HEARING ON THE "FINANCIAL INSTITUTION BANKRUPTCY ACT OF 2014"

HEARING

BEFORE THE

SUBCOMMITTEE ON
REGULATORY REFORM,
COMMERCIAL AND ANTITRUST LAW

OF THE

COMMITTEE ON THE JUDICIARY
HOUSE OF REPRESENTATIVES

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JULY 15, 2014

HEARING ON THE "FINANCIAL INSTITUTION BANKRUPTCY ACT OF 2014"

TUESDAY, JULY 15, 2014

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON REGULATORY REFORM, COMMERCIAL AND ANTITRUST LAW
COMMITTEE ON THE JUDICIARY,
Washington, DC.

The Subcommittee met, pursuant to call, at 3:57 p.m., in room 2141, Rayburn House Office Building, the Honorable Spencer Bachus (Chairman of the Subcommittee) presiding.

Present: Representatives Bachus, Goodlatte, Marino, Holding, Johnson, and Conyers.

Staff Present: (Majority) Anthony Grossi, Counsel; Ashley Lewis, Clerk; and (Minority) Susan Jensen, Counsel.

Mr. BACHUS. Good afternoon. The Subcommittee on Regulatory Reform, Commercial and Antitrust Law hearing will come to order.

And, without objection, the Chair is authorized to declare a recess of the Committee at any time.

And we have had kind of a helter-skelter day. And that may be a little severe, that word. But we expect to have votes probably in a little over 30 or 40 minutes. So we are going to still have opening statements, and then we will hear your statements, and we will have time for both of those, if that is okay. And I will start with my opening statement.

Having lived through it legislatively, first during the financial crisis of the fall of 2008 and then the deliberations that resulted in Dodd-Frank, I know that a question people often ask is why distressed financial firms were not resolved through the bankruptcy process instead of drawing on emergency government support, or what many people characterize as bailouts, government bailouts.

Over the last few years, industry legal and financial regulatory experts have examined this question in detail. This Committee, through its ongoing oversight of the Bankruptcy Code, has closely reviewed the question in addition to consulting experts in the field, and we have actually heard from several of you before. We have held a number of hearings on the issue, including two hearings in the past year on this precise matter.

Two points of general agreement appear to have emerged. The first is that the single-point-of-entry approach seems to be the most feasible and efficient method to resolve a financial institution that is organized with a holding company atop its corporate structure. The second point of agreement is that the Bankruptcy Code as currently drafted containsimpediments to using the single-point-of-entry approach.

The bankruptcy process has long been favored as the primary mechanism for dealing with distressed and failing companies because of its impartiality, adherence to established precedent, judicial oversight, and grounding in the principles of due process and rule of law.

We are here today as part of an effort to structure a bankruptcy process that is better equipped to deal with the specific issues raised by failing financial firms. By doing so, we can also address what some have described as bailout fatigue on the part of the American taxpayer.

The subject of today's hearing, draft legislation titled the "Financial Institution Bankruptcy Act," includes several provisions that could improve the ability of financial institutions to be resolved through the bankruptcy process.

It allows for a speedy transfer of a financial firm's assets to a newly formed company. It would continue the firm's operations for the benefit of its customers, employees, creditors, and the financial stability of the marketplace. This quick transfer is overseen by and subject to approval of an experienced bankruptcy judge and includes due-process protection for parties in interest.

Second, the draft bill provides the financial institutions' regulators with standing to be heard on issues impacting the general financial marketplace. Under a narrow set of circumstances, the Federal Reserve would be allowed to initiate a bankruptcy case over the objection of a financial institution. Specifically, the Federal Reserve must demonstrate to a judge by a preponderance of evidence that the financial institution is at or near insolvency and commencing a case is necessary to prevent substantial harm to financial stability.

In addition, there are provisions that facilitate the transfer of derivative and similarly structured contracts to the newly formed company which will improve the ability of the company to continue the financial institution's operations.

Finally, the legislation recognizes the factually and legally complicated questions presented by the resolution of a financial institution. To that end, the bill provides that specialized bankruptcy and appellate judges will be designated in advance to preside over these cases.

We have an esteemed panel of witnesses with expertise on bankruptcy and financial implications of the draft legislation. I will look forward to their testimony and the ensuing discussion as the Committee continues its consideration of this important issue.

And let me say before I turn to the Ranking Member, under Dodd-Frank, a study was commissioned, which actually the Federal Reserve and the Bank of England both said that bankruptcy, a single point of entry—they endorsed that approach.

