries such as FTX, Celsius, BlockFi and others. In the modern economy it would be shortsighted not to view these intermediaries as part of the bank regulatory ecosystem.

a. Investment Banks

The mortgage crisis of 2007-08 called attention to the fact that instability in the financial sector could emerge from entities that were not technically within the bank-regulatory structure. Ten years earlier, it would have been inconceivable to worry that an investment bank like Bear Stearns or Lehman might fail. Their balance sheets and sheer size made failure inconceivable. In 2007, however, the collapse of the real estate market, followed by the collapse of the market for mortgage-backed securities led to a run on the repo market. This run, in turn, triggered the global financial crisis.[31] In other words, a run on leveraged financial intermediaries outside the banking system led to a run on mortgage-backed securities that implicated the stability of the financial sector as a whole.

The investment banks were not entirely unregulated—the SEC regulates broker-dealers through FINRA, and securities deposited with broker-dealers were insured by SIPC.[32] But they were beyond the jurisdiction of the FDIC. If investment banks failed, they were to be liquidated under SIPA, in bankruptcy court, and the customer deposits would be insured. However, with SIPA, the principal worry was not insolvency but error—that securities would be missing from the accounts and would

28. Diana B. Henriques, *Bernie Madoff, Architect of Largest Ponzi Scheme in History, Is Dead at 82*, N.Y. TIMES (Apr. 15, 2021), https://www.nytimes.com/2021/04/14/business/bernie-madoff-dead.html [https://perma.cc/XC6S-V4GW]

29. *See generally* ROGER LOWENSTEIN, WHEN GENIUS FAILED: THE RISE AND FALL OF LONG-TERM CAPITAL MANAGEMENT (2001).

30. *Global Impact of the Collapse*, HARV. BUS. SCH., https://www.library.hbs.edu/hc/lehman/exhibition/global-impact-of-the-collapse [https://perma.cc/KTZ8-B8XA].

31. Gary B. Gorton & Andrew Metrick, *Securitized Banking and the Run on Repo* 1, (Nat'l Bureau of Econ. Rsch., Working Paper No. 15223, Aug. 2009), https://www.nber.org/system/files/working_papers/w15223/w15223.pdf [https://perma.cc/RWF5-VMC6].

32. *What SIPC Does*, SIPC, https://www.sipc.org/for-investors/what-sipc-protects [https://perma.cc/AHK6-3NBK].

have to be replaced.[33] The regulatory scheme for broker-dealers rested on an empirical assumption that turned out to be wrong. Broker-dealers' capital is established by the net capital rule, a convoluted rule that penalizes them for holding illiquid assets. Customer deposits don't come into play because under other SEC financial responsibility rules; they should be held apart from the broker-dealer's own securities.[34] Neither did systemic risk. The assumption was that only small, non-systemically significant, broker-dealers would fail, the depositors would be protected, and the failure would not have systemic implications.[35] Beyond imagination was the possibility that a large investment bank like Lehman (or Bear Stearns) might fail with significant repercussions for financial markets.

The lesson for regulators of 2008 was that systemically important financial institutions needed to be regulated, both with regard to capital and resolution.[36] The result was the granting, in the Dodd-Frank Act, of "Orderly Liquidation Authority," along with a new regulatory requirement of resolution planning. The "bail-in" architecture known as single point of entry is described in more detail below.[37]

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33. *See* Onnig H. Dombalagian, *Substance and Semblance in Investor Protection*, 40 J. CORP. L. 599, 601-09 (2015). This same distinction between solvency and error/theft has reappeared in the crypto space, as crypto-intermediaries have blurred the line between borrowing from their customers and bailing their assets.

34. Exchange Act Rule 15c3-1 (Net Capital Rule) requires that firms must at all times have and maintain net capital at specific levels to protect customers and creditors from monetary losses that can occur when firms fail. This is what crypto firms like FTX didn't do. Of course, there was no one to tell them to do it, because they were not, or so they argued, under SEC jurisdiction.

35. Edward J. Janger, *Treatment of Financial Contracts in Bankruptcy and Bank Resolution*, 10 BROOK. J. CORP. FIN & COM. L. 2, 2-5 (2015). *See also* Janger & Pottow, *supra* note 14. at 164-65. *See* Stockbroker-Commodity Broker Amendments to the Bankruptcy Code, Pub. L. No. 97-222, 96 Stat. 235 (1982); *In re Grafton Partners*, 321 B.R. 527, 532-33 (B.A.P. 9th Cir. 2005) (Klein, J.) ("Public Law 97-222 was a package of amendments designed to protect the carefully-regulated mechanisms for clearing trades in securities and commodities in the public markets from [the] dysfunction that could result from the automatic stay and from certain trustee avoiding powers."); H.R. REP. NO. 97-420, at 1-2 (1982), *quoted* in *In re Grafton Partners*, 321 B.R. at 536. The House Report states:

> The commodities and securities markets operate through a complex system of accounts and guarantees. Because of the structure of the clearing systems in these industries and the sometimes volatile nature [of] the markets, certain protections are necessary to prevent the insolvency of one commodity or security firm from spreading to other firms and possibly threatening the collapse of the affected market. The Bankruptcy Code now expressly provides certain protections to the commodities market to protect against such a "ripple effect." One of the market protections presently contained in the Bankruptcy Code, for example, prevents a trustee in bankruptcy from avoiding or setting aside, as a preferential transfer, margin payments made to a commodity broker.

Id.

36. FIN. STABILITY BD., RECOVERY AND RESOLUTION PLANNING FOR SYSTEMICALLY IMPORTANT FINANCIAL INSTITUTIONS: GUIDANCE ON DEVELOPING EFFECTIVE RESOLUTION STRATEGIES 7 (total loss absorbing capacity), 12-14 (single and multiple point(s) of entry) (July 16, 2013), https://www.fsb.org/wp-content/uploads/r_130716b.pdf [https://perma.cc/QUR9-7D97].

37. Final Guidance for the 2019, 84 Fed. Reg. 1438 (Feb. 4, 2019). The requirement of resolution planning regulated both corporate structure and capital and were designed to make sure that if one of an institution's businesses suffered a shock, the group was structured in a

b. Novel Intermediaries–e.g. Crypto

Another way that leverage can build up in the financial system, outside the regulatory structure, is through the advent of novel financial technologies. Mortgage-backed securities2008 crisis. In 2023 the new technology was (and is) digital assets and the shadow banks are the intermediaries that facilitated the trading in those novel assets.

Digital assets must be divided into two categories: old and new; or centralized and decentralized. In this regard, assets have been digital for a long time. Broker-dealers hold "stock" in an account for their customers, but there is no physical transfer of a stock certificate.[38] This is the province of old-style financial intermediaries. The advent of blockchain has created a new class of digital assets that do not require a centralized intermediary to transfer them or record ownership. This has given rise to the advent of so-called "decentralized" finance or "defi." Assets in the form of bitcoins, stablecoins, NFTS and so on, allow for a wide variety of digital assets to store value and transact without the intervention of the banking system—or so it is said.[39] In one respect this is no different from cash. There has always been a cash economy that existed outside the more formal banking system. The difference (or at least *a* difference) with the new assets is that they don't need to be physically transported in a briefcase or stored in a treasure chest (or vault). They can move long distances and be kept secure with a few strokes of a computer keyboard. Because they do not (necessarily) require the intervention of a bank, they are thought to be more private. That said, as Hilary Allen has pointed out, most consumers hold their crypto assets in and transact through intermediaries. Moreover, these intermediaries look a lot like banks.[40]

Because they are new and heterogeneous, digital assets raise many regulatory issues for the banking system. To the extent that they are used

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manner that would facilitate "bail-in" and that the institution could be resolved without requiring a bailout. As a matter of corporate structure, systemically important financial institutions (SIFIs) were required to provide the FDIC with a resolution plan that would facilitate a "single point of entry" into bankruptcy court. The holding company would be required to serve as a source of strength for its subsidiaries by retaining sufficient capital and liquidity to recapitalize a troubled subsidiary. Therefore, the only entity that might ever find itself in bankruptcy would be the holding company, not an operating subsidiary. The creditors of the holding company would be structurally subordinated to the creditors of the operating company and would therefore become the source of "bail-in" capital. The operating companies would not fail, and systemic contagion would be prevented. The creditors of the holding company would in turn become the owners of the new holding company that would hold the stock of the recapitalized subsidiaries.

38. Nominally a stock certificate exists at the Depositary Trust Company, in street name, while broker-dealers track the ownership of the individual shares. *The Depository Trust Company (DTC)*, DTCC, https://www.dtcc.com/about/businesses-and-subsidiaries/dtc [https://perma.cc/3YFP-MZ3L].

39. Hilary J. Allen, *DeFi: Shadow Banking 2.0*, 64 WM. & MARY L. REV. 919, 934-37 (2023).

40. *Id.* at 937-43.

as "investments," they might be subject to securities regulation.[41] To the extent that they are used as a medium of exchange or a payment device, they look like money. To the extent that they are a means for storing value and are held in deposit accounts, they could be subject to either bank or broker-dealer regulation. One of the current concerns about crypto assets and crypto-intermediaries is the extent to which they exist in regulatory limbo, neither regulated as money, securities nor commodities. They have grown, flourished and failed largely outside the regulated environment. For the purposes of this paper, however, I will focus on the fact that most people who use crypto do not ever directly handle the digital assets. Instead, they hold their "crypto" in "wallets" provided by financial intermediaries like Celsius, FTX, and BlockFi (all of which are now in bankruptcy).[42] This Essay will consider crypto-intermediaries from the perspective of their similarity to banks: (1) they hold customer assets; (2) they often reinvest customer assets (with or without permission),[43] and (3) they facilitate the use of customer assets to pay for things. Significantly, the intermediaries also proclaimed their "safety" even sometimes claiming that they were "safer than banks."[44] This claim was, of course, pure salesmanship. While it may not have been apparent to many customers, from the outset, like banks, their business model was built on leverage, and they were, as it turns out, subject to runs (as well as fraud).[45]

41. *See* SEC v. W. J. Howey Co., 328 U.S. 293, 298-99 (1946); SEC, *Framework for "Investment Contract" Analysis of Digital Assets*, https://www.sec.gov/files/dlt-framework.pdf [https://perma.cc/B6F9-SC6F].

42. Allen, *supra* note 39, at 937-43; Julia Kagan, *What Is a Digital Wallet?*, INVESTOPEDIA (Apr. 1, 2024), https://www.investopedia.com/terms/d/digital-wallet.asp [https://perma.cc/N4ZW-K3HF].

