

CREDITOR EQUALITY, SECURED TRANSACTIONS, AND SYSTEMIC RISK: A COMPLEX TRILEMMA

RODRIGO OLIVARES-CAMINAL*

I

INTRODUCTION

According to the Oxford Dictionary, “equality” is the state of being equal.¹ This simple definition has been subject to an extensive debate. From the legal point of view, it is even an indeterminate concept. It requires a major creative effort by the interpreter, that is, the judge, when deciding whether a particular rule or situation can produce a damaging or undermining effect.² The equality principle has been historically undetermined because the valuation of aspects used to distinguish people or give preferential treatment have changed over time.

This article examines whether, in our increasingly complex and interconnected financial world, the risk of a systemic economic collapse should justify changing fundamental concepts of commercial law such as the relative ranking and remedies of secured and unsecured creditors. For example, should systemically important secured parties have greater remedies against collateral, in order to protect themselves, than other secured parties? Should systemically important debtors have greater immunities against foreclosure than other debtors? In an attempt to answer these two main questions, this article analyzes two systemically important types of entities in distress.

First, it analyzes the bankruptcy reorganizations of Chrysler LLC and General Motors Corporation, which were seen as systemically important corporations because their failure posed a significant risk to financial market stability.³ As such, they received official financial assistance. In connection with

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* Professor in Banking and Finance Law, Centre for Commercial Law Studies, Queen Mary University of London. E-mail: r.olivares-caminal@qmul.ac.uk. The author would like to thank Professor Steven L. Schwarcz for valuable comments on an early draft of this paper and Dr. Marco Bodellini, Dr. Andrea Miglionico, Dr. Teresa D. Silva and Georg Wabl for their research assistance. Any errors or omissions are only attributable to the author.

1. *Equality*, OXFORD ENGLISH DICTIONARY (2d ed. 1989).

2. See Miguel Carbonell, *Los Derechos de Igualdad en el Constitucionalismo Contemporáneo* 74 REVISTA DE DERECHO PÚBLICO 57, 64 (2011).

3. See *TARP Programs: Auto Industry*, U.S. DEP'T OF TREASURY, <https://www.treasury.gov/initiatives/financial-stability/TARP-Programs/automotive-programs/Pages/default.aspx> [<https://perma.cc/WFQ4-YKTS>] (last visited Nov. 1, 2017) (noting that the collapse of the auto industry would have “posed a significant risk to financial market stability, threatened the overall economy, and resulted in the loss of one million U.S. jobs”).

these restructurings, certain unsecured creditors received even better treatment than secured creditors. Second, this article analyzes the new regime for Systemically Important Financial Institutions (SIFIs) in the context of bank insolvencies, where the characterization of these institutions as systemically important allows for a differential treatment of otherwise equally ranked creditors. These analyses highlight an *ad hoc* transformation of the principle of equality and the traditional role of secured transactions that, in turn, undermine long established principles of commercial law.

Because collateral remedies and preferences are most relevant in the context of a debtor's insolvency, the discussion begins by analyzing the principle of equality from the insolvency⁴ perspective. In this context, it addresses the equal ranking, equal treatment and pro-rata principles.

II

PRINCIPLES OF EQUALITY IN INSOLVENCY LAW

As a baseline proposition, creditors rank equally in a debtor's insolvency. This is a result of the *pari passu* (or equal ranking) principle, which is often said to constitute a fundamental rule of corporate insolvency law.⁵ Two related propositions supplement and complement this principle. These are the *par condicio creditorum*, or equal treatment of creditors, and the pro-rata or ratable payment. Under the former proposition, certain actions taken by the debtor in the lead-up to insolvency can be nullified if they favor some creditors over others. Under the latter proposition, the net proceeds of the debtor's assets are to be distributed to meet creditor claims on a proportional basis.⁶

Secured transactions historically have been a fundamental exception to the *pari passu* principle; a secured creditor has priority access to the assets pledged as collateral.⁷ For example, when a bank creates a security interest, it is entitled in a default situation to satisfy its claim from the proceeds of collateral, ahead of other remaining creditors. Additionally, secured lenders might sometimes lend at lower rates, facilitating the flow of credit. In some circumstances, collateral importantly enables a firm to borrow when it needs liquidity and unsecured borrowing is not feasible.

4. For purposes of this article, the terms "insolvency" and "bankruptcy" are used interchangeably.

5. VANESSA FINCH, CORPORATE INSOLVENCY LAW: PERSPECTIVES AND PRINCIPLES 599 (2d ed. 2009).

6. See *Wilson v. City Bank*, 84 U.S. 473, 484 (1873) ("[T]he grant feature of [the Bankrupt Act] is to secure equality of distribution among creditors in all cases of insolvency . . .").

7. Security can be personal or real. Personal security refers to the creation of a personal obligation that can be enforced against the person of the debtor but against no other. The most important type of personal security is the common guarantee (a contractual obligation for which only the guarantor is responsible). The concept of real security goes beyond the scope of contractual obligations. The creation of real security such as a charge, mortgage, or pledge grants property rights over an asset for the purpose of securing the performance of a debt obligation. For an enlargement on economic and legal aspects related to the use of security, see Lucian Bebchuck & Jesse Fried, *The Uneasy Case for the Priority of Secured Claims in Bankruptcy*, 105 YALE L.J. 857 (1996); Jay L. Westbrook, *The Control of Wealth in Bankruptcy*, 82 TEX. L. REV. 795 (2004).

Secured transactions result from the legal system allowing a bilateral contractual convention reflecting a pre-established policy interest to alter the equal ranking of creditors. The rationale for allowing this bilateral agreement to undermine the equal right of other parties lies in the ulterior motive of facilitating liquidity, which will most likely result in economic growth.⁸

III

EXCEPTIONS TO THE EQUAL RANKING AND EQUAL TREATMENT OF CREDITORS' PRINCIPLES AND IMPLICATIONS FOR SECURED TRANSACTIONS

As a result of the global financial crisis and credit crunch, there have been a series of regulatory and judicial developments that have challenged the equality of creditors in insolvency and altered the rights of secured and unsecured creditors. The violation of the equality of creditors in the Chrysler LLC and General Motors Corporation (hereafter referred to as Chrysler and GM, respectively) bankruptcies and the preference granted to unsecured creditors over some secured creditors, as well as the exceptions for SIFIs in the context of bank insolvencies, have prompted the re-thinking of the current status quo in cases of systemic risk, particularly focusing on secured transactions. These new approaches are analyzed below.

A. The Breach of the Equal Ranking and Equal Treatment of Creditors in the Chrysler and GM Bankruptcies and Its Impact on Secured Transactions

In the midst of the global financial crisis, U.S. courts have varied the equal ranking and the equal treatment principles and even prioritized some unsecured creditors over secured creditors, as illustrated by the Chrysler and GM bankruptcies.

1. Background

The global financial crisis put serious pressure on Chrysler and GM, which were going through a recessive period. At the beginning of 2009, both companies were “bleeding to death”⁹ and needed external assistance. Fearing an unmanageable collapse of the automotive industry, the U.S. and Canadian governments granted financial assistance to both car manufacturers. The funds were mainly provided by the Troubled Asset Relief Program, TARP.¹⁰ This financial assistance played a key role in these unprecedented bankruptcy reorganizations, which might—from an economic point of view—arguably be called “two of the biggest success stories of the Obama administration.”¹¹

8. This general exception to the equality principle is not the only one. There are two more: (1) legal priorities or preferences, which results from legislative policy interests; and (2) subordination, which results from contractual freedom.