And we have worked very closely with Members of the Democratic minority on this, and I think this is one of those issues where there is some bipartisan agreement that we can work together. And I think we have; our staffs have worked closely together on this.

And so, with that, I would recognize my Ranking Member, Mr. Johnson, for his opening statement.

Mr. JOHNSON. Thank you, Mr. Chairman.

And I, too, am heartened by the manner in which our staffs have been able to coordinate and cooperate and get to this point with a product that can be said to be bipartisan.

And I also want to acknowledge the brilliance of the people on this panel today. It doesn't get much better, from an intellectual point of view, than the gentlemen that we have seated before us today.

Thank you for your work, all of you.

And today's hearing concerns legislation that would attempt to accommodate the efficient winding down of a systemically important financial institution while promoting stability in the financial marketplace, rather than forcing a resolution under Title 2 of the Dodd-Frank Act. In other words, this legislation concerns how the Bankruptcy Code should treat the failure of the next Lehman Brothers, whose collapse caused untold insecurity in our Nation's financial system and wreaked havoc across the globe.

Four years ago, Congress enacted the Dodd-Frank Act in response to the greatest financial crisis since the Great Depression. I support this landmark legislation because it was a crucial step in reining in financial institutions that caused immeasurable hardship to so many American families. Built on the back of predatory lending of subprime mortgages to the most vulnerable members of society, including low-income, minorities, and the elderly, the great recession was indeed a study in corporate greed.

But despite stemming the hemorrhaging of our Nation's financial system, it is clear that Dodd-Frank left too many issues unaddressed. Banks are still too big for regulation, too big for trial, too big to fail, and too big to jail. I would also note that under the Roberts Court's interpretation of corporate speech, banks are also too big to respect the reproductive rights of women and too big to be bound by campaign finance law.

Later this week, this Subcommittee will conduct an oversight hearing on the Department of Justice's attempt to rein in fraud against the elderly and consumers. Imagine that. Banks are also too big to investigate for fraud and money laundering and too big to be held accountable for defrauding Americans.

With these observations in mind, it is my strong belief that any legislation to accommodate the winding down of a systemically important fiscal institution must promote the public interest through a transparent process.

Although I commend the Chair for the staff-level process for the discussion draft we are considering today, we have not heard from the bank regulators and many other important stakeholders on the draft bill. The purpose of this legislation should be the protection of the public interest. The input from bank regulators and other interested parties, specifically on the question of whether this legislation truly protects consumers, is vital to my support for the underlying bill.

We are all in the same boat when it comes to our Nation's financial system. I therefore urge the Chair to allow ample time to hear from all parties and stakeholders for their comment on this legislation and to not impose an arbitrary deadline on legislation that affects one of the most important aspects of the financial system.

Lastly, as I mentioned in this Subcommittee's hearing on Title 2 of Dodd-Frank in March, it is imperative that this Subcommittee consider the strengths and weaknesses of the Bankruptcy Code in not just business bankruptcy but in consumer bankruptcy, as well.

Few other areas are as important to most Americans as the crippling effects of student-loan debt, which has reportedly ballooned into the largest source of debt for American consumers. This debt is practically nondischargeable, growing exponentially, and has far-reaching consequences. I have little doubt that, if we put our minds to it, we could reach a bipartisan solution to alleviate the suffering of many of those consumers who are affected and afflicted by crushing student-loan debt.

Furthermore, I would remind the Chair that it is very difficult for the minority to routinely support the majority's priority legislation without reciprocity in consideration of issues. There are a number of outstanding bipartisan issues, like consumer bankruptcy, that merit discussion. I urge the Chair to consider these requests.

And I look forward to our witnesses' testimony on the discussion draft of the Financial Institutions Bankruptcy Act of 2014.

And, with that, I yield back.

Mr. BACHUS. Thank you, Mr. Johnson.

I would now like to recognize the full Committee Chair, Mr. Bob Goodlatte of Virginia, who later tonight will be playing tennis for charity against an opponent from the Administration.

Mr. GOODLATTE. On the other hand, I might be here working on immigration reform.

Mr. BACHUS. The great tennis match might be postponed, huh?

Mr. GOODLATTE. I thank the Chairman and welcome our panelists today.

This is an important hearing. Our Nation's financial system provides the lifeblood for industry to develop, grow, and prosper. Ensuring that this system functions efficiently in both good times and bad is critical to the ongoing vitality of our economy.