43. A key focus for insolvency treatment of digital assets held by failed intermediaries is whether the account meet the requirements to be a "custody" account where the asset remained customer property or a more traditional deposit account, where the intermediary becomes the owner of the asset and the depositor is a creditor of the intermediary. *See* UNIDROIT PRINCIPLES ON DIGITAL ASSETS AND PRIVATE LAW 68-94 (Jan. 2024), https://www.unidroit.org/wp-content/uploads/2024/01/Principles-on-Digital-Assets-and-Private-Law-linked.pdf [https://perma.cc/H5CC-UB6P] (describing requirements for an account holding digital assets to be considered a custody account). Judge Glenn's decision in *Celsius* found that the assets held by customers in "earn" accounts were property of the estate, while withholding judgment on the status of so-called "custody" accounts. *In re* Celsius Network LLC, 647 B.R. 631, 641 (Bankr. S.D.N.Y. 2023).

44. Rick Steves, *"Safer than a bank": Celsius' Alex Mashinsky Sued By NYAG For Defrauding Over 26,000 New Yorkers*, FIN. FEEDS (Jan. 6, 2023, 3:27 PM UTC), https://financefeeds.com/safer-than-a-bank-celsius-alex-mashinsky-sued-by-nyag-for-defrauding-over-26000-new-yorkers [https://perma.cc/LR5B-2WS2].

45. As will be discussed below, crypto-intermediaries provided two types of accounts: (1) Earn accounts, which earned interest or other consideration; and (2) Custody accounts. Conceptually, the difference was that the earn accounts contemplated a transfer of title to the intermediary, while a custody account did not. The actual terms of service varied, and the practices followed by the intermediaries varied even more.

C. Bankruptcy—Resolution of Financial Intermediaries

Like the word "bank," the word "bankruptcy" can be interpreted in a manner that is either narrow or broad. The narrow definition is the opening of a proceeding in a United States Bankruptcy court.[46] This definition excludes banks and many other financial institutions, but includes others, not commonly thought of as banks. The functional definition of financial intermediaries, includes institutions that take deposits of customer assets and invest those assets, borrow against those assets, or charge for the service. The broader functional definition of financial institution bankruptcy would include other resolution schemes, including the administrative resolution of financial institutions in specialized proceedings such as FDIC receiverships as well as liquidation of investment banks or broker-dealers in bankruptcy court.[47]

1. Resolution of non-systemic banks by the FDIC

When a chartered bank fails, the process is handled by the FDIC through an administrative receivership process.[48] Functionally, it is a liquidation, but it is handled by the agency, not by a bankruptcy court. Regardless of the forum, the process of liquidating financial institutions is broadly similar. The FDIA suspends the obligations of the bank for one day, so that the assets can be transferred without a default. When the FDIC takes over an institution (usually on a Friday), the process follows a familiar pattern. The FDIC splits the bank into two institutions, a "good bank" that contains the core and liquid assets of the institution, and a "bad bank" that contains illiquid assets and liabilities. The good assets are then sold to another solvent financial institution which steps into the shoes of the failed bank and performs its obligations. From the customer's perspective, they go to bed on Friday with their account at one bank, and wake up on Monday with an account at the new solvent bank. The same is true for derivative counterparties. The right to terminate the contracts is briefly suspended, to allow for the transfer, and once the transfer is accomplished, the contract is reinstated, and any default is deemed cured. Meanwhile, illiquid and unsaleable assets and liabilities are transferred to the FDIC, which backstops the insured obligations, and allows

46. 11 U.S.C. § 109 sets the terms of eligibility to use Chapters 7 and 11 of the Bankruptcy Code.

47. The resolution of banks is covered by the Federal Deposit Insurance Act. 12 U.S.C. § 1823 *et seq*. The resolution of systemically important financial institutions is governed by the orderly liquidation authority contained in Title II of the Dodd-Frank Act. *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203 (July 21, 2010). Broker-dealers are liquidated in bankruptcy courts under the Security Investors Protection Act. 15 U.S.C. § 78 *et seq*.

48. *See Receivership Management Program*, FDIC (Feb. 8, 2022), https://www.fdic.gov/about/strategic-plans/strategic/receivership.html [https://perma.cc/4BDW-3NBT].

for default (at least in theory) on those that are not. Once the assets are liquidated, uninsured depositors and other creditors are paid pro-rata.[49]

2. Resolution of non-systemic investment banks

As noted above, when an investment bank fails, instead of following the administrative receivership route used by banks, the proceeding is handled in bankruptcy court through a liquidation proceeding under the Securities Investor Protection Act. While the SIPA liquidation is conducted in bankruptcy court, it is not technically a bankruptcy case. Nonetheless, the basic outline of a SIPA liquidation is similar to a non-systemic bank resolution, with SIPC standing in the position of the FDIC as an insurance fund that assures that the securities in an investors account or their value are returned to them once the assets of the institution are sold, and that uninsured creditors are paid a distribution.[50]

3. Resolution of novel intermediaries

More recently, another set of financial institutions have been making use of the bankruptcy courts to resolve their affairs. Crypto-intermediaries such as FTX, Celsius, BlockFi and others have, in the wake of crypto winter, found their way into bankruptcy courts.[51] They are neither "banks" nor are they broker-dealers. But, if one takes a financial view of banks they fit squarely within the definition. Issues have arisen as to how to maximize the value of these firm's holdings, but the biggest question that has arisen with the crypto-intermediaries is the priority of customer deposits vis-à-vis other creditors.[52] The crypto-exchange's customers *thought* they had deposited their property with the exchange, but whether this was an ownership interest in a digital asset or just a debt obligation of the exchange is something that was both non-transparent and where the answer was not obvious under current law. However, as will be discussed below, if one takes a functional approach to resolution, the proper answers are readily apparent.

49. For an overview of the FDIC resolution process, see generally LYNN SHIBUT, CRISIS AND RESPONSE: AN FDIC HISTORY, 2008-2013, ch. 6 (2017).

50. *See* Securities Investor Protection Act of 1970 (SIPA), 15 U.S.C. § 78aaa *et seq*.

51. *See, e.g.*, *In re* FTX Trading Ltd., Case No. 22-11068 (JTD) (Bankr. D. Del. ECF Case No. 22-11068, Doc. # 157); *In re* Celsius Network LLC, 644 B.R. 276, (Bankr. S.D.N.Y. 2022); *In re* BlockFi, Case No. 22-19361 (MBK) (Bankr. D.N.J. Case No. 22-19361 Doc. # 53).

52. *See supra* note 51 and accompanying text.

4. Resolution of systemically important financial institutions—Single-Point-of-Entry

When Lehman failed in 2008, it uncovered gaps in the existing resolution architecture. First, the FDIC did not have jurisdiction over Lehman, and therefore there was no administrative track for resolution. Second, certain features of bankruptcy, designed to address the failure of smaller investment banks, undercut the orderly resolution of Lehman. In particular, the fact that most of the derivative instruments held by Lehman were exempted from the bankruptcy stay by the so-called "bankruptcy safe harbors,"[53] led to significant value destruction, as counterparties treated the bankruptcy as an opportunity to walk away from their transactions.[54]

Lehman and the 2008 crisis led to a global rethinking of how to protect the safety and soundness of the financial system from the potential failure of another systemically important financial institution In the United States this rethinking led to the passage of the Dodd-Frank Act in 2010. Dodd-Frank implemented a broad regulatory package that addressed both the safety and soundness of SIFIs through capital rules, and also through a required process of resolution planning.

The approach followed by Dodd-Frank contemplated that non-bank SIFIs would use bankruptcy court to address their financial distress, but would do so in a way that protected the stability of the financial system, without requiring a government bailout. The approach, referred to as "Single Point of Entry," required SIFIs to engage in a process of resolution planning. [55] The institution had to develop a plan that would satisfy the FDIC. If one of the group's businesses suffered a financial shock, bankruptcy courts could be used to restructure the group and continue operations. The resolution plan had three key components:

1) A holding company structure,
2) A support agreement whereby the bank holding company would serve as a source of strength for its component businesses, and
3) Sufficient liquid assets and loss-absorbing capacity to allow the parent to "bail-in" the troubled business.[56]

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53. 11 U.S.C. §§ 362(b)(6), (7); 546(e).

54. Stephen J. Lubben, *Lehman's Derivative Portfolio*, HARV. L. SCH. BANKR. ROUNDTABLE (Mar. 15, 2016), https://bankruptcyroundtable.law.harvard.edu/2016/03/15/lehmans-derivative-portfolio [https://perma.cc/MSF5-C47F].

55. RANDALL GUYNN, "SINGLE POINT OF ENTRY" RESOLUTION STRATEGY FOR U.S. GLOBAL SYSTEMICALLY IMPORTANT BANKING GROUPS (G-SIBS) 1-13, WORLD BANK (June 6, 2018), https://thedocs.worldbank.org/en/doc/857691528991163692-0130022018/original/GuynnDavisPolkSessionTwo.pdf [https://perma.cc/D74A-BJC6].

56. *Id.* at 1, 13.

The idea was (and is) that if one of the businesses suffered a shock, the holding company would recapitalize the troubled subsidiary. This might render the parent insolvent, but instead of the business failing, the holding company would go into bankruptcy and reemerge as a trust that would operate for the benefit of the holding company's now defaulted and subordinated creditors. In other words, the operating companies would never go into bankruptcy, only the corporate parent.[57] In addition, as a backstop, the FDIC was given "Orderly Liquidation Authority" which provided an administrative option if it was determined that using the bankruptcy courts would be too disruptive to the financial system.[58]

A second aspect of the post-crisis SIFI resolution regime was a strategy to address the early termination of financial contracts (derivatives) upon the filing of a bankruptcy petition. As noted above, the early termination provisions in derivative contracts, coupled with the bankruptcy safe-harbors made it impossible to transfer those contracts in an orderly fashion. The solution adopted by regulators was a contractual regulatory hybrid. Regulators took advantage of the fact that most traded derivatives were written on forms drafted by the International Swaps and Derivatives Association ("ISDA"). At the insistence of the FDIC, ISDA issued the so-called "ISDA Stay Protocol" that altered the standard derivatives contracts such that they included:

1) A short two-day stay of default (to allow for transfer) and
2) Reinstatement of the contract upon transfer to a solvent institution.[59]

In short, the FDIC created a regime that mimics the bank resolution regime and facilitates orderly transfer.

D. A functional approach to financial intermediary resolution

The discussion above outlines a series of common features of an effective resolution regime for financial intermediaries. That framework was worked out in the context of Dodd-Frank, but it is broadly adaptable and calibrated to other types of intermediaries. The features include:

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57. *Id.* at 1.

58. Aaron Klein, *A primer on Dodd-Frank's Orderly Liquidation Authority*, BROOKINGS (June 5, 2017), https://www.brookings.edu/articles/a-primer-on-dodd-franks-orderly-liquidation-authority [https://perma.cc/Z4D5-PMWH].