9. Douglas G. Baird, *Lessons from the Automobile Reorganizations*, 4 J. LEGAL ANALYSIS 271, 271 (2012).

10. Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, 122 Stat. 3765 (2008).

11. Ralph Brubaker & Charles Tabb, *Bankruptcy Reorganizations and the Troubling Legacy of Chrysler and GM*, 5 U. ILL. L. REV. 1375, 1377 (2010).

Chrysler and GM took advantage of the insolvency practice of reorganizing businesses via a § 363 sale. This practice refers to § 363(b) of the U.S. Bankruptcy Code, which allows a sale of assets outside of the ordinary course of business. This provision was originally intended to address the urgent and non-bureaucratic sale of assets like vegetables, fruits, or other products with a short durability, which rapidly decrease in value. It also became used to sell significant parts of, or entire, businesses as a going concern instead of reorganizing and/or selling them in a normal Chapter 11 proceeding.¹²

In Chapter 11 proceedings, creditors are able to vote on a proposed plan and therefore have the opportunity to pursue their interests. In a § 363 sale, it is mainly up to the court to sanction the sale and consider the interests of all affected parties. Brubaker and Tabb refer to this as a “shift from ‘direct democracy’ to ‘representative democracy.’”¹³

One of the landmark rulings giving guidance to the courts on how to exercise their responsibility arising from this “representative democracy” is *Lionel*,¹⁴ which established a detailed test. Detailed findings and requirements as well as further specifications of this test have already been analyzed elsewhere.¹⁵ The main advantage of § 363 sales is that they usually can be performed quickly and are less expensive and less complex than a Chapter 11 reorganization plan.¹⁶ The urgency rationale (remember the fruits mentioned above) allows expedited restructuring transactions. Hugely complex restructurings such as Chrysler and GM were able to be finalized in forty-one and thirty-nine days, respectively.¹⁷ In the GM bankruptcy, the U.S. Bankruptcy Court for the Southern District of New York illustrated this point by stating that courts “have the power to authorize sales of assets at a time when there still is value to preserve—to prevent the death of the patient on the operating table.”¹⁸ The economic and political implications arising from systemic risk concerns are a possible explanation as to why § 363 sales are being used to allow these complex restructurings.¹⁹

These sales have been highly criticized by commentators—before and after the Chrysler and GM reorganizations—fearing that they undermine main principles of the U.S. Bankruptcy Code. Thus, some commentators provocatively declare that § 363 sales will lead to “bankrupting bankruptcy” law.²⁰ This article

12. See Kimon Korres, *Bankrupting Bankruptcy: Circumventing Chapter 11 Protections Through Manipulation of the Business Justification Standard in § 363 Asset Sales, and a Refined Standard to Safeguard Against Abuse*, 63 FLA. L. REV. 959, 964 (2011) (noting that “ordinarily, § 363 transactions concerned only expedited sales that were imperative to preserve values that would rapidly diminish” but recently, “there has been movement . . . toward adopting more liberal standards for approving § 363 sales”).

13. Brubaker & Tabb, *supra* note 11, at 1389.

14. *In re Lionel Corp.*, 722 F.2d 1063 (2d Cir. 1983).

15. RODRIGO OLIVARES-CAMINAL ET AL., *DEBT RESTRUCTURING* 193–95 (2d ed. 2016).

16. *Id.* at 195.

17. Brubaker & Tabb, *supra* note 11, at 1377.

18. *In re Gen. Motors Corp.*, 407 B.R. 463, 474 (Bankr. S.D.N.Y. 2009).

19. See *infra* Part III.D for a critical discussion on this point.

20. See Korres, *supra* note 12 (titling his journal publication “*Bankrupting Bankruptcy*”:

analyzes whether such sales can affect the principles of equal ranking and equal treatment as well as the implications that this has on secured transactions. This brings us to the so-called “*sub rosa* sales,” a variation of § 363 sales.

2. Potential for Circumventing Chapter 11 Protections Through Sub Rosa § 363 Sales

The Latin phrase *sub rosa* refers to something done, or happening, in secret. Therefore, if a § 363 sale is done in a secretive manner to allegedly deceive creditors it is referred to as a § 363 *sub rosa* sale. The first case dealing with the *sub rosa* variant of business reorganizations was *Braniff*.²¹ The court held that a proposed § 363 sale was a de facto reorganization plan and therefore impermissible, stating the following:

The debtor and the Bankruptcy Court should not be able to short circuit the requirements of Chapter 11 for confirmation of a reorganization plan by establishing the terms of the plan *sub rosa* in connection with a sale of assets . . . [w]ere this transaction approved, and considering the properties proposed to be transferred, little would remain save fixed based equipment and little prospect or occasion for further reorganization. These considerations reinforce our view that this is in fact a reorganization.²²

The relevant question is “if the sale itself seeks to allocate or dictate the distribution of sale proceeds among different classes of creditors.”²³ When the sale aims to bypass “baseline protections with respect to the *distribution* of the value of the estate amongst the debtor’s creditors and owners,”²⁴ then the court should not sanction a § 363 sale.

The detailed requirements for a Chapter 11 confirmation can mainly be found in §§ 1121–1129 of the U.S. Bankruptcy Code.²⁵ Relevant for this article, are the following principles which aim to provide the same protection as the earlier defined equal ranking and equal treatment principles: (1) equal treatment of similarly situated creditors (§ 1123(a)(4)); and, (2) cramdown protection (§ 1129(b)(2)) which includes the “fair and equitable” and the “not discriminate unfairly” or “unfair discrimination” rules.

3. Absolute Priority as the Ratio of Equal Treatment, Unfair Discrimination and Fair and Equitable Rules

The equal treatment, unfair discrimination and fair and equitable rules mainly derive from the concept of absolute priority, which is based on century-old cases in the area of equity receivership reorganizations.²⁶ Since these cases,

Circumventing Chapter 11 Protections Through Manipulation of the Business Justification Standard in § 363 Asset Sales . . .”).

21. *In re Braniff Airways, Inc.*, 700 F.2d 935 (5th Cir. 1983).

22. *Id.* at 940.

23. *In re Gen. Motors Corp.*, 407 B.R. at 495.

24. Brubaker & Tabb, *supra* note 11, at 1390.

25. A more detailed examination of those requirements can be found in OLIVARES-CAMINAL ET AL., *supra* note 15, at 196–200.

26. See OLIVARES-CAMINAL ET AL., *supra* note 15, at 171.

which dealt with the restructuring of railroad companies, it has been made clear that these principles as well as the absolute priority rule derive from the right of property in its purest sense.²⁷ The principles of equal treatment of similarly situated creditors and unfair discrimination mainly mirror the equal treatment principle analyzed earlier.