The recent financial crisis illustrated that the financial system and existing laws were not adequately prepared for the insolvency of certain institutions which threaten the very stability of the global economy and our financial industry. There has been considerable debate over whether Congress' main response the financial crisis, the Dodd-Frank Wall Street Reform and Consumer Protection Act, is adequate to respond to a future crisis.

Today's hearing, however, is not focused on that debate. Instead, we turn our attention to the private and public efforts to strengthen the Bankruptcy Code so that it may better facilitate the resolution of an insolvent financial firm while preserving the stability of the financial markets.

The subject of today's hearing, the Financial Institution Bankruptcy Act of 2014, is a reflection of these efforts. The bill is calibrated carefully to provide transparency, predictability, and judicial oversight to a process that must be executed quickly and in a manner that is responsive to potential systemic risks.

Additionally, it incorporates the single-point-of-entry approach, which a growing consensus of experts in public and private industry believe is the most effective and feasible method to resolve a financial institution that has a bank holding company.

The Judiciary Committee has a long history of improving the Bankruptcy Code to ensure that it is equipped properly to administer all failing companies. The Financial Institution Bankruptcy Act adds to this history by enhancing the ability of financial firms to be resolved through the bankruptcy process.

The development of the discussion draft before us today has been a collaborative effort that included the financial and legal community as well as the Democratic staff. This collaboration has continued through a broader circulation of the bill, including to, among others, the Federal Reserve, the FDIC, the courts, and Treasury. We look forward to feedback from all parties regarding the proposed text of the bill.

Over the course of the past year, during two separate hearings, this Committee has heard testimony that the Bankruptcy Code could be improved and that a measure that creates a new Subchapter V within Title 11 of the Bankruptcy Code should be enacted.

Today, we will hear from a panel of experts whether the draft before us meets these goals and whether the text could be further refined. I look forward to hearing from today's witnesses on this important measure.

Thank you, Mr. Chairman, for holding this hearing, and I yield back to you.

Mr. BACHUS. Thank you, Chairman Goodlatte.

I would now like to recognize the full Committee Ranking Member, Mr. John Conyers, Jr., of Michigan, for his opening statement.

Mr. CONYERS. Thank you, Chairman Bachus.

Welcome, witnesses.

I am the last presenter on this side of the table. And we are trying to ensure that the resolution of complex bank holding companies on the verge of insolvency can be better facilitated under the Bankruptcy Code, and I would appreciate your views on that.

Any legislative fix should be premised on the critical lessons learned from the near collapse of our Nation's economy just 5 years ago. Without doubt, the great recession was a direct result of the regulatory equivalent of the wild west. And in the absence of any meaningful regulation of the mortgage industry, lenders developed high-risk subprime mortgages and, frankly, used predatory marketing tactics, targeting the most vulnerable.

These doomed-to-fail mortgages were then securitized and sold to unsuspecting investors, including pension funds and school districts. Once the housing bubble burst, the ensuing 2008 crash stopped the flow of credit and trapped millions of Americans in mortgages they could no longer afford, causing waves of foreclosures across the United States, massive unemployment, and international economic upheaval.

And to this day, we are still dealing with the lingering effects of the great recession of 2008. Neighborhoods across the Nation are still blighted by vast swaths of abandoned homes. Many municipalities, big and small, continue to struggle with the attendant costs resulting from mortgage-foreclosure-induced blight as well as reduced revenues.

Thus, lesson number one is the legislation should make it easier, not harder, for regulators to respond to an imminent threat to the Nation's financial marketplace.

Then, as demonstrated by the failure of Lehman Brothers and the resultant near collapse of Wall Street, it is critical that liquidity and trust in the financial marketplace be restored as soon as possible after the collapse of a major financial institution. Fortunately, Dodd-Frank goes a long way toward reinvigorating a regulatory system that makes the financial marketplace more accountable and, hopefully, more resilient.

The act also institutes long-needed consumer protections. While Dodd-Frank establishes a mandatory resolution mechanism to wind down a systemically significant financial institution, the act implicitly prioritizes using a bankruptcy solution before invoking Dodd-Frank's orderly liquidation process. This is because the Bankruptcy Code has, for more than 100 years, enabled some of the Nation's largest companies to regain their financial footing, including, more recently, General Motors and Chrysler.