59. *See generally* INT'L SWAPS & DERIVATIVES ASS'N, ISDA U.S. RESOLUTION STAY PROTOCOL (July 31, 2018), https://www.isda.org/a/CIjEE/3431552_40ISDA-2018-U.S.-Protocol-Final.pdf [https://perma.cc/89LK-ZRHK].

1) A holding company structure,
2) A support agreement whereby the bank holding company would serve as a source of strength for its component businesses,
3) Sufficient liquid assets and loss-absorbing capacity to allow the parent to "bail-in" the troubled business;[60]and
4) A legal toolkit that provides for the orderly transfer of assets and liabilities to the government or a solvent institution. These include:
    a. A short two day stay of default (to allow for transfer); or
    b. Reinstatement of contracts upon transfer to a solvent institution or assurance of performance.

E. The role of bankruptcy in bank regulation

The discussion above lays out a landscape of financial intermediaries, and a series of regulatory policies that are implicated by bank regulation and hence by financial intermediary resolution. The question explored in the next Part is: what, if any, is the role of bankruptcy courts in implementing these regulatory policies, and how these policies interact with the process and principles of the Bankruptcy Code? On the one hand, bankruptcy courts are a forum, but one that is charged with implementing a particular statute—the Bankruptcy Code. On the other hand, all of the policy concerns that exist outside of bankruptcy are mediated and addressed in the bankruptcy (or other resolution) forum. Bankruptcy courts and administrative resolution for a are where institutions end up when prudential regulation fails. It falls to the resolution forum to mitigate harm and allocate the harm equitably. The next Part will seek to identify the strengths and weaknesses of bankruptcy courts in resolving financial institutions, and also to identify the "bankruptcy" policies that interact with the policies implicated by bank regulation. The lessons from bankruptcy have implications for other resolution fora.

II. Value Maximization and Equity in Bankruptcy

What is the role of bankruptcy courts in the regulation of failing financial intermediaries? On one level, bankruptcy court is where regulatory failures go to die. Regulation, at least to the extent it is enforced by imposing costs on shareholders, has limited effect on a financially troubled bank. If a debtor is judgment proof, or merely insolvent, they do not internalize the full cost of the harm they cause. Contractual breach claims, tort claims, and taxes are all paid in cents on the dollar. When eq-

60. *Id.* at 1, 13.

uity is out of the money, they may have an incentive to actually increase their risk-taking, in the hope of a recovery, recognizing that they are largely playing with other people's money. The risk taken by the financial institution can be mutualized—borne by the industry through a privately funded insurance fund, or it can be socialized—borne by creditors or social insurance (the taxpayers). Much of what we think about as prudential regulation of financial institutions is designed to prevent bankruptcy by assuring the safety and soundness of the institution. If a firm fails, the bankruptcy courts (or administrative receiver) have two jobs: (1) to maximize the value realized for the benefit of stakeholders; and (2) to allocate that value amongst those stakeholders. The value preservation function is handled through the resolution processes described above, but it is also necessary to develop a functional set of principles for value allocation.

Allocation of value (or loss) is where things get tricky. In a piecemeal liquidation, value can be allocated easily according to priority, with the lien holders getting the proceeds of their collateral, and unsecured creditors sharing according to priority, and ultimately, pro rata. When a financial institution is resolved quickly, and whole business lines are transferred, individual assets may not be liquidated. Attributing value amongst entities and encumbered and unencumbered assets can be tricky. A consolidated business enterprise may consist of multiple corporate entities. Each may have their own creditors and capital structure. If an entity continues to operate value may be realized through earnings rather than asset sales. Attributing the contribution of each entity or asset to the whole may be more art than science.[61]

A. Equity Amongst Creditors in Bankruptcy—Neutralizing the Race of Diligence

Outside of bankruptcy, creditor priority upon default is determined by the first to grab assets, either by contract (secured credit) or through the race to the courthouse (judgment liens). This race of diligence is unequal and destroys value. Bankruptcy seeks to address both effects of the race of diligence by distributing value according to existing legal entitlements and preventing value destruction by allowing time to address distress in an orderly fashion. In prior work, Melissa Jacoby and I have explained how the Bankruptcy Code manages to preserve equity amongst creditors while finding pragmatic and flexible ways to preserve the going concern value of the business while assuring the equitable treatment of

61. Janger & Madaus, *supra* note 12, at 334 (groups); Jacoby & Janger, *supra* note 11, at 676-709 (security)

creditors.[62] Those same principles apply when resolving financial intermediaries. But they require a bit of translation.

When creditors run against an institution, the first to grab assets wins. This result is inequitable. Bankruptcy courts can solve this problem through collective liquidation under Chapter 7. But liquidation destroys going concern value. In Chapter 11, by contrast, the collection efforts of individual creditors are stayed, but the business continues to operate.[63] The "debtor-in-possession," is given the power to continue to operate the business in order to preserve its going concern value.[64] It has crucial powers such as the power to borrow money, and the power to assume and assign contracts.[65] These tools help preserve value, but they take time, and over time, the relative positions of creditors may shift. The genius of the Bankruptcy Code is that it has found a way to maintain the relative position of creditors over time, as the value of the firm changes in the bankruptcy case. This is a process that we call "equitable realization." Equitable realization establishes the priority and pro rata positions of claims against the firm as of the petition date, while simultaneously fixing the pool of assets available for distribution to creditors with security.

The key concepts to understand are: (1) the distinction between asset-based (in rem) rights and value-based (in personam) claims against the debtor; (2) the distinction between equitable realization and value realization; and (3) the rejection of situational, or "crisis" leverage as a means for particular claimants to alter their distributions. A proper understanding of these distinctions will show that they have both beneficial allocative effects (enhancing equity), and governance effects (encouraging cooperation). Together they contemplate a role for bankruptcy courts that might be called "constitutive equity," that can allow bankruptcy courts to act as an effective complement to the broader regulatory regime.

If the business is liquidating, equitable allocation of the proceeds is relatively simple. Encumbered assets are sold, and the proceeds are distributed to the creditors who held those assets as collateral. Unencumbered assets are sold, and the proceeds are distributed to those with claims against the entity. Modern bankruptcy adds a complication. In reorganization, the business often continues, either through a negotiated recapitalization of the firm, or through a going concern sale. Negotiating a restructuring, fixing the business, or selling the whole company may take time. As the company continues to operate collateral may be sold, and new valuable assets purchased. If the whole business is sold, assets

62. Jacoby & Janger, *supra* note 11, at 676-709.

63. 11 U.S.C. § 362.

64. 11 U.S.C. § 363(c).

65. 11 U.S.C. §§ 364 (post-petition credit), 365 (executory contracts).

will not be priced separately; and if the business is recapitalized; the recapitalization may take time, but the collateral may never be sold. Further, if the business is sold or recapitalized as a going concern, there will be value to distribute that is not tied to assets.

Chapter 11 addresses this problem in an elegant fashion, by dividing the process of "realization" into two pieces: (1) equitable realization; and (2) value realization. On the petition date, the Bankruptcy Code freezes the relative position of creditors. Each unsecured creditor's pro-rata share of the value of the estate is set based on the amount of the claim as of the petition date.[66] For secured creditors their pool of collateral is fixed as well.[67] But at that moment nobody knows what the dividend will be on an unsecured claim: 5%, 10%, 80%? And nobody knows what the value will be of the secured creditor's collateral. The value of the firm will not be known until it is sold or recapitalized. Similarly, the value of particular assets will not be known until they are sold, or some agreement or finding is made as to their value. Until then, however, the secured creditors are assured that they will get the value of their collateral, while the unsecured creditors (including any secured creditor deficiency) will get the pro rata share of the remaining value of the firm. This is what we mean by "equitable realization." It is distinct from the moment of "value realization" which is when the dollar value of the assets or firm is determined by sale of the assets or the value of the firm is determined upon confirmation of the plan of reorganization.

This, at least, is the basic concept. Nonetheless it is not unusual for particular creditor constituencies to spend significant effort trying to either structure transactions to assure their priority in the event of a future default, or to even be excluded from the bankruptcy process altogether.

Secured credit is one way of obtaining priority. For many, however, the protection of security of security is not enough. There are limits to the priority enjoyed by secured creditors. They are required to participate in the bankruptcy. Their collateral may be used or sold or both, so long as they receive adequate protection.[68] Their priority is balanced against the goals of reorganization in ways that limit the rights of secured creditors to pick up their marbles to walk away.[69] If the debtor has equity in the property, or if the property is necessary to an effective reorganization, the secured creditor's right to foreclose is stayed, so long as the monetary value of the claim is preserved by providing adequate protection.[70]

66. 11 U.S.C. § 502.
67. 11 U.S.C. § 552(a).
68. 11 U.S.C. § 363.
69. 11 U.S.C. § 364(a).
70. 11 U.S.C. § 361.

For decades, transactional lawyers have sought to create transaction structures that avoid bankruptcy entirely. The holy grail is to create a transaction that is "bankruptcy proof." The favored device is to characterize a financing transaction as a sale rather than a loan or a secured sale. In a securitization the debtor "sells" assets (usually financial assets) to a trust, which in turn issues bonds (to be paid as the loans or receivables are repaid) which are sold to the capital markets. Whether these structures are truly sales or loans turns on the financial attributes of the initial sale transaction. Was the transfer an outright purchase, or did it come along with credit enhancements, such as a guaranty of payment or a right to sell defaulted obligations back to the originator at par? Was the trust "overcollateralized" with an agreement to refund any surplus?[71] The devil is in the details. But the fact that bankruptcy remoteness was an essential feature of these deals became apparent in the late 1990s, when a number of courts gave a hard look at these structures and suggested that the assets in the trust might be estate property.[72] State statutes were immediately passed that stated that assets transferred into a securitization would be excluded from any debtor's bankruptcy estate as a matter of state law.[73] One example was the candidly named Delaware Asset-Backed Securitization Facilitation Act.[74] Similar statutes were passed in Ohio and North Carolina.[75] Another was the inclusion within what later became the bankruptcy amendments of 2005 of a similar safe harbor for securitizations. That one was removed in the wake of the Enron scandal of 2000.[76] A second example is the so-called "bankruptcy safe harbors," which except certain "financial contracts" from the automatic stay and preference avoidance. These will be discussed further below.

The point is that when exclusions from bankruptcy are obtained, they are good news for the particular class of creditors, but this benefit for one class of creditors often comes at the expense of value maximization. For example, the assets tied up in a securitization facility that is

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71. Peter V. Pantaleo (Reporter), Herbert S. Edelman, Frederick L. Feldkamp, Jason Kravitt, Walter McNeill, Thomas E. Plank, Kenneth P. Morrison, Steven L. Schwarcz, Paul Shupack & Barry Zaretsky, *Rethinking the Role of Recourse in the Sale of Financial Assets*, 52 BUS. LAW. 159, 160 (1996). *See also* Lynn M. LoPucki, *The Death of Liability*, 106 YALE L.J. 1, 23-30 (1996).