The fair and equitable principle is the core of the absolute priority rule²⁸ and has been clearly codified. Section § 1129(b)(2)(B)(ii) of the U.S. Bankruptcy Code states that when a class is not satisfied in full and therefore impaired, “the holder of any claim or interest that is junior to the claims of such class will not receive or retain under the plan on account of such junior claim or interest any property” In short, as long as an impaired class does not receive full payment (that is 100%), junior classes must not receive anything. This applies in the relationship between secured and unsecured creditors, within classes of unsecured creditors and also between unsecured creditors and shareholders.²⁹ Courts tend to interpret this principle in a strict way.³⁰ As such, the absolute priority rule and the fair and equitable principle especially address the ranking of creditors—manifested in the principle of equal ranking—in underlining that the ranking and thereby classification of creditors necessarily means that senior creditors trump junior creditors—also known as the waterfall principle in insolvency.

In certain circumstances, old shareholders can stay or find their way back in the reorganized company by contributing new value.³¹ There is still uncertainty about whether this principle should be fully accepted. Recently, courts have been reluctant in applying it and have required a strict market test.³²

The following parts analyze the interaction between these rules and § 363 sales in the context of the Chrysler and GM bankruptcy reorganizations, respectively.

27. See *N. Pac. Ry. Co. v. Boyd*, 228 U.S. 482 (1913) (explaining: “[I]n either event it was a right of property out of which the creditors were entitled to be paid before the stockholders could retain it for any purpose whatever.”). See also *Case v. L.A. Lumber Prod. Co.*, 308 U.S. 106 (1939) (applying this principle outside of a railroad company).

28. Courts even label the words “fair and equitable” as a rule of full or absolute priority. See *L.A. Lumber Prod. Co.*, 308 U.S. at 117.

29. See OLIVARES-CAMINAL ET AL., *supra* note 15, at 172–73. Section §1129(b)(2) provides detailed regulations for all scenarios in §§ (A)–(C).

30. See, e.g., *In re Armstrong World Indus.*, 432 F.3d 507, 513 (3d Cir. 2005) (holding “[T]he plain language of the statute makes it clear that a plan cannot give property to junior claimants over the objection of a more senior class if that class is impaired.”).

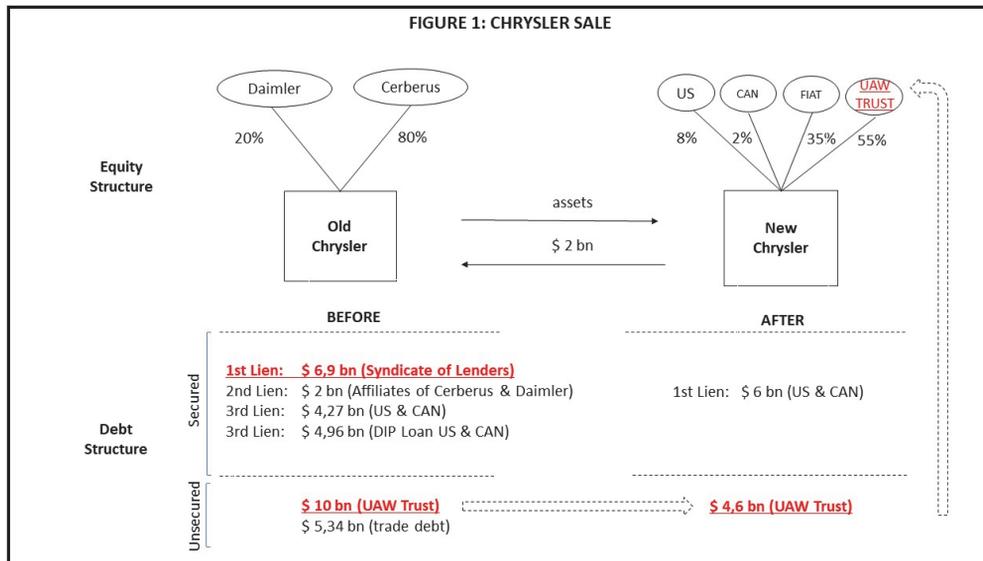
31. See OLIVARES-CAMINAL ET AL., *supra* note 15, at 173–76 for comprehensive reference to case law.

32. According to this test, efforts by junior interests to add new value into a debtor entity under a plan of reorganization must be exposed to market competition in order to ensure that “top dollar” is received. For example, see *In re Cypresswood Land Partners, I*, 409 B.R. 396, 438–439 (Bankr. S.D. Tex. 2009). See OLIVARES-CAMINAL ET AL., *supra* note 15, at 174–75 for further analysis.

B. The Chrysler Bankruptcy Reorganization

1. The Proceedings

Due to its systemic implication and dimension, the Chrysler bankruptcy resulted in a highly complex transaction. A detailed analysis of its background and the implementation of the process can be found elsewhere.³³ Analysis for the purpose of this article will focus on specific aspects and therefore deliberately exclude some details of the transaction. Figure 1 below³⁴ (“Chrysler Sale”) aims to summarize the main structure of the transaction (the position of creditors which are particularly of interest are underlined):



Chrysler required \$9.2 billion in external funding, which the U.S. and Canadian governments provided.³⁵ These funds were mainly secured by third-lien collateral on all of Chrysler’s assets. A condition for this financial support was the preparation of a viability plan. Despite having multiple options, the Auto Task Force, appointed by President Obama, concluded that an alliance with Fiat was Chrysler’s most advantageous alternative.³⁶ On April 30, 2009, Chrysler and its subsidiaries filed for bankruptcy protection under Chapter 11 of the U.S. Bankruptcy Code.³⁷ Ten days later, Chrysler sold its business to a Fiat affiliate, a NewCo (“New Chrysler”), as a going concern via a § 363 sale.³⁸

33. See, e.g., A. Joseph Warburton, *Understanding the Bankruptcies of Chrysler and General Motors: A Primer*, 60 SYRACUSE L. REV. 531, 533–37 (2010).

34. The structure of Figure 2 is based on the structure of the Chrysler Reorganization. *Id.* at 535.

35. See *In re Chrysler LLC*, 405 B.R. 84, 89–92 (Bankr. S.D.N.Y. 2009).

36. Brubaker & Tabb, *supra* note 11, at 1381.

37. See Voluntary Petition, *In re Chrysler LLC*, 405 B.R. 84 (Bankr. S.D.N.Y. 2009) (No. 09-50002).

38. *In re Chrysler LLC*, 405 B.R. at 91–92.

Upon filing, Chrysler had several secured and unsecured liabilities. A syndicate of lenders held a senior secured claim of around \$6.9 billion, collateralized mainly by all of Chrysler's assets.³⁹ Chrysler also owed approximately \$2 billion in second-lien secured debt to affiliates of the former shareholders.⁴⁰ Besides that, they owed approximately \$10 billion to a trust established to provide healthcare benefits to retirees of the International Union, United Automobile, Aerospace and Agricultural Implement Workers of America (UAW).⁴¹ Chrysler owed a further \$5.34 billion to various trade creditors.⁴²

The restructuring transaction had the following main effects:⁴³

- Chrysler effectively transferred all of its assets to a newly established entity, "New Chrysler."
- In return, New Chrysler paid a cash consideration of \$2 billion to Old Chrysler.
- New Chrysler assumed specific liabilities, including part of those owed to the UAW trust (\$4.6 billion) and certain trade liabilities.
- The U.S. Treasury (8%), Canada (2%), Fiat (35%) and the UAW Trust (55%) become the shareholders of New Chrysler.⁴⁴
- The assumption of the UAW liabilities and the allocation of shares to the UAW Trust was part of a deal negotiated between New Chrysler and UAW to keep the workforce motivated and thereby ensure the continuation of the business.⁴⁵
- After the sanction of the sale, the consideration of \$2 billion was distributed to the first-priority secured lenders within the Chapter 11 proceeding.⁴⁶

2. The Criticism

The Chrysler sale was met with various criticisms in and out of court.⁴⁷ Mainly relevant for this article is the criticism addressing the relation between (1) the senior secured creditors (Syndicate of Lenders with a claim of \$6.9 billion) receiving the consideration of \$2 billion as highlighted in bold in Figure 1 above

39. *Id.* at 89.

