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Legal Sidebar

Federal Statutory Bankruptcy Alternatives: A Roadmap

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In most cases, a bankrupt entity will either liquidate or reorganize under the U.S. Bankruptcy Code, and the U.S. bankruptcy courts will administer those proceedings. There are, however, certain entities, such as banks and brokerages, that follow a different path when they become insolvent.

This Legal Sidebar presents an overview of federal restructuring regimes that operate alongside the Bankruptcy Code. Some of these regimes have been in place for decades, such as those operated by the Federal Deposit Insurance Corporation (FDIC), the National Credit Union Administration (NCUA) Board, and the Securities Investor Protection Corporation (SIPC). The Orderly Liquidation Authority (OLA), a product of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act) is a newer and untested system. This Sidebar also discusses the subchapter of the Bankruptcy Code that deals with commodities brokers, which incorporates laws and rules from the Commodity Futures Trading Commission (CFTC). For each of these regimes, this Sidebar explains how they differ from a traditional bankruptcy. There also are legal mechanisms under each state's law that govern the resolution of insurance company insolvencies, but this Sidebar discusses only federal bankruptcy alternatives. This sidebar concludes with brief considerations for Congress on how a bankrupt or distressed crypto company may fit into these statutory regimes.

The SIPC – A Unique Trustee Program for Brokerage Firms

The Bankruptcy Code provides for the liquidation of a stock brokerage, yet these firms have another way to liquidate. The Securities Investor Protection Act of 1970 (SIPA), codified at 15 U.S.C. §§ 78aaa-111, created the SIPC. The SIPC is a nonprofit, private-membership corporation consisting of most brokers and dealers registered under Section 15(b) of the Securities Exchange Act of 1934. As of December 2021, more than 3,400 entities are SIPC members.

Of special importance to the SIPC liquidation regime is the SIPC fund. All SIPC members must make payments to the fund, which in turn pays for all SIPC expenditures. Also included in the value of the fund is the fair market value of and interest accrued on U.S. Government securities owned by the SIPC. As of December 2021, the value of the fund was $4.16 billion. The fund reimburses customers of a failed brokerage firm for the value of up to $500,000 in securities, with claims for cash limited to $250,000 per customer.

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A seven-member board of directors oversees the SIPC. Self-regulatory organizations—including stock exchanges and the Financial Industry Regulatory Authority (FINRA)—and the Securities and Exchange Commission (SEC) report to the SIPC about member broker-dealers who are in or nearing financial difficulty. If SIPC determines that the member's customers require SIPA protection, SIPC begins a "customer protection proceeding" by applying to a U.S. district court for the appointment of a trustee (SIPC trustee) to carry out a liquidation.

A SIPC trustee has the same powers as a bankruptcy trustee under Title 11 of the Bankruptcy Code. A SIPC trustee's authority also goes further. Unlike a bankruptcy trustee, a SIPC trustee may purchase securities to satisfy customer net equity claims to particular securities. As to "street name" securities, or securities held by a brokerage firm on behalf of a client, customers file a claim with the SIPC trustee and, if the claim is meritorious, the trustee will satisfy the claim with either cash or, when possible, securities. A SIPC trustee also must return "customer name securities," or securities registered directly in the customer's name, to the brokerage's customers and make distributions of customer property from the fund.

In most cases, a failed brokerage firm will not proceed to SIPC liquidation if the SIPC can transfer the failed firm's assets to a different brokerage firm, but the firm will proceed to the rare next step of liquidation if SIPC cannot arrange the account transfer. In a SIPC liquidation, the SIPC and the SIPC trustee close down the failed brokerage firm and work to assume control of the firm's books and records. Next, the trustee compiles a list of all customers who had an account with the brokerage firm within the prior year, while obtaining court approval for the forms customers will use to file claims in the liquidation. The SIPC trustee works to recover assets belonging to the firm and its customers and report on the reasons for the firm's failure to the court and SIPC.