But for bankruptcy to be truly viable as an alternative to a Title 2 resolution process, the bank holding company must have access to lenders of last resort, even if it is the Federal Government. Unfortunately, the draft bill is utterly silent on that critical component. In fact, the Senate counterpart to this measure strictly forbids government assistance. So I need you to think with me of whether we are engaged, at least to some degree, in a futile effort.

And, in concluding, this legislation must be carefully analyzed to ensure that the constitutional due-process and property rights are not violated. Although there appears to be a consensus that the bankruptcy law must be amended to better accommodate the resolution of large bank holding companies, we must ensure that fundamental rights and protections are not adversely affected, even unintentionally.

In the rush to expedite the transfer of a troubled company's assets, does the bill ensure that the interests of all affected parties are adequately protected? And I hope you will respond to that. Does the legislation strike the right balance between stemming panic contagion and transparency? Are the legislation's time limits for judicial determinations and appeals workable?

And so here we are today trying to struggle through these and other considerations, and we have to continue to realize that the regulators and the Federal courts play a critical role in these determinations. And so I invite you to join us in what is a very, very important hearing.

And Mr. Chairman, I yield back the balance of my time.

Mr. BACHUS. Thank you, Ranking Member Conyers.

Without objection, all Members' written statements will be made a part of the record.

As Ranking Member Johnson said, we have a very distinguished panel before us, and I will first start by introducing our witnesses.

Mr. Don Bernstein is partner of Davis Polk, where he heads the firm's insolvency and restructuring practice. During his distinguished 35-year career, he has represented nearly every major financial institution in numerous restructurings, as well as leading a number of operating firms through bankruptcy, including Ford, LTV, and Johns Manville.

Mr. Bernstein has spent the last several years working on resolution plans, commonly referred to as living wills, for large financial firms, as well as representing financial institutions on resolution-related issues.

Mr. Bernstein has earned multiple honors for his practice, including being elected by his peers as chairman of the National Bankruptcy Conference, the most prestigious professional organization in the field. Mr. Bernstein received his A.B. Cum laude from Princeton University and his J.D. From the University of Chicago Law School.

We welcome you.

Professor Tom Jackson holds faculty positions in the William E. Simon School of Business Administration and the Department of Political Science at the University of Rochester, where he also served as president from 1994 to 2005.

Before he became Rochester's ninth president, Mr. Jackson was vice president and provost for the University of Virginia, where he first joined as the dean of Virginia's School of Law. Previously, he was professor of law at Harvard and served on the faculty at Stanford University.

He clerked for U.S. District Court Judge Marvin Frankel in New York from 1975 through 1976 and then for Supreme Court Justice and later Chief Justice William H. Rehnquist from 1976 to 1977.

Professor Jackson is the author of bankruptcy and commercial law texts used in law schools across the country. Recently, he has spent considerable time on the issue of improving the Bankruptcy Code to facilitate the resolution of financial institutions, including working with the Hoover Institute, the Bipartisan Policy Center, and the FDIC on this issue.

And he received his B.A. From Williams College and his J.D. From Yale Law School.

So, welcome.

Mr. Stephen Hessler is a partner of the restructuring group of Kirkland & Ellis. His practice involves representing debtors, creditors, and investors in complex corporate Chapter 11 cases, out-of-court restructurings, acquisitions, and related trial and appellate litigation.

He has counseled clients across a broad range of industries, including energy, gaming, hospitality, and real estate, telecommunications, financial institutions, and manufacturing.

Prior to joining Kirkland & Ellis, Mr. Hessler was a law clerk for Judge Ambro at the United States Court of Appeals for the Third Circuit, as well as Justice Hepburn at the United States District Court for the Western District of Kentucky. He also served on the staff of Senator Spencer Abraham.

In addition to practicing law, Mr. Hessler is a frequent lecturer and author on a variety of restructuring-related topics. He currently serves as the chairman of one of the advisory boards to the

American Bankruptcy Institute's Commission to Study the Reform of Chapter 11. He also teaches a restructuring class each fall at the University of Pennsylvania to both law school and Wharton students.

Mr. Hessler recently was selected by Turnarounds and Workouts as one of their 2013 outstanding young restructuring lawyers. He received his B.A. And J.D. From the University of Michigan, where he served as a managing editor of Michigan's Law Review.

Again, quite impressive.

And particularly for you who teach classes at law schools, or Wharton students in your case, you better know your subject if you teach at that level.

Professor Steven Lubben is the holder of the Harvey Washington Wiley Chair in corporate governance and business ethics at Seton Hall and is a recognized expert in the field of corporate finance and governance, corporate restructuring, financial distress, and debt.