40. *Id.* The "old shareholders" were Cerberus Capital Management L.P. and its affiliates (80%) and Daimler AG and its affiliates (20%).

41. *Id.* at 89–90.

42. *Id.* at 90.

43. For more details regarding the transaction see Warburton, *supra* note 33, at 534–37.

44. *In re Chrysler LLC*, 405 B.R. at 92.

45. See Warburton, *supra* note 33, at 536–37 (noting that "such an agreement was obtainable, in part, because the UAW wanted to ensure continued employment for its active employees as well as continued funding of the UAW Trust.").

46. *In re Chrysler LLC*, 405 B.R. at 92, 97.

47. Within the judicial proceeding, the court had to deal with many arguments stating that the sale was impermissible because it was a *sub rosa* sale, there was a strong governmental influence, etc. The arguments were extensively analysed in Brubaker & Tabb, *supra* note 11, at 1391–99. Further criticisms and an academic debate were broadly analysed in Warburton, *supra* note 33, at 547–72.

and (2) the UAW Trust receiving better treatment than other senior secured creditors (also highlighted in bold in Figure 1 above).

Three Indiana state pension funds—members of the Syndicate of Lenders—objected to the § 363 sale arguing that the sale was a *sub rosa* sale, as unsecured creditors (the UAW Trust) received value while secured creditors (the Syndicate of Lenders) only received twenty-nine cents on the dollar.⁴⁸ Thus, the main question is if via the sale, funds were improperly distributed from “retired Indiana policemen” to “retired Michigan autoworkers.”⁴⁹

The U.S. Bankruptcy Court for the Southern District of New York dealt with this argument stating that “there is no attempt to allocate the sale proceeds away from the First-Lien Lenders. Rather, the security interest of the First-Lien Lenders will attach to the sale proceeds and there will be an immediate and infeasible distribution of all of the \$2 billion dollar cash sale price to the First-Lien Lenders, who are owed \$6.9 billion.”⁵⁰ The court observed that a purchaser may decide to assume certain contracts and liabilities which “reflects the purchaser’s business judgment, the effect of which does not constitute a *sub rosa* plan because the obligation is negotiated directly with the counterparty. Thus, any of the obligations under those agreements are satisfied by New Chrysler and do not constitute a distribution of proceeds from the Debtor’s estates.”⁵¹ Finally, the court held that this also applies for the “ownership interests in the new entity, which was neither a diversion of value from the Debtor’s assets nor an allocation of the proceeds from the sale of the Debtor’s assets. The allocation of ownership interests in the new enterprise is irrelevant to the estates’ economic interests.”⁵²

The Second Circuit disagreed with the position of the Indiana pension funds, stating that all proceeds would be distributed entirely to the first-priority secured creditors and “[n]ot one penny of value of the Debtor’s assets is going to anyone other than the First-Lien Lenders.”⁵³ Thus, according to the courts the transaction was concluded as consistent with bankruptcy priority rules and did not constitute a *sub rosa* plan.⁵⁴ On appeal, the U.S. Supreme Court vacated the Second Circuit’s decision, remanding it with instructions to dismiss the appeal as moot.⁵⁵

Another weakness in the arguments put forth by the Indiana state pension funds was that the Syndicate of Lenders had already consented to the § 363 sale. Section 363(f) provides that assets may only be sold “free and clear of any interest in such property” if (amongst others) the holder of an interest (for example the holder of a collateral/lien) consents to the sale (§ 363(f)(2)). The Syndicate of

48. See Warburton, *supra* note 33, at 543–44.

49. *Id.* at 563.

50. *In re Chrysler LLC*, 405 B.R. at 98.

51. *Id.* at 99 n.18.

52. *Id.* at 99.

53. *In re Chrysler LLC*, 576 F.3d 108, 118 (2d Cir. 2009), *vacated as moot*, 558 U.S. 1087 (2009).

54. *Id.* at 118 n.9.

55. *Indiana State Police Pension Tr. v. Chrysler LLC*, 558 U.S. 1087 (2009). Discussed in detail in Warburton, *supra* note 33, at 575–78.

Lenders was represented by a Collateral Trustee, which was directed by an Administrative Agent. This agent was bound by the decisions of lenders holding a majority of the Syndicate's indebtedness. Although the Indiana state pension funds did not agree to the sale, lenders holding 92.5% of the indebtedness did.⁵⁶ The Indiana state pension funds challenged the release of the sold assets, arguing that the agents' consent was not valid and, furthermore, the consenting lenders were also recipients of TARP-funds and therefore brought under undue pressure by the US Government.⁵⁷ Still, the Bankruptcy Court concluded that the Administrative Agent's consent "satisfies the section and allows for the purchased assets to be sold free and clear"⁵⁸ and that the argument about the U.S. Government exerting pressure would be "without any evidentiary support" and "mere speculation and without merit."⁵⁹ The Second Circuit affirmed the position of the Bankruptcy Court on both aspects.⁶⁰

Cases like this conflate two concerns: whether the § 363 sale is a *sub rosa* reorganization, and whether that sale can facilitate the distortion of creditor—especially secured creditor—priorities. Commentators agree that cases like Chrysler can be suspected to be *sub rosa* sales, and especially when the transaction includes the assumption of liabilities—such as the liabilities towards the UAW Trust or trade creditors—the potential of priority distortion increases.⁶¹ Additionally, U.S. courts are aware of such a risk caused by the assumption of liabilities. The courts' argument in cases like Chrysler—and also GM, explained below—is that "the disparate treatment of creditors occurs as a consequence of the sale transaction itself and is not an attempt by the debtor to circumvent the distribution scheme of the Code."⁶² Thus, the question is not if liabilities get assumed, but if such assumption takes value away from the debtor—and therefore the other creditors. The latter may openly be the case when instead of paying a cash consideration, which can be easily distributed following the distributional principles of the Bankruptcy Code, specific liabilities get assumed without (or with less) distribution to the rest of the creditors. If the assumption of liabilities does not affect the consideration but rather is a business judgment by the purchaser—such as a necessary deal with the UAW Trust—then no value may be taken away.⁶³

56. *In re Chrysler LLC*, 405 B.R. at 102.

57. *Id.* at 103.

58. *Id.* at 102.

59. *Id.* at 104.

60. *In re Chrysler LLC*, 576 F.3d 108, 119–120 (2d Cir. 2009), *vacated as moot*, 558 U.S. 1087 (2009).

61. See, e.g., Mark J. Roe & Joo-Hee Chung, *How the Chrysler Reorganization Differed from Prior Practice*, 5 J. LEGAL ANALYSIS 399, 402 (2013).

62. *In re Trans World Airlines, Inc.*, 2001 Bankr. LEXIS 980 at *32 (Bankr. D. Del. 2001) (quoted and affirmed in *In re Gen. Motors Corp.*, 407 B.R. 463, 497 (Bankr. S.D.N.Y. 2009)).