72. *See, e.g.*, Octagon Gas Sys., Inc. v. Rimmer, 995 F.2d 948, 957 (10th Cir. 1993) ("[B]ecause, under Article 9, a sale of accounts is treated as if it creates a security interest in the accounts, accounts sold by a debtor prior to filing for bankruptcy remain property of the debtor's bankruptcy estate."); *In re* LTV Steel Co., Inc., 274 B.R. 278, 285 (Bankr. N.D. Ohio 2001) ([T]he Court concludes that Debtor has at least some equitable interest in the inventory and receivables, and that this interest is property of the Debtor's estate.").

73. Edward J. Janger, *The Death of Secured Lending*, 25 CARDOZO L. REV. 1759, 1760 (2004).

74. DEL. CODE ANN. tit. 6, §§ 2701A-2703A (2003).

75. OHIO REV. CODE ANN. § 1109.75 (2003).

76. N.C. GEN. STAT. §§ 53-425, 53-426 (2004).

found to be bankruptcy remote would otherwise be available to the debtor to use as "cash collateral."

The interaction between financial distress, the race of diligence, value destruction and equity is complex. Financial distress may trigger the race of diligence (a run). But the race of diligence is not just a race for priority, it is also a race for leverage. Grabbing assets does not just reallocate value. It can destroy value in the process. So, with speed comes both priority and leverage. Bank lenders may call their loans and engage in the race of diligence, but also suppliers can stop shipping, landlords may threaten to evict, etc. When a debtor is in financial distress, creditors will use their leverage in an effort to get paid ahead of other creditors. The automatic stay freezes those creditors in place for the purposes of distributional equity. But it also allows the debtor to take reasonable steps to maximize value. The stay stops creditors from using their leverage to threaten the reorganization and to deny other creditors of the reorganization surplus. In other words, use of leverage to obtain priority also undercuts the goal of value maximization.

B. Equity Amongst Policies—Regulatory Competitions in Bankruptcy

Just as creditors may try to opt-out of equal treatment, the creditors located in each of the policy silos described above may try to use the "policy" rationales that are implicated to obtain preferential treatment. Just as creditors may jockey for position, regulators may argue that their particular policy trumps others. In the bank regulatory context, the catchphrase for "my policy beats your policy" is "systemic risk."

1. Systemic risk as a trump card

The banking crisis of 2007-08 provides a crisp example of how competing claims of systemic risk aggravated the crisis situation rather than ameliorating it. This story starts in the "money" silo with the adoption of bankruptcy "safe-harbors." As early as the 1984 Amendments to the Bankruptcy Code, two concerns were raised about potential systemic risk implications if a broker dealer or derivative counterparty were to fail. The systemic concerns were slightly different in each case, but the solution was the same. With regard to a possible broker-dealer failure, there was concern that the automatic stay might interfere with the clearance of securities transactions that were in process and have systemic ripple effects. With regard to counterparty failure, there was concern that certain money-like instruments—treasury repos, swaps and other derivatives that were treated by the markets as "money-like" or "safe" assets might not

clear as expected and that might interfere with the role played by those instruments in portfolios worldwide.[77]

Both of these systemic risk concerns were solved through the creation of the so-called "bankruptcy safe-harbors" contained in sections 362(b)(6) and (7), and sections 546 (e), (f), and (g). The combined effect of these sections is to exempt these transactions from the bankruptcy case, exempting them from the automatic stay, and treating them as final and protected from later avoidance as a preference or fraudulent conveyance.

To make these examples more concrete, one set of safe harbors applies to transactions, in particular "settlement payments," allowing them to close, even if an intermediate institution in the clearance process fails. The second involves types of instruments, swaps, repos, and other instruments. There, if one of the counterparties goes into bankruptcy, the non-bankrupt party is free to liquidate any collateral or set off against other transactions (close out netting), without regard to the automatic stay.

The principal consequence of the safe harbors is that it abandons equity in favor of payment in full for the specified instruments or transactions. But as a second order effect, this means that firms with safe harbored assets or that engage in safe harbored transactions cannot stop a run. They lose the benefit of the automatic stay, and hence any ability to stop a bank run. This makes it impossible for a firm in the business of holding and trading in safe-harbored securities to reorganize. When these safe harbors were put in place, the risk was seen as tolerable for two reasons: (1) it was assumed that the only institutions likely to fail were small non-systemic institutions; and (2) to the extent that customer deposits of securities were at issue, they were insured.

In sum, the decision was made to sacrifice the reorganization of small broker-dealers to protect the integrity of the instruments and the payment and settlement system. Bankruptcy goals of value maximization and equal treatment were sacrificed to the "money" policies of protecting safe assets and markets.

2. Policymaking in a "zero-sum" world

There are risks to using policy as trumps. A "carveout" from bankruptcy is a decision to sacrifice bankruptcy (and other regulatory) policies. Standing alone, the policy goals of the safe harbors seem sensible—protect the securities clearance process, and the integrity of derivatives markets. But this particular move had three serious unintended consequences. One of those interfered with the bankruptcy goals of

77. Gelpern & Gerding, *supra* note 21, at 393.

equal treatment, while the other led to value destruction. The safe harbors created a privileged set of transactions that were exempt from bankruptcy. Creative lawyers found ways to use these categories to insulate otherwise suspect transactions from avoidance. Transfers in leveraged buyouts that might otherwise have been characterized as fraudulent conveyances or preferences were insulated from avoidance.[78] This consequence was utterly unrelated to the systemic goal of the safe harbors, but it distorted distributions in bankruptcy until the Supreme Court at least partially fixed the problem (after 30 years).[79]

The second unintended consequence was more serious. It never occurred to the advocates of the safe harbors that the broker-dealer that might fail would be a bank of systemic importance and size. Lehman changed all of that. The collapse of Lehman had consequences for global financial markets that lasted for years. Those problems were exacerbated by the inability to stop a run on its derivative portfolio as a result of the safe harbors. Billions of dollars of portfolio value were lost as investors fled.[80]

This led to a third unintended consequence. As Mark Roe has convincingly pointed out, the acts taken to protect the money/clearance policies resulted in systemic contagion.[81] Because of the safe harbors the bankruptcy court in Lehman was unable to stop the bleeding and stabilize the firm. A run on a single institution led to a global run on financial institutions, fundamentally destabilizing global financial markets and setting in motion the "Great Recession." The paradox here is that provisions that granted an opt-out from bankruptcy, ostensibly to prevent one form of systemic risk—clearance risk—ended up exacerbating a second type of risk—contagion risk. The more creditors excluded from the bankruptcy stay, the less effective bankruptcy is at stopping runs. The less ability to stop runs, the less effective in stopping contagion.

Indeed, this point is not lost on bank regulators. Unlike in bankruptcy, where financial contracts are exempted from bankruptcy, when banks

78. *In re* Quebecor World (USA) Inc., 719 F.3d 94, 100 (2d Cir. 2013), *abrogated by* Merit Mgmt. Grp., LP v. FTI Consulting, Inc., 583 U.S. 366 (2018). *Cf. In re* Bernard L. Madoff Inv. Sec., LLC, 440 B.R. 243 (Bankr. S.D.N.Y. 2010) (finding that bankruptcy safe harbor applies to cases of constructive fraudulent conveyance under 11 U.S.C. § 541(a)(1)(B), but not to cases involving intentional fraud under § 541(a)(1)(A)).

79. Merit Mgmt. Grp., LP v. FTI Consulting, Inc., 583 U.S. at 386 (finding that the court must look at the overarching transaction). Even after *Merit Management,* courts have been inclined to re-expand the scope of the safe harbor, using such novel theories as agency. *See In re* Nine W. LBO Sec. Litig., 87 F.4th 130, 145 (2d Cir. 2023), *cert. denied sub nom.* Stafiniak v. Kirschner, No. 23-1081, 2024 WL 2116507 (U.S. May 13, 2024).

80. S*ee* Mark Roe & Stephen Adams, *Restructuring Failed Financial Firms in Bankruptcy: Learning from Lehman*, 32 YALE J. ON REGUL. 363, 386 (2015) ("Alvarez & Marsal, Lehman's restructuring advisor, estimated that the disorderly close-outs of Lehman's derivative portfolio caused the Lehman estate to lose at least $50 billion in portfolio value, and maybe more.").

81. *Id.*

are resolved through an administrative receivership, there are no "safe harbored" financial contracts. Every contract is subject to the same short stay. As will be discussed below, this failure to think across regulatory silos (to give investment banks the same short stay as commercial banks) had significant unintended consequences.

C. Equity and Value Maximization—A Functional Approach

The Lehman experience further illustrates the crucial interrelationship between equity and value maximization in bankruptcy. In financial institution resolution, under Dodd-Frank, SIPA, or otherwise, just as in a more typical bankruptcy, the goal of Chapter 11 is to help accomplish a coordinated resolution of the troubled entity, through a sale of assets, a sale of the enterprise or a recapitalization of the enterprise.

When it works properly, Chapter 11 accomplishes this by seeking to separate the governance decision (what to do with the enterprise) from the value allocation decision. It does this by bringing everybody into the process. The broad automatic stay and the consolidated estate deprive the various creditors (and policy actors) of the power to act unilaterally. The quid pro quo for this loss of a veto right is equity—the assurance that pre-bankruptcy entitlements will be respected in any ultimate distribution. The secured creditor loses the right to foreclose but is assured of the value of their allowed secured claim. The unsecured creditors lose the right to obtain judgments and execute, but are assured that the corporate capital structure will be respected and that the residual value of the firm will be distributed equitably (amongst the junior most claimants that are not wiped out. To the extent that there are inequalities built into the system, they must be in place prior to insolvency. But to the extent that those allocations exist, there must be trust that they will be respected. To accomplish this, creditors must not be allowed to use their situational leverage at the time of financial distress to reallocate distributions.

This principal operates pervasively in the Bankruptcy Code: secured creditors are not allowed to liquidate their collateral; suppliers cannot be paid on their prepetition debt unless approved by the court as beneficial to the estate as a whole; the same is true for curing contractual defaults; preferences are unwound; secreted assets are recovered. Chapter 11 contemplates a three-step process: (1) stop the run; (2) figure out how to maximize the value of the estate as a whole; (3) distribute the value equitably. Both creditor competition and policy competition intersect with this process in the same way. Creditors and policy competitors seek the right to run (exemption at the first stage) so that they can reallocate value (distort equitable distribution at the third stage). The cost is often value destruction.