He is the author of a leading corporate finance text and a contributing author to the Bloomberg Law on Bankruptcy treatise. He is also a columnist for the New York Times Deal Book page.

And I read that. I will have to pay more attention to your articles.

Following graduation from law school, Professor Lubben clerked for Justice Broderick in the New Hampshire Supreme Court. He then practiced bankruptcy law in the New York and Los Angeles offices of Skadden & Arps, where he represented parties in Chapter 11 cases throughout the country.

Since joining Seton Hall, Professor Lubben has presented his papers at academic conferences around the world and frequently provides commentary on Chapter 11 and related issues for national and international media outlets, including the Wall Street Journal, the New York Times, the Financial Times, Reuters, the Associated Press, Bloomberg, and BBC.

Professor Lubben received his B.A. From the University of California Irvine and his J.D. From Boston University, his LLM from Harvard Law School and his Ph.D. From the University of Groningen—is that right?

Mr. LUBBEN. Yes, close.

Mr. BACHUS. He tried to teach me, but I couldn't get it—in the Netherlands.

Mr. LUBBEN. My wife can't get it either, so don't worry about it.

Mr. BACHUS. Thank you.

All right. We will start with Mr. Bernstein.

TESTIMONY OF DONALD S. BERNSTEIN, PARTNER, DAVIS POLK & WARDWELL LLP

Mr. BERNSTEIN. Thank you, Chairman Bachus and Ranking Member Johnson, as well as Chairman Goodlatte, Ranking Member Conyers, and the other Members of the Subcommittee. I want to thank you for inviting me to testify before this Subcommittee once again about the resolution of systemically important financial institutions under the Bankruptcy Code.

I am especially pleased to be commenting on the draft, which I commend the staff on, of the Financial Institution Bankruptcy Act of 2014 that would add a new Subchapter V to Chapter 11 of the Bankruptcy Code dealing with insolvencies of large financial firms.

In light of time constraints, I am going to focus on a few key issues in my testimony; I am not going to focus on everything. But I commend the testimony to you.

The first issue is bankruptcy as the first method of resolution but retaining Title 2 of Dodd-Frank, as well. As others have mentioned, Title 2 can only be invoked if resolution in bankruptcy can't be effectively accomplished. And I think this is as it should be.

Bankruptcy is a transparent process. It is driven by the rule of law. But Title 2 should remain as a backup resolution tool. It is important to have that available. And we don't know whether we will ever need to use it, and, hopefully, if this bill is passed, it will make it far less likely that we will need to use Title 2.

When I was before the Subcommittee in December, I did recommend that the Bankruptcy Code be amended to add tools to facilitate what I called at the time whole-firm recapitalizations, similar to the single-point-of-entry resolution strategy advocated by the FDIC.

I think it is increasingly recognized, not only in the United States but in other parts of the world, that whole-firm recapitalization is the best way of resolving large financial institutions in a manner that minimizes losses, minimizes systemic disruption, and prevents taxpayer bailouts.

This is because recapitalization preserves the going-concern value of a financial firm by avoiding what I will call a short-stop liquidation of the kind that we had in Lehman Brothers. It maintains the continuity of the firm's operations that may be critical to the financial system. Examples are custody, clearance, settlement of transactions. All of these things run through our financial institutions, and if they get disrupted or stopped, it could be very systemically damaging.

And, most importantly, the recapitalization imposes the firm's losses on private-sector creditors rather than on taxpayers. This is a highly important point because, by removing an implicit government backstop of financial firms, it incentivizes private-sector creditors to appropriately price risks and, most importantly, to engage in more effective monitoring of these firms.

And I would point out—and Representative Conyers made the point about making sure that financial firms are not taking undue risks—the creditors should actually be monitoring that. And having an incentive for them to do it, by making it clear that they are going to absorb the losses, is extremely important.

Professor Jackson and I describe in our testimony that single-point-of-entry recapitalization is facilitated by the bank holding company structure that we have in the United States. In other countries, they don't necessarily have holding companies.

What a holding company does is it creates a class of structurally subordinated debt at the holding company which can be used to be bailed in, or recapitalized, by being left behind in our system in a bankruptcy or a receivership. And the process is described in all of the witness statements, so I am not going to belabor it, but it facilitates a recapitalization solution to have this holding-company structure.