Although the bankruptcy and SIPA regimes are similar—the Bankruptcy Code also provides for the return of customer name securities, for instance—liquidation under SIPA differs from a traditional bankruptcy in many ways. A bankruptcy trustee will seek to convert securities to cash in satisfaction of the claims against the debtor and then distribute the proceeds ratably, while a SIPC trustee must distribute securities to their associated customers. Unlike the Bankruptcy Code, SIPA provides preferential treatment to one type of creditor, customers with claims for securities and cash in their accounts by providing them with insurance. A bankruptcy trustee seeks to sell all non-customer name securities while a SIPA trustee works to return securities to customers where possible. Also distinct from Chapters 7 and 11 of the Bankruptcy Code, an individual or group of individual creditors may not drag a debtor into SIPA liquidation.

The FDIC – Receiverships and Prompt Corrective Action for Banks

The FDIC plays a similar role in the winding down of failed banks that SIPC does for struggling brokerage firms. The FDIC is an independent agency created to maintain stability in the American banking system. The agency's enabling statute is the Federal Deposit Insurance Act (FDI Act). The FDIC plays two roles in the event of a failed bank, by insuring deposits up to $250,000 through the Deposit Insurance Fund (DIF) and by serving as the failed bank's receiver.

The need for an agency to supervise the administration of a failed bank comes from the Bankruptcy Code. Section 109 of the Code, which sets forth who may be a debtor, carves out banks from eligibility for bankruptcy. This means that neither a bank nor its creditors may bring a bank into bankruptcy.

Following a bank's failure, the FDIC evaluates the bank's finances and seeks to have a healthy bank acquire the failed bank's assets, in all or in part. If acquisition of the bank is impossible, the FDIC may act according to its authority under the FDI Act, as modified by the Financial Institutions Reform, Recovery, and Enforcement Act of 1989, to act as either a receiver or conservator for the failed bank. The key distinction between a conservatorship and a receivership is that a conservator may continue to operate a bank or dispose of it, while a receiver is empowered to liquidate the bank and wind down its affairs. As summarized by the Seventh Circuit, a "conservatorship that *required* liquidation would be, in effect, a receivership."

As to the distinctions between an FDIC proceeding and bankruptcy, perhaps the greatest procedural difference is that FDIC receiverships are administrative while a bankruptcy takes place in court. There is thus no ongoing judicial oversight of an FDIC conservatorship or receivership. An FDIC receiver is also acting under statutory authority, while a bankruptcy trustee is appointed by the bankruptcy court.

As for substance, the FDIC and the Bankruptcy Code have different priority schemes. The FDIC must resolve a failed bank according to what is least costly to the DIF. The FDIC's rule and regulations give preferential treatment to a failed bank's depositors vis-á-vis other unsecured creditors. Additionally, creditors have fewer means of participating in an FDIC resolution scheme than they do in bankruptcy.

The NCUA – A Credit Union Parallel to Banks

The NCUA is an independent agency overseen by a three-person board (the NCUA Board). Along with the FDIC, the NCUA is one of two agencies that provide deposit insurance; in the NCUA's case, to credit unions. Under the Federal Credit Union Act, the NCUA's role is to charter federal credit unions, regulate federal credit unions and state-chartered credit unions, and administer the Share Insurance Fund, which insures the deposits for credit union members up to $250,000.

Upon learning that a credit union is in danger of failing, the NCUA Board has the authority to place a credit union into a conservatorship. During a conservatorship, the credit union remains open and the Share Insurance Fund continues to insure accounts. Following the creation of a conservatorship, a credit union may apply to a U.S. district court for an order requiring the NCUA Board to show cause why it should not be enjoined from continuing the conservatorship.

The agency may also close an insolvent credit union for liquidation and appoint itself the liquidating agent for the credit union. For now, the NCUA's Asset Management and Assistance Center sets up an asset management estate to control the former credit union's assets, settle insurance claims by credit union members, and attempt to recover value from the former credit union's assets.

The text of the Federal Credit Union Act defines liquidation in mandatory terms. The NCUA board does not have discretion when closing a failed credit union for liquidation. In a departure from the Bankruptcy Code, where a debtor may move to dismiss an involuntary petition, a credit union has no express legal recourse once the NCUA had closed it for liquidation. At least one district court has ruled that a credit union should have a chance to contest the NCUA's decision to liquidate, but only upon a showing that the credit union was not insolvent. That court held that the credit union's rights here sounded in the Due Process Clause, and not the Federal Credit Union Act.