The Lehman safe harbor story told above illustrates the interaction. Because "money" policy appeared to dictate an exemption for qualified

financial contracts from the stay, safe harbored creditors were allowed to run, and value was destroyed. The Dodd-Frank architecture was a response to the gaps in the regulatory regime revealed by the 2008 crisis, and it got a lot right. It was organized around the two key insights that are described above—that the then existing administrative bank resolution regime was not broad enough in scope to limit contagion, and that regulatory policy could not be implemented at the time of crisis in bankruptcy court, it needed to be worked out in advance and transparently.

The 2023 crises in the banking and crypto sectors provided a first test of this architecture, and it confirmed that Dodd-Frank was on the right track, but that it was insufficient in scope. Its failure to recognize that bank regulation and resolution cannot be limited to banks, or SIFIs, or broker-dealers have left crucial gaps in the regulatory and resolution architectures. Contagion risk does not follow industry boundaries and cannot be limited to regulatory silos. "Bank" capital regulation needs to comprise the regulation of financial intermediaries—any institutions that take customer deposits of money or other investment property. The same is true for bankruptcy courts. If they are called on to maximize value through orderly resolution, they need to be able to broadly stop runs, but stopping runs is also essential to value allocation. The power to run confers a veto on orderly restructuring, and along with that, the power to hold value maximization hostage—fiat priority. In other words, claims of priority should only be recognized if they were built into the regulatory structure in advance.[82]

III. The Lessons of 2023: Resolving non-Systemic Banks and Crypto-intermediaries

In the wake of the financial crisis of 2008, the Dodd-Frank Act addressed the failure of bankruptcy courts to protect the financial system when Lehman failed. On the one hand, the collapse of Lehman can be traced to a regulatory failure—insufficient capital to withstand a downturn in the value of residential mortgage-backed securities. On the other hand, there was a failure in the bankruptcy system to effectively preserve value due to the "safe harbors" described above. The solution was twofold: (1) on the regulatory side, resolution planning for SIFIs; and (2) to facilitate orderly resolution, a grant of Orderly Liquidation Authority. Each of these aspects of Dodd-Frank was designed to make sure that the role played by bankruptcy courts in a SIFI failure was focused on the things that bankruptcy courts do well: value maximization and equity. To

82. While it is beyond the scope of this Essay, the proposed Financial Institution Bankruptcy Act of 2017 reflects a positive attempt to reconcile and harmonize resolution under the Bankruptcy Code and Dodd-Frank. *See* Financial Institution Bankruptcy Act of 2017, H.R. 1667, 115th Cong. (2017).

the extent that safety, soundness and systemic concerns were to be addressed, the hope was that these would be addressed in advance. The lesson of the Silicon Valley Bank failure was that this vision was incomplete and only partially realized.

One of the commands of Dodd-Frank was that non-Bank Systemically Important Financial Institutions would have to prepare themselves for resolution in bankruptcy court should one of their businesses fail. One piece of that process was resolution planning—requiring the financial institution to structure itself so that it could be resolved in bankruptcy with only the holding company filing for bankruptcy. A second piece, however, still unrealized, was to make sure that bankruptcy would work to resolve the assets of and claims against the holding company.

The same safe harbors that caused mischief in the Lehman bankruptcy are still present in the Code. In order for the Bankruptcy Court to fulfill its role in the Dodd-Frank architecture, this needed to be fixed to remedy this. From 2014-17 a statute was introduced to remedy this—the Financial Institutional Bankruptcy Act.[83] The key modification in the proposed legislation would have been to impose a short stay on the closeout netting of qualified financial contracts—balancing the "money" policy of assuring that the parties to financial contracts would get the benefit of their bargain, but also stopping the run to allow for the completion of a transfer of assets and preservation of value for other creditors. This would have implemented an important piece of the functional architecture.

A problem, however, with the proposed amendment to Chapter 11 for bank holding companies is (1) that it never became law, and (2) that it applied only to banks deemed systemic.[84] Even if it had been enacted, it might not have applied to the failure of SVB. As such, the failures of SVB and other banks in 2023, as well as the failure of FTX and other crypto-intermediaries both offer insights into the consequences of these failures.

A. Silicon Valley Bank—Systemic Implications of a non-SIFI Bank Failure

1. Regulatory policy v. equity

The story of Silicon Valley Bank's failure is by now well known. SVB grew its business by catering to tech startups. They both loaned to

83. H.R. 5421, 113th Cong. (2014); H.R. 2947, 114th Cong. (2015); Financial Institution Bankruptcy Act of 2017, H.R. 1667, 115th Cong. (2017).

84. The threshold for access to the proposed subchapter was $50 billion. SVB was larger than that when it failed, but lower than the threshold applicable under Dodd-Frank, at the time it failed.

startups and took their deposits. At the time of their failure, 93% of their deposits were uninsured.[85] Part of the reason for this was that they required their loan clients to maintain deposits at SVB as security for their loans. The flaw in the business model was that a large part of the SVB loan portfolio was held in government bonds. These bonds had the advantage of being low-risk, but their value was sensitive to interest rates. As the Fed raised interest rates in the winter of 2022-23, the value of SVB's assets shrank, to the point where they were carrying significant unrealized losses on their books.[86] This might not have been a problem had they been able to wait until the interest rate environment changed, but instead, a social media-fed run on deposits forced SVB to sell assets at the worst possible moment. On March 10, the bank failed.[87] The FDIC then commenced a receivership and transferred its assets to a bridge bank.[88]

The lead up, failure, and wind down of SVB offers a number of lessons that arise from the failure to extend the Dodd-Frank architecture to banks that were seen as small enough to fail: as a smaller (but still very large) bank, SVB was not subject to capital regulation that was imposed on larger banks; as a smaller (but still very large) bank, SVB was not required to engage in stress testing and resolution planning; and as a smaller (but still very large bank) the trip of its holding company through bankruptcy was anything but orderly. I will take these questions in order, but note first, that all of these failures were failures of bank regulation, not of bankruptcy *per se.*

Somewhat perversely, the guiding principle of the Dodd-Frank architecture was the politics of "too big to fail." The lesson of Lehman was that some financial institutions are so big that if they fail, the reverberations will crash the financial system. This fear motivated the bailout of Bear Stearns, as well as the post-Lehman bailouts of AIG and the formation of the Troubled Asset Relief Program ("TARP"). While the "bailout" of the banking system stabilized the economy and avoided an even worse crisis, the reforms that followed were predicated on the idea that there would be no future bailouts. So, there had to be a dividing line

85. Felix Salmon, *Why Failed Silicon Valley Bank was an Outlier*, AXIOS MKTS. (Mar. 15, 2023), https://www.axios.com/2023/03/15/silicon-valley-bank-outlier-uninsured-deposits [https://perma.cc/SPF5-SGTW]

86. CONG. RSCH. SERV., BANKS' UNREALIZED LOSSES PART 2: COMPARING TO SVB 1 (Sept. 1, 2023), https://crsreports.congress.gov/product/pdf/IN/IN12232 [https://perma.cc/N46W-MQEX].

87. Will Daniel, *Twitter poses a risk to the financial system and helped fuel the SVB run, says first major study to investigate the topic*, FORTUNE (Apr. 24, 2023, 2:39 PM EDT) https://fortune.com/2023/04/24/twitter-financial-system-risk-silicon-valley-bank-run-study [https://perma.cc/P8WH-AZC9].

88. *Failed Bank Information for Silicon Valley Bank*, FDIC, https://www.fdic.gov/resources/resolutions/bank-failures/failed-bank-list/silicon-valley.html [https://perma.cc/NC3X-CBUY].

between banks that could be allowed to fail (because they were small enough) and banks that needed to be closely regulated so that they would not fail.

The Dodd-Frank resolution regime was constructed and imposed only on the largest banks. So, as noted above, TBTF banks were subject to a stress test requirement that required them to maintain sufficient capital and liquidity so the parent holding company could serve as a source of strength for the corporate group. They were required to enter into support agreements between the parent and the subs that would assure that the assets in the holding company would be directed toward the troubled institution, rather than horded for the benefit of the solvent entities. None of these requirements were imposed on smaller banks. Initially the threshold for inclusion in the Dodd-Frank regime was $50 billion. But during the Trump administration the mistake was compounded, when the scrutiny was reduced for banks under $250 billion.[89] Indeed, much of the lobbying for this change came from banks like SVB that were brushing up against the $50 billion threshold.[90]

The error in this calculation was to think that systemic risk lives in a single institution. The hallmark of systemic risk is not the failure of one bank, but the ensuing contagion. A run on one institution may spread to other institutions, and then to the larger economy. As a result, there is no guaranty that the spark that starts the fire will be a TBTF institution. This was the first lesson of SVB. The run on SVB triggered runs at Signature Bank and First Republic as well. In all three cases, uninsured depositors feared that their deposits were at risk. In all three cases, the result was that the FDIC stepped in to "bail out" the uninsured depositors. It invoked an emergency exception to the $250,000 insured deposit limit. Since the run was happening amongst the uninsured depositors, they had to be bailed out. It has long been suggested that TBTF banks were subject to an implicit guaranty. But it turned out that in 2023 the systemic risk was not caused by size—too big to fail—but instead too 'runnable' to fail. There are lots of reasons that the $50 billion threshold for systemic significance left a lot of systemic risk out of the system. Banks on the margin might turn out to be systemically significant. Banks can become systemically significant before the regulators notice, but more importantly, a campfire can start a forest fire.

Leaving medium-sized banks outside the Dodd-Frank framework had a number of unfortunate consequences. In addition to being free of

89. Economic Growth, Regulatory Relief, and Consumer Protection Act (EGRRCPA), Pub. L. No. 115-174 (2018); Erik Sherman, *Congress just approved a bill to dismantle parts of the Dodd-Frank banking rule*, NBC NEWS (May 23, 2018, 7:08 AM EDT), https://www.nbcnews.com/business/economy/congress-just-approved-bill-dismantle-parts-dodd-frank-banking-rule-n876516 [https://perma.cc/WN5E-DV9T].

90. *See supra* note 5.

the stress test obligation, SVB was not required to engage in resolution planning. This failure to plan led to a conflict between the bankruptcy policies of equity and value maximization and the policy of mutual risk bearing embodied in the bank resolution regime. At the time it failed, Silicon Valley Bank was part of a financial services group—Silicon Valley Financial Group, that consisted of SVB, along with over 160 subsidiaries.[91] The holding company had close to $2 billion on deposit at the bank.[92] The treatment of those funds highlights the tension between regulatory policy and bankruptcy principles. Under the functional approach, the holding company would have served as a source of strength and would have been required to commit those assets to the failing bank. In this regard, to understand what actually happened, it is necessary to contrast what would have happened had SVB engaged in resolution planning, and what ended up happening,

If SVB had engaged in resolution planning, the holding company would have been called upon to serve as a source of strength to the bank. It would have entered into an agreement with a bank to give it first call on the holding company's assets. Creditors of the holding company would be required to subordinate themselves to the obligations to the Bank, and to use the holding company assets to maintain the solvency of (bail-in) the bank by pushing those funds into the bank. The theory is that the capital regulations (maintained through stress testing), and the bail-in debt at the holding company level, even if the bank suffered a shock, it would be preserved at the expense of the holding company.