63. Ralph Brubaker and Charles Tabb explain this in more detail using two different scenarios (see Brubaker & Tabb, *supra* note 11, at 1396–98).

According to most commentators, the Chrysler transaction represented the latter case and therefore seems “fundamentally sound.”⁶⁴ Following the U.S. jurisprudence, this would mean that no basic principles of insolvency law were circumvented and/or breached. Concessions or gifts given to the UAW Trust by New Chrysler are therefore referred to as a “cost of doing business.”⁶⁵ Still, the amount of assumed liabilities has been described as abnormally high in comparison to other § 363 sales.⁶⁶

Finally, Brubaker and Tabb point out that the absolute priority rule of § 1129(b)(1) only protects dissenting classes and, therefore, the objection of the Indiana state pension funds may also face formal difficulties.⁶⁷ Given that the Syndicate of Lenders consented to the release of the sold assets under § 363(f)(2) with a 92.5% majority, these authors argue that “one can safely presume that this class of secured claims would vote to accept if the Fiat sale were proposed through a plan of reorganization.”⁶⁸ This is an essential aspect because the consent to an alteration of priorities is one of the main exceptions of existing rules.⁶⁹

C. The GM Bankruptcy Reorganization

1. The Proceedings

The GM situation was similar to Chrysler in terms of the need of governmental support and the basic structure of the deal. Again, this analysis will focus on the relevant issues in terms of the principle of equality and therefore deliberately exclude some aspects of the transaction. Figure 2 below, “GM Sale,”⁷⁰ summarizes the main structure of the transaction (the position of creditors that are primarily relevant for the scope of this article are underlined):

64. Brubaker & Tabb, *supra* note 11, at 1399.

65. Baird, *supra* note 9, at 279.

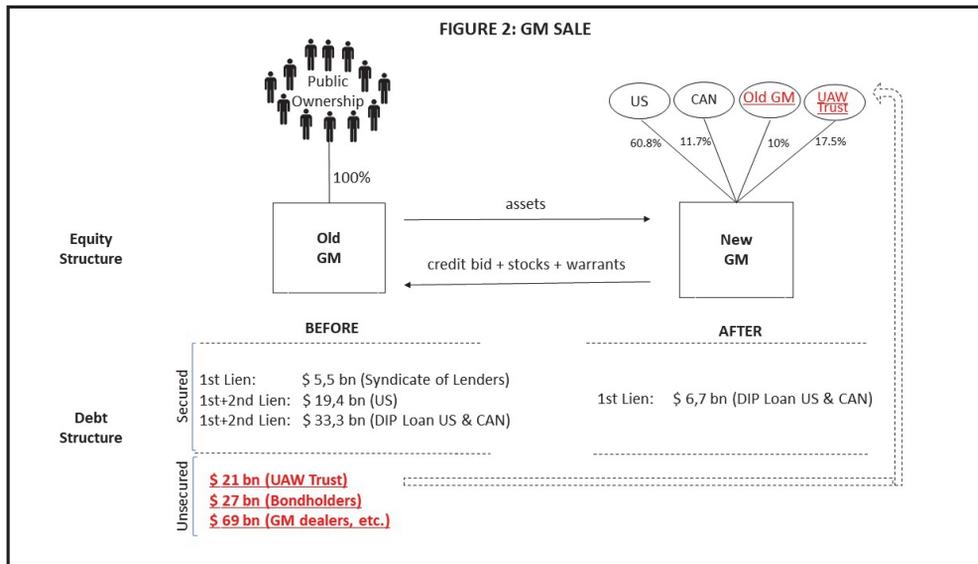
66. See Roe & Chung, *supra* note 61, at 409–12.

67. Brubaker & Tabb, *supra* note 11, at 1391.

68. *Id.* at 1392.

69. See *infra* Part III.D.

70. The structure of Figure 3 is based on the structure of the GM Reorganization provided in Warburton, *supra* note 33, at 535.



GM needed governmental support in the total amount of more than \$50 billion to be able to continue operating. Unlike Chrysler, there was no alliance with another car company such as Fiat, but a § 363 sale was still possible due to the strong commitment of the U.S. and Canadian Governments.⁷¹

On June 1, 2009, GM and its subsidiaries filed for bankruptcy protection under Chapter 11 of the US Bankruptcy Code.⁷² One month later, GM sold its business to a NewCo (“New GM”) as a going concern in a § 363 sale.⁷³ Upon filing, GM had less secured credit (around \$5.5 billion owed to a Syndicate of Lenders)⁷⁴ than Chrysler; it also had a substantial amount of unsecured debt (\$117 billion owed to the UAW Trust, bondholders and others).⁷⁵

The restructuring transaction had the following main effects:⁷⁶

- GM effectively transferred all of its assets to a newly established entity (New GM).
- The U.S. Treasury and Canada assigned their loans to New GM which then credit bid for the assets of Old GM.⁷⁷

71. *In re Gen. Motors Corp.*, 407 B.R. 463, 479 (Bankr. S.D.N.Y. 2009) (including Exhibit A: Draft DIP Facility (No. 09-50026)).

72. *See* Voluntary Petition, *In re Gen. Motors Corp.*, 407 B.R. 463 (Bankr. S.D.N.Y. 2009) (No. 09-50026).

73. Warburton, *supra* note 33, at 537–38.

74. *See id.* at 537 (explaining that GM owed “\$3.9 billion to a syndicate of lenders led by Citicorp US, Inc., \$1.5 billion to a syndicate of lenders led by JP Morgan Chase, \$400 million to Export Development Bank Canada, and \$125 million to Gelco Corporation.”).

75. *In re Gen. Motors Corp.*, 407 B.R. at 481.

76. For more details see Warburton, *supra* note 33, at 537–39.

77. Warburton, *supra* note 33, at 538.

- Old GM received 10% of the common stock issued by New GM and warranted to purchase an additional 15% that would serve to distribute value to its unsecured creditors (bondholders, GM dealers, etc.).⁷⁸
- The senior secured Syndicate of Lenders was repaid in full by New GM.⁷⁹
- The U.S. Treasury (60.8%), Canada (11.7%), the UAW Trust (17.5%) and Old GM (10%) became the shareholders of New GM.⁸⁰
- The allocation of shares to the UAW Trust was part of a deal negotiated between New GM and UAW to keep the workforce motivated and ensure the continuation of the business.⁸¹

2. The Criticism

Similar to Chrysler, creditors claimed that the preferential treatment of the UAW Trust constituted a *sub rosa* plan and allegedly breached basic insolvency principles. The senior secured creditors had no reason to object given that they already had been repaid in full and therefore had to release the sold assets anyway, but unsecured bondholders objected, arguing that the UAW Trust received “more” than their *pari passu* share by directly receiving equity interests in New GM.⁸² The court disagreed and endorsed UAW Trust’s treatment by arguing that the transaction “does not rise to the level of establishing a *sub rosa* plan. The objectors’ real problem is with the decisions of the Purchaser, not with the Debtor, nor with any violation of the Code or caselaw.”⁸³ The court thus continued the jurisprudence that business judgments and gifts on the level of the purchaser (New GM) as such do not automatically lead to a *sub rosa* plan as long as they do not take away value from the debtor.⁸⁴

Commentators usually describe the Chrysler and the GM sales as involving the same types of issues.⁸⁵ Still, Brubaker and Tabb undertook a very different analysis of the GM sale, calling it a “Trojan horse assault on chapter 11’s distributional norms.”⁸⁶ These commentators compare the GM sale with the equity receiverships discussed above,⁸⁷ which have led to the absolute priority rule, as we know it today. In such equitable receiverships, creditors of struggling businesses were—similar to today’s sales practice—able to purchase the business

78. *In re Gen. Motors Corp.*, 407 B.R. at 482–83.