The OLA – An Untested Mechanism

Title II of the Dodd-Frank Act created the OLA. Under the OLA, the FDIC administers a regime geared towards resolving nonbank financial firms whose standalone failure could destabilize the national financial system. Congress created the OLA as an alternative to bankruptcy.

The OLA authorizes the Secretary of the Treasury, following the recommendation of the Federal Reserve Board and the Board of the FDIC, to appoint the FDIC as receiver of a distressed financial company. The FDIC occupies a similar role in this space as it does in its traditional capacity. Here, it steps in as receiver for entities that would normally declare bankruptcy. Much of the debate around the OLA's creation focused on whether it was necessary given the Bankruptcy Code. The government has yet to use the OLA more than a decade since its implementation.

Although untested, the OLA operates at a meeting point of multiple regulatory agencies. In 2020, the FDIC and the SEC adopted a final rule that clarified the liquidation process under the OLA for certain brokers or dealers who would normally liquidate through an SIPC proceeding. Under the final rule, in an orderly liquidation of a covered broker or dealer, the FDIC would continue to serve as receiver while the SIPC would act as a trustee, looking to determine and satisfy customer claims just as it would during a SIPA liquidation.

The OLA's aim of mitigating systemic risk signifies an instance in which the Bankruptcy Code is inadequate to resolve a failing company. If a company's failing triggers the OLA, a practitioner would not only need an understanding of the Dodd-Frank Act, but the OLA's implementing regulations, codified at 12 C.F.R. § 380. Additionally, as the OLA empowers the FDIC to wind down a large company, it also removes those proceedings from the court system.

The CFTC – A Hybrid Title 11

The process for liquidating a futures commission merchant (FCM) or derivatives clearing organization (DCO) occurs partially under the Bankruptcy Code. Chapter 7, Subchapter IV, of the Bankruptcy Code deals exclusively with the liquidation of a commodity broker. This subset of bankruptcy resides in Chapter 7 of the Bankruptcy Code (liquidation) because the Bankruptcy Code renders commodity brokers ineligible for Chapter 11 reorganization.

While Chapter 7, Subchapter IV, outlines the type of bankruptcy that a commodity broker may undertake, the rules governing those bankruptcies go beyond the terms of the Bankruptcy Code. The Commodities Exchange Act (CEA) and the CFTC's bankruptcy rules published at 17 C.F.R. § 190 (the Part 190 Rules) at different points supplement and supersede the provisions of Subchapter IV. For instance, Section 20 of the CEA authorizes the CFTC to issue bankruptcy regulations "notwithstanding the Code." The CFTC may also elect to liquidate an FCM or DCO through an agency receivership.

The most significant departure here from a standard bankruptcy is the mixed model of governing law. To understand an FCM or DCO's journey through bankruptcy is to look beyond the Bankruptcy Code. Like the OLA, a commodities-related bankruptcy implicates administrative law, which rarely bears on the Bankruptcy Code.

Congressional Considerations

The recent spate of crypto company bankruptcies, with their unique financial structures and issues over account ownership, poses the question of whether the Bankruptcy Code is the ideal framework for resolving those bankruptcies. Even more broadly, there is the question of where crypto companies fit in the financial system.

Experts continue to debate whether crypto assets constitute securities or commodities, or some combination of both. If they are the former, then perhaps a crypto company could be liquidated under SIPA. If they are the latter, then they may qualify for liquidation under Chapter 7, Subchapter IV, of the Bankruptcy Code. Action by Congress could clarify how distressed crypto companies restructure themselves, and to what extent, if any, customers receive protection during that restructuring.

The agencies overseeing banks and credit unions have a weaker connection to crypto companies. For instance, the FDIC does not insure crypto exchanges. The FDIC has also sought to distance itself from crypto companies that asserted on their websites that certain crypto-related products are FDIC-insured. With that said, neither the FDIC nor the NCUA prohibit covered entities from dealing in crypto assets. For crypto companies to fall under the authority of the FDIC, Congress would likely need to amend the statute defining depository institutions.

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