So, when SVB suffered a run, two things happened: (1) the available capital was not sufficient to calm the depositors and stop the run; and (2) the FDIC acted as if there was a support agreement. However, because of the absence of resolution planning, there was no such agreement. The logic of Dodd-Frank was that the bail-in structure would guaranty that an operating company would never fail, and that the losses would be covered by the holding company. Neither assumption proved true with SVB. The holding company did not have sufficient capital to prevent the receivership. Nonetheless, the FDIC acted as if it had a claim on the $2 billion dollars of holding company assets on deposit pursuant to a support agreement that did not exist. The FDIC sought to hold the assets deposited by the holding company at the bank, to use it to pay depositors. While there is a priority in the Bankruptcy Code for commitments made by

91. SVB Fin. Grp., Exhibit 21.1-Subsidiaries of SVB Financial Group, Annual Report (Form 10-K) (Dec. 31, 2022).

92. Alexander Saeedy, *Silicon Valley Bank's Former Parent Sues FDIC Over $2 Billion in Deposits*, WALL ST. J. (July 10, 2023, 1:21 PM ET), https://www.wsj.com/articles/silicon-valley-banks-former-parent-sues-fdic-over-2-billion-in-deposits-e710cc12 [https://perma.cc/S7F7-EWY7].

banks to the FDIC,[93] courts have required any such commitment to be in writing, and in the case of SVB there was no such written agreement.[94] The problem is that, in the absence of a commitment to support the bank, the holding company had no obligation to do so.[95]

Judge Glenn was faced with a decision about whether to favor the SVB depositors at the expense of other creditors of the bankrupt holding company in the absence of a regulatory of legislative command to do so.[96] Faced with complex questions of the interaction between the administrative powers of the FDIC, and the Bankruptcy Code, Judge Glenn granted the FDIC's motion to withdraw the reference to the District Court.[97]

In sum, the failure of Congress to consider smaller banks when imposing both the stress test and resolution planning obligations under Dodd-Frank left the regulators with no help or backstop in bankruptcy court.

2. Resolution and value maximization

The second job of the bankruptcy court was to accomplish the stable transfer of the non-bank businesses of SVB to maximize value for the debtor's estate. This task was divided between the Bankruptcy Court which handled the bankruptcy of SVB's parent company, and the FDIC, which dealt with the resolution of the insured depositary institution. The FDIC initiated a receivership, created a bridge bank, and sold SVB to First Citizens Bank, which continued to honor the accounts of the SVB customers. The sale did not go quickly, as there was not much interest, and the FDIC sold the assets at a $16 billion loss.[98] But the bank was not SVB group's only asset. The holding company owned a variety of other non-bank financial services entities. Those entities were managed in the SVB bankruptcy. In particular, the investment bank subsidiary was sold

93. 11 U.S.C. § 507(a)(9).

94. FDIC, *supra* note 8.

95. Todd H. Baker, *Why SVB Financial is Getting Off Easy in Bankruptcy Court*, WALL ST. J. (July 25, 2023, 6:22 PM ET), https://www.wsj.com/articles/why-svb-financial-is-getting-off-easy-in-bankruptcy-court-holding-company-strength-chapter-11-fdic-14ebcd2 [https://perma.cc/2EQW-GGAN].

96. Dietrich Knauth, *SVB Financial seeks to escrow nearly $2 bln seized by FDIC over lost interest*, REUTERS (Aug. 15, 2023, 3:15 PM EDT), https://www.reuters.com/legal/litigation/svb-financial-seeks-escrow-nearly-2-bln-seized-by-fdic-over-lost-interest-2023-08-15 [https://perma.cc/54PF-4YHW]. *See also* Dietrich Knauth, *SVB Financial says FDIC won't return seized $2 bln*, REUTERS (Nov. 6, 2023, 6:24 PM EST) https://www.reuters.com/legal/litigation/svb-financial-says-fdic-wont-return-seized-2-bln-2023-11-06 [https://perma.cc/3RC4-9G2S].

97. *In re* SVB Fin. Grp., No. 23 CIV. 7218 (JPC), 2023 WL 8622521, at *12 (S.D.N.Y. Dec. 13, 2023) ("Resolution of that [adversary] proceeding will require a court to determine complicated and novel legal issues implicating various provisions of Title 12. . . . . Withdrawal of the reference is thus required.").

98. Lauren Hirsch, *Silicon Valley Bank Sold to First Citizens in Government-Backed Deal,* N.Y. TIMES (Mar. 27, 2023), https://www.nytimes.com/2023/03/27/business/silicon-valley-bank-first-citizens.html [https://perma.cc/6NQF-2PVF].

back to the Bank's founder Jeff Leerink, with court approval.[99] While it was not without hiccups, the receivership appears to have been handled effectively.

In sum, the bankruptcy court fulfilled its responsibility with regard to value maximizing, as did the FDIC. But with regard to distribution, it had to take the institution as it found it. The failure of the FDIC to mandate resolution planning in a smaller bank meant that holding company assets were not available to bail-in the bank. This gap in the regulatory structure was noted by the Federal Reserve's vice-chair for supervision at the time SVB failed.[100] As he put it: "a firm's distress may have systemic consequences through contagion—where concerns about one firm spread to other firms—even if the firm is not extremely large, highly connected to other financial counterparties, or involved in critical financial services."[101] He further recognized that the only way to stop runs is for there to be faith in the capital and the liquidity of the financial institutions: "While the proximate cause of SVB's failure was a liquidity run, the underlying issue was concern about its solvency."[102] This motivates a second lesson from SVB. Trust in the system could not be maintained by insuring only smaller deposits. If the FDIC is going to have to stand behind the small and large depositors of institutions of any size, then stress test (capital) and resolution planning must be comprehensive, and not just limited to larger banks.

B. Crypto-intermediaries

The failures of crypto-intermediaries offer related but slightly different lessons. Again, the failures of Celsius, FTX and others highlight the crucial but limited role that bankruptcy courts play in the regulation of financial services: realization and equitable allocation. The bankruptcies of Celsius and FTX, together illustrate the role of bankruptcy courts in using the concept of "constitutive priority" to give effect to the principle of what Melissa Jacoby and I have previously called, "equitable realization."

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99. *SVB Financial gets court approval to sell investment bank*, REUTERS (July 5, 2023, 6:44 PM EDT), https://www.reuters.com/legal/svb-financial-gets-court-approval-sell-investment-bank-2023-07-05 [https://perma.cc/NA8D-PB48].

100. Jeff Cox, *Fed's Barr calls Silicon Valley Bank failure a 'textbook case of mismanagement',* CNBC (Mar. 27, 2023, 1:29 PM EDT), https://www.cnbc.com/2023/03/27/feds-barr-calls-silicon-valley-bank-failure-a-textbook-case-of-mismanagement.html [https://perma.cc/WV77-9BPF].

101. MICHAEL S. BARR, REVIEW OF THE FEDERAL RESERVE'S SUPERVISION AND REGULATION OF SILICON VALLEY BANK 2, BD. OF GOVERNORS OF THE FED. RSRV. SYS. (Apr. 28, 2023), https://www.federalreserve.gov/publications/files/svb-review-20230428.pdf [https://perma.cc/RR5B-Q2SE].

102. *Id.*

Much of the excitement about digital assets turns on the decentralized architecture facilitated by blockchain. The promise of crypto is that it provides a mechanism for transferring and storing value without the need to interact with a financial—to allow cash and other formerly paperized negotiable instruments, such as checks, promissory notes, mortgage notes, and chattel paper, to exist on a computer. Blockchain creates the ability to create a single authoritative computer record that can be authenticated and carries with it its own provenance or chain of title. This is not exactly new. Checks and other forms of commercial paper functioned in this way for hundreds of years. The limitation was that they were all on paper, and paper takes up space and is difficult to move from place to place.

The irony of crypto is that, in practice, the way in which owners of digital assets held their assets or transacted was through the use of digital wallets provided by crypto-intermediaries like Celsius, BlockFi and FTX. The great question raised when these intermediaries failed was who "owned" the crypto held in the various wallets—the customer/depositor or the intermediary. Customers viewed the assets as "theirs," and their claim to those assets as senior to other claims against the intermediary. Whether this was in fact true came before the court in *Celsius* and has been an issue in the FTX case. The issue played out differently in each, and in ways that are instructive.

1. Celsius

After filing for bankruptcy, Celsius sought to sell digital assets (in this case stablecoins) that were held in customer's so-called "Earn" accounts (wallets). The debtor wished to sell the assets to provide liquidity to fund the case. Representatives of the customers objected, arguing that they owned the assets in their accounts. The debtor responded that under the terms of service for the Earn accounts, the customers agreed to transfer the title to their crypto to Celsius.[103] At the time of the filing a Celsius account holder could participate in three different programs. The main program was the "Earn" program, under which Celsius was permitted to reinvest the customer's deposited crypto, and the customers would share in the benefit of those transactions. The second was the "Custody" program under which Celsius could not reinvest the deposited funds, but the accounts did not bear interest. Finally, in the "Borrow" program, customers would deposit crypto with Celsius as collateral for cash advances. The vast majority of deposits were held in Earn accounts which earned inter-

103. *In re* Celsius Network LLC, 647 B.R. 631, 640 (Bankr. S.D.N.Y. 2023).

est of approximately 20%.[104] The Custody customers were further divided into two categories—customers who only had custody accounts, and customers who moved their money between their Custody and Earn accounts. This was significant because Custody expanded its Custody account program to include all Earn account holders on April 15, 2022, 89 days before Celsius filed for bankruptcy.[105] So, while the motion to sell only involved assets that were still in the Earn accounts, the result had implications for the Custody account holders as well, as customers who moved funds from Earn accounts into Custody accounts within 90 days of the bankruptcy were faced with possible preference liability.

The court resolved the question as a contract issue, concluding that the language of the contract was clear and unambiguous. Even though the contract language was contained in a standard form of adhesion, the court concluded that under New York law, the transfer of title would be effective. As a result, the customers were to be treated as ordinary unsecured creditors of the debtor.[106] Significantly, Judge Glenn made no determination as to the status of the "custody" accounts.