79. Warburton, *supra* note 33, at 538.

80. *In re Gen. Motors Corp.*, 407 B.R. at 482–83.

81. See Warburton, *supra* note 33, at 538 (describing UAW’s collective bargaining agreement with New GM).

82. *In re Gen. Motors Corp.*, 407 B.R. at 474, 495.

83. *Id.* at 496.

84. The court also explicitly refers to the Chrysler decision (see *In re Gen. Motors Corp.*, 407 B.R. at 497–98). See also *supra* Part III.B.2.

85. A summary of the arguments at stake can be found in Warburton, *supra* note 33, at 547–72.

86. Brubaker & Tabb, *supra* note 11, at 1380.

87. See *supra* Part III.A.3.

via a new entity, allocate the shares of this entity amongst each other, and keep the business running.⁸⁸ In *Boyd*,⁸⁹ the Supreme Court made it clear that creditors were not free to do whatever they wanted in the process and especially not in the allocation of shares, but rather had to respect rights of property.⁹⁰ Brubaker and Tabb argue that at its core, the GM sale was a similar way of reorganizing the business by selling it to its creditors.⁹¹ Neither commentator questions the general view of the courts regarding business judgments and gifts in the sphere of the purchaser. They also appreciate that there can be fair discrimination between creditors. Their concern lies in the court's clear statement that "the allocation of value by the purchaser d[oes] not affect the debtor's interest."⁹² According to them, this "supposed dichotomy" between the values of the purchaser and the debtor would be "a manifestly false one"⁹³ and would mean that "anything goes" and that "[t]here are no limits."⁹⁴ Thus, they are not concerned about the mere fact that the UAW Trust received more than the other unsecured creditors. Rather, they believe that there was no objective justification or valuation for the extent of this preferential treatment and that the court was explicitly favoring a reorganization without the required information to scrutinize the outcome.⁹⁵ As explained in the next part, the courts' decisions pose a real threat to long established commercial law principles.

D. An Overarching Critical Analysis of the Chrysler and GM Cases

There is no doubt that the Chrysler and GM bankruptcies were unique in terms of their dimensions, complexity and especially their systemic importance, the last being evidenced by the provision of governmental support. As a result of this support, the governmental providers of new financing mainly dictated the terms of the transactions. While this huge interference was one of the main criticisms,⁹⁶ others argued that what happened was not any different from "a

88. See Brubaker & Tabb, *supra* note 11, at 1399–1406.

89. *N. Pac. Ry. Co. v. Boyd*, 228 U.S. 482 (1913).

90. In *Boyd*, the property rights of unsecured creditors were violated because they were squeezed out of the new entity while the old shareholders received shares in order to retain their expertise in running the railroad. See Brubaker & Tabb, *supra* note 11, at 1402.

91. See *id.* at 1400 ("One could hardly imagine a starker example of a transaction that, regardless of its nominal form, is a quintessential 'reorganization.'").

92. *In re Gen. Motors Corp.*, 407 B.R. 463, 497 (Bankr. S.D.N.Y. 2009) (quoting *In re Chrysler LLC*, 405 B.R. 84, 99 (Bankr. S.D.N.Y. 2009)).

93. Brubaker & Tabb, *supra* note 11, at 1402.

94. *Id.* at 1404.

95. See *id.* at 1404 (noting that "The point, therefore, is not that there was unjustified 'unfair discrimination' in favor of UAW . . . the point is that . . . the disparate treatment the UAW retiree benefit claims indisputably received was immunized from any scrutiny whatsoever as to whether its value was commensurate with the UAW's contribution to the value of New GM.").

96. See, e.g., Brubaker & Tabb, *supra* note 11, at 1405 (noting that this "allowed the government to dictate all terms of the purchases") and Baird, *supra* note 9, at 271 (stating that the government was "a large creditor exercising control over its debtor and pushing for a speedy sale of the assets"). See also Roe & Chung, *supra* note 61, at 402 (arguing: "The implication is that since the government filled the role of the DIP lender in Chrysler, it got to make the rules, distributional and otherwise.") and

private creditor trying to maximize its return on a bad investment”⁹⁷ or from a dominant DIP-lender.⁹⁸ Because of the dimension of interests at stake, the pressure on all parties involved (including the courts) was considerable. This pressure and the “need for speed”⁹⁹ led to the fact that both Chrysler and GM finally “rocketed”¹⁰⁰ through the proceedings.

Still relevant is what these cases mean for the principles of equal ranking and equal treatments. One might wonder if U.S. courts “have established a de facto priority for unpaid, unfunded pension plans?”¹⁰¹

The court’s reasoning in these cases was that business judgments and gifts in the sphere of the purchaser do not necessarily lead to violations of main principles regarding ranking and treatment of creditors. This is valid as long as the decisions of the purchaser do not take away value from the debtor’s estate or violate or alter the rights of creditors in other ways. If that is the case, it can indeed be argued that they “do not affect the debtor’s interest.”¹⁰² However, these decisions are problematic when “used to corrupt the reorganization process.”¹⁰³

Thus, arguments indeed suggest that in Chrysler, there was no violation of the principles at stake because the whole consideration of \$2 billion went to the senior secured creditors of Old Chrysler. Even if New Chrysler would have assumed more liabilities, allocated the shares differently or taken other business judgments, the distribution of the \$2 billion to the senior secured creditors would not have changed. Still, it must be stated that this line is very thin because one can always argue that such business judgment may indirectly affect the amount of the cash consideration.¹⁰⁴ Furthermore, one might ask why the vast majority of the senior secured creditors consented to the release of their lien on the sold assets under § 363(f)(2). Given that there is no evidence that the U.S. Government put the majority of these lenders under pressure, as argued by the Indiana state pension funds, senior secured creditors might simply have not seen any better alternative. As Judge Gonzalez noted, they had “numerous options under the Bankruptcy Code: they could have refused to consent to the sale or, having consented, they could have chosen to credit bid instead of agreeing to take cash.”¹⁰⁵ In this regard, Brubaker and Tabb may be right in assuming that the

Warburton, *supra* note 33, at 531 (“The federal government’s investment in the American automotive industry in 2008 and 2009 has sparked controversy over the government’s role in private enterprise, in general, and the bankruptcy process, in particular.”).

97. Baird, *supra* note 9, at 280.

98. See Roe & Chung, *supra* note 61, at 401 (“Those with the gold make the rules.”).

99. *In re Gen. Motors Corp.*, 407 B.R. 463, 484 (Bankr. S.D.N.Y. 2009).

100. Brubaker & Tabb, *supra* note 11, at 1377.

101. As asked in Roe & Chung, *supra* note 61, at 428.

102. *In re Gen. Motors Corp.*, 407 B.R. at 497.

103. Baird, *supra* note 9, at 292.

104. Thus, the distinction between the two scenarios developed by Brubaker & Tabb (*see supra* note 11, at 1396) might often be difficult to make.

105. *In re Chrysler LLC*, 405 B.R. 84, 98 (Bankr. S.D.N.Y. 2009).

senior secured creditors would have also consented to a corresponding Chapter 11 plan of reorganization and thereby waived their right to reject the plan because of a breach against the absolute priority rule.¹⁰⁶

There might also be reasons to sympathize with the skepticism of Brubaker and Tabb regarding the GM sale. Here, the business judgments of New GM and especially the allocation of shares arguably affected the debtor's estate (Old GM) as it received a part of the common shares of New GM—and warrants to acquire more. In both the Chrysler and GM cases, the court held that a purchaser is free to allocate ownership interests. The allocation of ownership interests can lead to an unequal treatment of the unsecured creditors of Old GM, who share the distributions out of the equity interests in New GM. Potentially, this could lead to violations of priority rules because exceptions to these rules should only be possible within strict limits. It is not clear that there was such a violation in the GM case, and the court did not investigate further to find out.

In summary, there was no court order that the equal ranking and the equal treatment principles were breached in the Chrysler and GM bankruptcy reorganizations. However, both cases presented potential for such breach. Even Buffett said that there will be “a whole lot of consequences” if priorities are ignored and “that’s going to disrupt lending practices in the future.”¹⁰⁷ In both reorganizations, the courts strictly followed precedents on § 363 sales and gifts of purchasers. Thus, the courts relied on precedent from less significant cases to sanction § 363 sales for these complex restructurings with systemic economic and political impact. Systemic risk was not used as a legal justification to create an exception of secured transactions and the equal ranking and treatment principles. Taking into account the initial purpose of § 363 sales—preserving value of perishable goods such as fruits—extending its application to reorganizations such as GM and Chrysler should be eyed very critically. If the real justification for overriding the rights of secured creditors and giving a different treatment to creditors is systemic risk, then the test must be whether systemic risk justifies such results. This is a concern that needs to be addressed by commercial law generally to preserve parties' expectations while at the same time bearing in mind systemic implications. Sometimes the fear of systemic risk is overstated and the remedies end up distorting parties' rights and the rule of law.

A parallel can be drawn to the bankruptcy law concept of “safe harbor” for derivatives transactions, where derivatives counterparties have special rights and immunities in the bankruptcy process—including virtually unlimited enforcement rights against the debtor. Although this safe harbor was ostensibly justified by its ability to reduce systemic risk, it has never been proven that the

106. See Confirmation of Plan, 11 U.S.C. §1129(b)(1) (providing that the court shall confirm the plan if the plan is fair and equitable with respect to each class of claims or interests that is impaired under, and has not accepted, the plan).

107. Jennifer Dauble, *CNBC Transcript: CNBC's Becky Quick Sits Down with Billionaire Investor Warren Buffett Today on CNBC's "Squawk Box"*, CNBC (May 11, 2009), <https://www.cnbc.com/id/30686337> [<https://perma.cc/AXW4-W8GK>].

risk is actually reduced. Some have concluded that this safe harbor is not necessary and probably even amplifies systemic risk.¹⁰⁸ It is important to remember that the bankruptcy of companies is a natural way to address inefficiencies and cleanse market participants that are not in a position to continue operating; it is the essence of the free market. No bankruptcy regulation gives rise to market distortion. Section 363 sales may well be needed to quickly restructure a collapsing systemically important firm but careful consideration should be given to the real nature of the transaction: whether the main aim is the rescue of the firm or circumventing the reorganization process at the expense of undermining long established pillars of commercial law.

Finally, exceptions to the fundamental principles at stake should always meet high thresholds—for example, the concept of contribution of new value described above.¹⁰⁹ Additionally, the statements of the courts in Chrysler and GM should be looked at in a critical way because the demarcation line is very thin—even if they do not constitute an actual breach, in practice they might amount to a breach to the equality principle and the order of priorities. The advancement of unsecured creditors over secured ones cannot be overlooked as it undermines one of the essential elements of commercial law. This approach was initially justified because it avoided adding to the instability in the financial market. But the economic crisis during which the GM and Chrysler bailouts occurred was an exceptional time. While exceptional circumstances require exceptional measures, now that the crisis has abated, courts have a duty to recast the use of § 363 sales and align them with their original purpose.

IV

THE VIOLATION OF THE EQUAL RANKING AND EQUAL TREATMENT OF CREDITORS IN THE FINANCIAL SECTOR

A. Introduction

The bail-in tool is one of the main responses in the aftermath of the global financial crisis to ensure that systemically important institutions can be aided without jeopardizing financial stability. It is designed to impose losses to shareholders and creditors of the failing institution by means of statutory debt write-down and conversion powers invested in the resolution authorities. Conceptually, bail-in is exactly the opposite of bail-out, because shareholders and creditors will bear the losses. However, from a general perspective, despite the fact that the new system is based on a transition to using bail-in to replace bail-out, there could be exceptional cases where it is not appropriate to make use of the tool.

The resolution tools used to deal with distressed financial institutions—including bail-in—are meant to avoid the creation of financial instability and

108. Steven L. Schwarcz, *Derivatives and Collateral: Balancing Remedies and Systemic Risk*, 2015 U. ILL. L. REV. 699, 718–19 (2015).

109. See *supra* Part III.A.3.

systemic risk. However, by writing liabilities down, the insolvency problems of the failing bank are likely to be transmitted as losses to its creditors, which can be other systemically important financial institutions. Therefore, an excessive use of the bail-in tool can generate exactly the same consequences that the resolution procedure is supposed to avoid, namely contagion, financial instability and systemic risk as a result of imposing losses to other entities which are being bailed-in. The problem when implementing bail-in is that it can be very difficult in practice to separate the relationships among financial institutions. The same institutions that fail can be investors or creditors of other institutions and vice-versa. This can make it very difficult and expensive for banks to find appropriate forms of financing.

In November 2015, the Financial Stability Board published a document that acknowledged the problem of contagion by applying bail-in,¹¹⁰ and suggested that “[a]uthorities should place appropriate prudential restrictions on G-SIBs’ and other internationally active banks’ holdings of instruments issued by G-SIBs” The rationale of such a principle is “[t]o reduce the potential for a G-SIB resolution to spread contagion into the global banking system.”¹¹¹

B. The BRRD Exceptions to the Use of Bail-in

At the EU level, article 44 paragraph 3 of the Bank Recovery and Resolution Directive (BRRD), in alignment with Recitals 72 and 83 of the same Directive, states that “[i]n exceptional circumstances, where the bail-in tool is applied, the resolution authority may exclude or partially exclude certain liabilities from the application of the write-down or conversion powers.”¹¹²

In delegated regulation, the EU Commission stated that in making the decision on whether or not to exempt liabilities from the application of bail-in, if the use of the tool may create direct contagion,¹¹³ the resolution authorities have to “assess, to the maximum extent possible, the interconnectedness of the institution under resolution with its counterparties.”¹¹⁴ If the use of the tool can generate indirect contagion,¹¹⁵ they have to “assess, to the maximum extent possible, the need and proportionality of the exclusion based on multiple

110. *Principles on Loss-Absorbing and Recapitalisation Capacity of G-SIBs in Resolution; Total Loss-Absorbing Capacity (TLAC) Term Sheet*, FIN. STABILITY BD. (Nov. 9, 2015), <http://www.fsb.org/wp-content/uploads/TLAC-Principles-and-Term-Sheet-for-publication-final.pdf> [<https://perma.cc/Q3M3-EAUX>].