Because Judge Glenn resolved the case based on contract, it was not necessary to reach either the preference issues, or the harder question of what would happen if the debtor had misappropriated or commingled assets held in the Earn accounts. Indeed, Judge Glenn acknowledged that, if that had happened there would have been a further question of whether the retention of title would be recognized in bankruptcy under the Trustee's strong-arm power.[107]

While Judge Glenn did not determine the status of the Custody accounts, the basic principles laid out in the Earn account decision dictated the remaining decisions in the case. For example, holders of Custody accounts who had never held assets in Earn accounts were allowed to withdraw their funds in March of 2022.[108] A settlement was negotiated with respect to the other Custody funds the court approved a settlement under which holders of Custody assets could resolve their preference liability if they limited their return to 72.5% of their assets.[109]

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104. Leo Jakobsen, *Bankruptcy Court Approves 72.5% Payout to Celsius Custody Customers*, YAHOO FIN. (Mar. 22, 2023), https://finance.yahoo.com/news/bankruptcy-court-approves-72-5-123540684.html [https://perma.cc/D7YY-J26X].

105. CELSIUS, *Custody FAQ,* https://support.celsius.network/hc/en-us/articles/4838161060381-Custody-FAQ [https://perma.cc/244Q-TH2R].

106. *See Celsius*, 647 B.R. at 651.

107. *Id.* at 658. The strong-arm power allows the trustee to avoid purported transfers of property that would not be recognized as effective against third parties under applicable non-bankruptcy law. 11 U.S.C. § 544.

108. Luke Huigsloot, *Celsius Custody customers finally begin withdrawals 263 days after freeze*, COINTELEGRAPH (Mar. 3, 2023), https://cointelegraph.com/news/celsius-custody-customers-finally-begin-withdrawals-263-days-after-freeze [https://perma.cc/68D2-E9PN].

109. Stephanie Murray, *Judge approves Celsius custody account settlement to return 72.5% of crypto assets*, THE BLOCK (Mar. 23, 2023, 1:23 PM EDT), https://www.theblock.co/post/

At the moment a plan of reorganization seems headed for approval under which the distribution to customers holding Earn accounts would have them treated as general unsecured creditors.[110] The estimated recovery for the unsecured creditors would be 69.7% if the plan was confirmed and the contemplated sale of the business was accomplished.[111] While the customers with Custody accounts were given the option to participate in the settlement described above, and receive 72.5%, or to receive a return of their crypto, but subject to any avoidance claims that might be held by the debtor.[112] By the standards of most bankruptcies, these recoveries are quite impressive. One twist is that since the effective date of the Plan, crypto values have increased substantially. However, since assets had to be liquidated on the effective date of the plan, to fund cash distributions, the claimants did not receive the benefit of that appreciation.[113]

2. FTX

A similar issue arose in the FTX bankruptcy—what was the priority of the depositor's crypto. But there was a difference. The FTX terms of service did not contain language transferring title. Indeed, the terms of service provided that, "title to your digital assets shall at all times remain with you and shall not transfer to FTX Trading."[114] Notwithstanding this representation, at the time of the bankruptcy filing, less than 1% of the Bitcoin and 1.2% Ethereum held in those accounts was actually there. But due to its ability to recover investments made in Alameda Research, and the AI company Anthropic, as well as increase in the value of crypto,

221642/judge-approves-celsius-custody-settlement-account-holders [https://perma.cc/HYM4-N8XG].

110. Fourth Notice of Filing of Revised Disclosure Statement for the Joint Chapter 11 Plan of Reorganization of Celsius Network LLC and its Debtor Affiliates 32, *In re* Celsius Network LLC, 647 B.R. 631 (Bankr. S.D.N.Y. Aug. 17, 2023), https://cases.stretto.com/public/x191/11749/PLEADINGS/1174908172380000000088.pdf [https://perma.cc/R2YQ-XN4X] [hereinafter Celsius Plan of Reorganization].

111. *Id.* at 27, Letter from Official Committee of Unsecured Creditors to Account Holders and General Unsecured Creditors of Celsius Network LLC, et al. 3, *In re* Celsius Network LLC, 647 B.R. 631, 640 (Bankr. S.D.N.Y. Aug. 18, 2023), https://cases.stretto.com/public/x191/11749/CORRESPONDENCE/1174908182350000000092.pdf [https://perma.cc/7WWU-QDDR]. The proposed resolution of the business is described here: Michael DiPietro, Stephen Rutenberg & Shreyas Kafle, *Celsius Bankruptcy: With the Filing of the Disclosure Statement, is the end in sight for this Marathon of Uncertainty*, JDSUPRA (Aug. 10, 2023), https://www.jdsupra.com/legalnews/celsius-bankruptcy-with-the-filing-of-9151416 [https://perma.cc/KN98-FQ5M].

112. Celsius Plan of Reorganization, *supra* note 110, at 33.

113. Christopher Roark, *Celsius creditors allege 30% less compensation than promised during bankruptcy*, COINTELGRAPH (Mar. 15, 2024) https://cointelegraph.com/news/celsius-creditors-allege-compensation-reduction [https://perma.cc/6JNV-KZMG].

114. Nikhilesh De, *SBF Trial: What Did FTX's Terms of Service Say About Customer Funds?*, COINDESK (Oct 16, 2023, 11:50 AM EDT), https://www.coindesk.com/policy/2023/10/16/sbf-trial-what-did-ftxs-terms-of-service-say-about-customer-funds [https://perma.cc/P3BG-V6JW].

the plan of reorganization will be returning depositors between 98 and 118% of their invested funds.[115]

Both the Celsius and FTX cases are illustrative. They reflect both the chaos and strong feelings that are generated when a financial intermediary goes bust. Hard decisions have to be made about priority, even when they defeat customer expectations. The demands of equitable treatment may feel unfair in the individual case. On the other hand, in both cases, the lawyers and bankruptcy courts managed to impose order on chaos, recovered assets, and administered them.

IV. Rhyme or Reason

When one looks at the 2023 resolution of non-systemic banks and crypto-intermediaries one sees a fair amount of chaos and ad hoc-ness. But there are successes as well. On the one hand, the system appears to have worked well enough. The banking system withstood the wave of bank and crypto failures without unraveling. Given the instability in the broader world at the same time, this is quite an accomplishment. Nonetheless, the crises of 2022-23 revealed some cracks in the system that should be addressed rather than ignored. In this last section, we consider both the cracks in the system and the role of bankruptcy courts in addressing those problems. So, first, the successes and failures of bankruptcy in particular, and then the successes and failures of the regulatory scheme more generally.

A. Resolution through Receivership and Bankruptcy—Value Preservation and System Stability.

The first takeaway of the last year is that the various resolution regimes have worked well enough. The bank resolution regime managed to protect the customers and borrowers of Silicon Valley Bank, First Republic, Signature Bank, and others. The bank receivership regime worked well where it needed to. The Silicon Valley Bridge Bank accomplished the sale of SVB's operations to Valley Bank. The Silicon Valley Group Bankruptcy accomplished the sale and continued operation of its non-bank businesses as well. In the case of Celsius and FTX, the bankruptcy courts have managed to simultaneously preserve the value of customer assets, saved the pieces of the businesses that were viable, and engaged in aggressive recovery of assets. Both the bank receivership and the bank-

115. Cheyenne Ligon, *Nearly All FTX Creditors Will Get 118% of Their Funds Back in Cash, Estate Says in New Plan*, COINDESK (May 7, 2024, 10:49 PM EDT), https://www.coindesk.com/policy/2024/05/08/nearly-all-ftx-creditors-will-get-118-of-their-funds-back-in-cash-estate-says-in-new-plan [https://perma.cc/5UTQ-PHJA].

ruptcy court demonstrated the institutional capacity to make the most of a bad situation.

B. Apparent Cracks in the Architecture

In each of the cases discussed above, while the resolution process worked, there were apparent inequities that arose because of failure in each of the regulatory silos discussed above, to take a systemwide approach. While these were not flaws in the resolution process, the regulatory failures were revealed as the resolution process unfolded. In the case of SVB, the failure to extend resolution planning to cover non-systemic banks allowed the shareholders of the non-bank entities to shift risk to the SVB depositors and therefore to the FDIC. In the case of Celsius, the failure to extend bank and securities regulation to cover crypto-intermediaries harmed the customers of Celsius and FTX. Customers who thought that they owned their crypto found that they were victims of both fraud and of the terms of the contracts they signed.

C. Constitutive Equity: Constitutive Priority and Fiat Priority

The common theme that emerges from each of the cases discussed above, is that while regulation of the financial system may be handled in each of the four silos discussed above, it falls to bankruptcy courts to pick up the pieces when things fall through the regulatory cracks. This is both bankruptcy's greatest strength and its weakness. It takes the debtor as it finds it. It also takes the regulatory regime as it finds it. Bankruptcy is a default regime. In this regard, the bankruptcy court's role is constitutive of the regulatory ecosystem, and the constitutive value is equitable treatment—to allocate value in a way that treats similarly situated creditors equally. In each of the cases discussed, nobody has criticized the bankruptcy courts for the decisions made to recover for creditors. The issues that have arisen are the apparent inequity of distribution. For the most part, bankruptcy law does not prioritize stakeholders itself; it seeks to respect the priorities that are established under applicable non-bankruptcy law, and to preserve the relative position of creditors while realizing the value of the debtor.

The point is that it is non-bankruptcy law that establishes when a loss allocation regime will deviate from equality. Or to put it the other way around, it is non-bankruptcy law that determines when one stakeholder will take priority over others. Each of the silos seeks to impose its imprint on the bankruptcy process and the bankruptcy distributional scheme. The examples described above illustrate three different models: (1) effective policy-based priority; (2) ineffective policy-based priority; (3) value-destructive priority. The first category can be illustrated by looking at the Dodd-Frank design as contemplated. The second category

is illustrated by both SVB and the seemingly random treatment of depositors in the crypto cases. The third is illustrated by the bankruptcy safe harbors as illustrated by Lehman (and by negative inference in the crypto cases).

In this Section, I will argue that the contours of the first two categories illustrate a concept that I call "constitutive priority" that gives effect to the bankruptcy principal of "equitable realization" that Melissa Jacoby and I have argued elsewhere serves both fairness and value creation. The third category is an illustration of pernicious policy competition that I call "fiat priority" that undercuts fairness and destroys value by allowing one stakeholder to hold the reorganization hostage to its whims.

1. Constitutive Priority

To understand the interrelated concepts of "equitable realization" and "constitutive priority" it is necessary to step back and look at the bankruptcy priority scheme from the first principles discussed above. Contractual promises and tort duties reflect the obligations that one member of society owes to another, based on their relationship with each other. Bankruptcy law is different. It is about adjudicating the competing claims of creditors against a debtor who has absconded. The only relationship amongst the creditors is that the debtor owes them money. This gives rise to the default rule that unless there's a reason to do otherwise, the creditors are on an equal footing with regard to sharing the value of the debtor. It recognizes that a competition of creditors to grab value will destroy value. It also recognizes that if priorities are to be given effect, they must either be transparent to other creditors or fair as a matter of policy. This is the logic behind requiring notice of perfection of mortgages and specified categories for statutory priority.[116] These principles allow creditors to manage risk when they extend credit. They also create the signposts for equitable treatment of creditors and for managing the relative position of creditors as value is realized.[117]

2. Fiat Priority

A second feature of modern bankruptcy statutes, and in particular Chapter 11 is that they seek to separate decisions about how to maximize the value of the debtor from how value is allocated—to prevent the use of creditor leverage to affect distributions. The automatic stay and the broad

116. 11 U.S.C. §§ 544, 507. The strong-arm power found in Section 544 of the Bankruptcy Code avoids unperfected security that do not satisfy the notice requirements contained in Article 9. For unsecured creditors to gain priority, they must fall into the categories described in Section 507 of the Bankruptcy Code.

117. Jacoby & Janger, *supra* note 11, at 708.

scope of the estate in Chapter 11 are the principal tools to accomplish this.[118] A secured creditor cannot repossess and liquidate their collateral. A lender cannot set off its claims, etc. They must wait until the debtor has had a chance to organize its affairs. Nonetheless creditors sometimes seek to use situational leverage—hostage value—to affect distribution. Critical vendors may refuse to ship unless paid in full.[119] A lender may refuse to extend credit unless prepetition debt is repaid.[120] In many cases the court may permit these transactions, but only after an opportunity to object and a determination that they are in the best interests of the estate. A fiat priority is a priority where the creditor has the unilateral power to end the game (the reorganization) by picking up their marbles and going home.

D. Constitutive Equity for Financial Intermediaries

The concepts of constitutive and fiat priority allow us to observe both the limits of bankruptcy, but also their superpower—by preserving and instantiating a norm of fair and equitable distribution, they help bolster the trust and stability that is constitutive of the financial system.

The Dodd-Frank architecture of stress testing, resolution planning and bail-in can be seen as a fully realized scheme of regulation through constitutive priority. The regulatory scheme contemplates and requires that a bank holding company operate as a source of strength for the operating companies. The FDIC required that the top-level holding company maintain adequate capital to refinance a troubled subsidiary. It further required that the creditors of the holding company structurally subordinate to the creditors of the operating company, and that the holding company enter into a support agreement with the operating companies. These plans were to be transparent, reviewed by the regulators, and public. One might argue that we still do not know if the structure will work. But this is because in the most recent crisis none of the banks that were subject to Dodd-Frank found themselves at risk.

Silicon Valley Bank's failure showed what might happen in the absence of a fully realized scheme. The parent did not maintain adequate capital, did not serve as a source of strength when one of the operating companies (SVB) fell into difficulty, and when the holding company failed there was no support agreement to force the holding company to put the consumer depositors ahead of the other still solvent entities. While this can be viewed as a regulatory failure, it was, but it was not a

118. 11 U.S.C. §§ 362, 541.

119. *In re* Kmart Corp., 359 F.3d 866, 873 (7th Cir. 2004).

120. *In re* Saybrook Mfg. Co., Inc., 963 F.2d 1490 (11th Cir. 1992); Otte v. Mfrs. Hanover Com. Corp. (*In re* Texlon Corp.), 596 F.2d 1092, 1094 (2d Cir. 1979); Shapiro v. Saybrook, 963 F.2d 1490 (11th Cir. 1992).

failure of the bankruptcy court. The problem is that the FDIC and hence the bank had not done what was required to establish a fully disclosed and transparent priority (constitutive priority). The interstitial default, the treatment when there is no planning, or it is not fully implemented is equality. The same lesson appears in Celsius, where the Earn account depositors sought priority in the absence of a contractual or statutory basis for special treatment.

The concept of fiat priority can be illustrated through the lessons of the derivative safe harbors in Lehman. The safe harbors are an intervention from the "money" silo described above. They are not a priority *per se*, but an exception from the automatic stay that gives the holders of certain assets the right to pick up their marbles and go home without seeking court authorization. Where a debtor holds a significant quantity of safe harbored assets, as a securities broker-dealer, or bank might, the safe harbors, as noted above can spell the end of an orderly winding down of the institution. This was not a problem for SVB, because it was a bank and the safe harbors do not apply to bank receiverships. It was also not a problem for FTX and Celsius because crypto assets have not been held to be securities or commodities contracts, so they are not safe harbored (though they might soon be). The fact that the safe harbors did not apply has allowed Celsius and FTX to engage in an orderly wind down and protect the viable parts of the business.

Each of the examples discussed above, reveals a distinct aspect of "constitutive priority. First, Lehman reveals the inequity and value destruction that occurs in a world of fiat priority. Because of the safe harbors, the resolution was disorderly and inequitable. Second, the normal functioning of the resolution regime under Dodd Frank and its resolution planning regime provides an example of how a transparent structure, clear expectations, in conjunction with capital rules can complement the regulatory structure, assure adequate capital and provide a robust buffer to financial distress. Meanwhile, both Celsius and FTX illustrate how constitutive equity can and should function where the requirements for priority are not met. On the one hand, Celsius illustrates that where the requirements for creating *in rem* rights are not adhered to, security fails, and the creditor shares pro rata. On the other hand, FTX illustrates what happens when the property rights are created, but the property disappears. The group of claimants with claims against the assets may take priority, but they also must share the loss suffered by the disappearance of collateral equally.[110]

E. The Role of Bankruptcy Courts in the Regulation of Financial Intermediaries

This review of the various roles played by bankruptcy courts in the resolution of the most recent round of failed financial institutions shows

that bankruptcy courts play a limited but crucial role in the regulation of financial institutions. Bankruptcy courts and the Bankruptcy Code do not set regulatory policy. They receive it. However, as with any complicated regulatory scheme, there are multiple institutions, players and policies in play. When an institution fails all of the various policy imperatives arrive on the courthouse steps. The Bankruptcy Judge is in the unenviable position of balancing the competing policy concerns like financial system stability, money policy, and value preservation, while trying to make sure that parties are treated fairly in the process.

This piece argues that the lesson of the 2023 crisis is twofold. First, the bankruptcy courts acquitted themselves well by attending to the principle of equal treatment unless a claim to priority can establish its bona fides, and the separation of decisions about realization of value from creditor attempts to wield transactional power. Second, 2023 demonstrated the limits to what Bankruptcy Courts can do. They can pick up the pieces. They can limit contagion, up to a point, and they can preserve value. But they still take the debtors as they find them. Orderly resolution ex post is not a substitute, for example, for an effective requirement of resolution planning for financial intermediaries of all shapes and sizes. Orderly resolution cannot function without an effective automatic stay, so exceptions in the form of safe harbors must be carefully drawn and limited to the instruments and institutions where they are absolutely essential. The same thing goes for priorities, that need to be transparent and adhered to.

These lessons are particularly important as new technologies and new types of assets make capital more and more mobile. Runs can start anywhere, and the technological interlinkages associated with digital assets enhance the possibilities of runs that start anywhere in the ecosystem to become systemic. The focus of this Essay has been on bankruptcy courts, but the fluidity of capital, the heterogeneity of intermediaries, and the multiplicity of fora make a functional and symmetric approach imperative.

Conclusion

This Essay has sought to situate bankruptcy courts and bankruptcy law within the broader ecosystem of the regulation of banks and other financial intermediaries. It seeks to take a functional view of both what is a "bank" and what are the regulatory policies served by "bank regulation." This Essay recognizes that the term "bank" comprises traditional government-chartered banks, but also investment banks, and so-called "crypto-banks," all of which hold customer deposits of money, securities, or digital assets, and all of which reinvest those funds in the hope of making a profit on the interest rate spread. These common features mean that these firms raise common regulatory concerns, even though they may not

be regulated by the same regulator: (1) depositor protection, (2) institutional safety and soundness, (3) systemic risk, and (4) fiscal policy. This is true, even though the various institutions may operate within, or fall between the cracks of a variety of regulatory regimes. Further, failed financial institutions may use bankruptcy courts in different ways depending on the governing regulatory regime.

This functional perspective reveals two fundamental insights—one about financial intermediary regulation and a second about the role of bankruptcy courts as a generic forum for resolving financial distress.

The first lesson demonstrated by the spate of near systemic "bank" failures in 2022-23 is that the Dodd-Frank regime made a fundamental error when it limited its focus to institutions that were deemed systemically significant—too big to fail. The principal systemic risk faced by our modern financial system is the risk of contagion. But contagion can originate anywhere, so the tools for stemming it, and the regulatory policies for avoiding it must be implemented across the financial ecosystem.

The second lesson that emerges from this functional approach is the crucial but limited role played by bankruptcy courts—providing a generic forum for minimizing disruption to the business enterprise, maximizing its value and distributing that value fairly to the failed firm's various stakeholders. This Essay concludes that bankruptcy courts are dependent on and may be frustrated by the failures in the non-bankruptcy regulatory regime. Indeed, the failures of, and seeming inequities[121] that have appeared in major cases can all be traced to failures in the underlying regulatory scheme rather than bankruptcy courts *per se*, or to attempts by partisans of one policy to interfere with the bankruptcy principal of constitutive equity.

To understand the role of bankruptcy courts, one must understand the central approach of bankruptcy law—to stop runs on a firm, and thereby preserve value and the ability to distribute that value equitably. In a traditional bankruptcy, this means stopping the rush of creditors to dismember the debtors by grabbing assets. This Essay points out that just as creditors compete for priority, so may regulators. Depositor protection policies may compete with anti-contagion policies, which may compete with safety and soundness policies, which may compete with fiscal policy concerns. This Essay argues that bankruptcy courts are well-situated to balance these concerns. This is the day-to-day job of bankruptcy courts. The automatic stay stops the race of diligence.[122] It stops collection efforts, while the relative positions of creditors are fixed as of the petition date, for unsecured creditors by 11 U.S.C. § 502 and as between secured

121. Such as the decision not to give priority to customer deposits in *Celsius,* discussed above.

122. 11 U.S.C. § 362.

and unsecured creditors, by § 552. But value can only be maximized fairly if the bankruptcy courts they are granted sufficient powers to stop policy competition as well as creditor competition, and only if they follow three fundamental principles of value allocation: giving effect to "equitable realization" and "constitutive priority," while rejecting "fiat priority."

First, equitable realization: when a bankruptcy (or other resolution proceeding) is opened, the relative position of creditors is fixed, even though the amount of recovery may still be uncertain. Second, constitutive priority: in the absence of a fully implemented policy-based priority or property right that meets the requirements for subordinating third parties. In the absence of such a clearly established priority or property right, the creditors should share with others pro rata (as in *Celsius*). Third, rejection or unwinding of fiat priority: priorities that operate by excepting a party from the bankruptcy moratorium, or which seek to distort the priority scheme through the exercise of situational leverage should be avoided (as with the safe harbors), closely scrutinized (as with critical vendors or financing orders) or clawed back.