111. Tobias H. Tröger, *Regulatory Influence on Market Conditions in the Banking Union: the Cases of Macro-Prudential Instruments and the Bail-in Tool*, 16 EUROPEAN BUS. ORG. L. REV. 588 (2015) (saying that “once implemented, the bail-in instrument must not destabilise markets. In order to prevent knock-on effects, the bail-inable instruments have to be held outside the banking sector by investors with sufficient loss-bearing capacity (e.g., insurance companies, pension funds, high-net worth individuals, hedge funds). Under these conditions, a bank failure may become a non-disruptive event that does not imperil market participants’ trust in the financial sector.”).

112. Council Directive 2014/59, 2014 O.J. (L 173) 190, 269.

113. See Council Decision 2016/859, 2016 O.J. (L 144) 3 (defines direct contagion).

114. See *id.* at 8 (provides the assessment methodology).

115. See *id.* at 3 (defines indirect contagion).

objective relevant indicators.”¹¹⁶

1. The Rationale

In all these cases, which represent exceptions to the general principle that creditors can be bailed-in, the rationale is to avoid contagion to other institutions and grant an exemption. However, this amounts to a breach of the equality principle as creditors standing in the same category can be exempt from being bailed-in because they are SIFIs or globally systemic important banks (G-SIBs), which in turn creates moral hazard—some institutions can take more risk because they would not be bailed-in due to their systemic implication.

The Financial Stability Board’s principle is a preventive measure which discourages banks from holding liabilities issued by other banks that can be made subject to write-down. Conversely, the legal instrument under article 44 paragraph 3 of the BRRD is a discretionary power given to the Resolution Authorities so that they can decide, after evaluation, when it is appropriate not to use the bail-in tool due to the possibility of generating a contagion that, in turn, produces financial instability.

Secured transactions are not currently affected, as the bail-in tool cannot be applied to assets on which a security interest has been created.¹¹⁷

C. The U.S. Regulation on Bail-in

In the U.S., the Dodd-Frank Act¹¹⁸ created a special federal receivership process with broad powers to resolve failing financial companies that pose a significant risk to the financial stability of the country in a manner that mitigates such risk and minimizes moral hazard.¹¹⁹ The authority to resolve the failing financial company¹²⁰ is entrusted to the Federal Deposit Insurance Corporation (FDIC), which acts as the Orderly Liquidation Authority (OLA). Section 204(a)(1) of Dodd-Frank Act indicates that creditors and shareholders will bear the losses of the financial company.

In 2013, the FDIC outlined its strategy to address the resolution of SIFIs. The core of its strategy was the “Single Point of Entry” (SPOE) resolution.¹²¹ Additionally, the FDIC also underlined that the Dodd-Frank Act provides itself with certain statutory authority to effect an orderly resolution; for example, the

116. *Id.* at 8.

117. Regulation No. 596/2014, 2014 O.J. (L 173) 1, 294 (states that secured liabilities including covered bonds cannot be bailed-in).

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

119. *See id.* § 204.

120. Financial companies include bank holding companies as defined in Section 2 of the Bank Holding Company Act, non-bank financial companies supervised by the Board of Governors, financial subsidiaries of these previous two and brokers and dealers registered with the SEC and that are members of SIPC.

121. Resolution of Systemically Important Financial Institutions: The Single Point of Entry Strategy, 78 Fed. Reg. 243, 76614 (Dec. 18, 2013).

FDIC may establish a bridge institution and transfer to it assets and liabilities of the holding company without obtaining consent or approval. To implement the SPOE strategy, the FDIC is to be appointed receiver of only the top-tier U.S. holding company, and subsidiaries would remain open to continue performing critical operations to avoid the disruption that would otherwise accompany their suspension—namely, the disturbance to the financial system and the risk of spillover effects to counterparties. The newly formed bridge financial company would continue to provide the holding company functions of the covered financial company.

This means that the regulatory approach used in the U.S. is different compared to the approach taken by the EU, but at the same time it should be able to allow for the orderly resolution of a bank without spreading systemic risk. Although it seems that due to the corporate organization structure of SIFIs in the U.S. there are no implications in relation to the equality principle, the FDIC has expressly stated in its SPOE strategy that in exceptional circumstances a disparate treatment of creditors can occur—although similarly situated creditors will not be treated differently so as to result in preferential treatment.¹²² There are no implications yet for secured transactions as these currently are exempted from bail-in.¹²³

D. EU vs. U.S. Resolution and the Principle of Equality

Both approaches to the same phenomenon are different. The EU, on one hand, faces certain impediments in the resolvability of SIFIs due to the corporate organization of its financial entities.¹²⁴ On the other, the U.S., due to its holding company structure, facilitates the resolution and liquidation of failing SIFIs through a SPOE strategy where the affected entity is the holding company and the other essential financial and banking functions are preserved.

The practical difficulties have led EU legislators to allow SIFIs, if needed, to breach the equality principle by exempting them from a bail-in if there is risk for contagion—while still bailing-in other similarly situated creditors. This policy exacerbates moral hazard. The U.S. approach is different and has minimized the possibility of a breach of the equality principle through regulation.

Secured transactions are currently unaffected in both legal systems as result of their exclusion from the bail-in tool.

122. See 12 CRF § 380.27 (2017).

123. See Resolution of Systemically Important Financial Institutions: The Single Point of Entry Strategy, 78 Fed. Reg. 243, 76614 (Dec. 18, 2013) (“Losses would be apportioned according to the order of statutory priority among the claims of the former equity holders and unsecured creditors, whose equity, subordinated debt and senior unsecured debt would remain in the receivership.”).

124. See Rosa Lastra, Rym Ayadi, Rodrigo Olivares-Caminal et al., *The Different Legal and Operational Structures of Banking Groups in the Euro Area, and Their Impact on Bank’s Resolvability*, EUR. PARLIAMENT, ECON. GOVERNANCE SUPPORT UNIT (Nov. 2016), [http://www.europarl.europa.eu/RegData/etudes/IDAN/2016/587377/IPOL_IDA\(2016\)587377_EN.pdf](http://www.europarl.europa.eu/RegData/etudes/IDAN/2016/587377/IPOL_IDA(2016)587377_EN.pdf) [<https://perma.cc/GXL2-Z86Y>].

V

CONCLUDING REMARKS

The genesis of equality in insolvency law is the principle that all creditors rank equally (*pari passu*). This is the departing point from which related propositions have been derived, for example, *pars condicio creditorum* or equal treatment. The *pari passu* principle works as an absolute rule unless the legislature decides, based on social needs, to depart from it. Policy changes have led to limiting or restricting the *pari passu* principle, creating distinctions between equals and sub-categories of equals. The *pars condicio creditorum* principle is a requisite to confirm what the *pari passu* principle has done (ranked creditors) and guarantee that everyone within the same rank or class are treated equally. In a distribution scenario, this is done by means of a pro-rata distribution. The essential issue at stake is whether avoiding systemically harmful consequences should be used as a normative justification for changing these principles.