The bill we are looking at today embraces the idea of whole-firm recapitalization. It includes many of the tools that I discussed in December, and I think the bill's overall approach is the right one. And its passage, with some minor modifications, would be a substantial step forward in helping to assure that taxpayer-funded bailouts never happen again.

I want to focus on three particular points in the legislation, and you will see why I think they are important. The first one is the definition of "capital structure debt." That is the debt that gets left behind when you recapitalize the firm. I noted in my written testimony that the bill's expansion of the definition of "capital structure debt" to include all unsecured debts of the holding company and to omit the words "debts for borrowed money" reduces the clarity that the market has over how the recapitalization is going to occur.

The Federal Reserve has announced that they plan to require companies to have substantial amounts of capital structure debt, and the discussion has been about long-term debt, which is not, for example, held by mutual funds or money market funds. And I actually favor the definition that is in the Senate version of the bill because it focuses on long-term debts with maturities of longer than a year and debt for borrowed money, and there are two reasons for this. First of all, I think it really corresponds to the expectation of what the Federal Reserve is likely to put out, and it is going to make it clear to creditors which class of debt is going to be the debt that ends up being used to recapitalize the firm.

One of the criticisms that has been leveled against Title II is that the statute doesn't make it sufficiently clear which category of debt is going to be the debt that is going to be bailed in and how that decision is going to be made.

Second, as I mentioned, those debts with maturities of less than a year are held in various places where they could become systemically significant. And if capital structure debt is defined to include those potentially systemically significant debts, it could require that a provision be included in the bill to give regulators the discretion to exclude certain capital structure obligations for favored treatment so that if there is a systemic risk associated with some of the capital structure debt, it would be assumed by the bridge company rather than left behind.

The National Bankruptcy Conference recommended this particular solution in its letter to the Subcommittee of January 29. The NBC was concerned that a bright-line test might create activities to avoid the test. But as noted in the written testimony, with the Federal Reserve actually promulgating a requirement that this debt be in place, I think the risk of avoidance goes away because the financial institutions will actually have to maintain the debt on their balance sheets. So this debt will be there if it is needed.

The second topic I want to discuss is the topic of the special trustee. The special trustee provision in this bill, in my view, is important and should be retained. Its use is not mandatory, but it does have an important purpose. From the point of view of the market, and from the point of view of foreign regulators, it is highly important that the new bridge company be returned to a state of normalcy as soon as possible. This will enhance the likelihood of quickly regaining access to private-sector liquidity and reduce the risk of ring fencing by local regulators.

To accomplish these goals, it may be highly desirable that the recapitalized firm be perceived as healthy enough to longer be subject to the bankruptcy process. The provisions of section 1186 of the bill permit the court to transfer the bridge company to a special handpicked trustee, and it gives the court the necessary authority to accomplish this if it is in the best interests of the estate and is going to preserve the value of the asset.

The last point I want to mention is the question of how the proceedings get commenced. I think it is very appropriate for the Federal Reserve to be given the right to file an involuntary case against a SIFI if a board of directors has not voluntarily done so in the appropriate circumstances; however, I think it is a failure if the Federal Reserve actually has do that. A dispute over commencement of the case could seriously impair the effectiveness of resolution proceedings.

With this in mind, I think the bill should do what it can to encourage voluntary petitions in Subchapter V cases where the firm is in financial distress. And I have suggested that the bill adopt an approach similar to the one taken in Title II of Dodd-Frank, where the simple act of filing or consenting to a case under Subchapter V should not cause liability for the board. Boards will remain accountable for their prebankruptcy actions, but they shouldn't feel at risk for the simple act of invoking Subchapter V.

In my written testimony I have made a number of other technical comments both about the safe harbor provisions as well as the provisions relating to avoidance actions. I generally support these provisions. I think they are critical to accomplishing the goal of Subchapter V. However, I think some of the technical tweaks I suggest are merely cross-reference errors in some cases, but they should be fixed so that the provisions work as intended. I welcome the opportunity to discuss these technical points directly with the staff, and would also like the opportunity to study the bill further and provide additional technical comments if I have any.

Once again, I am extremely grateful for the opportunity to present my views. I believe this bill is a very important step forward, and I thank the Committee for considering this legislation. I would, of course, be pleased to answer any questions about my written statement or my oral testimony. Thank you.

[The prepared statement of Mr. Bernstein follows:]

STATEMENT OF

DONALD S. BERNSTEIN

BEFORE

SUBCOMMITTEE ON REGULATORY REFORM, COMMERCIAL AND ANTITRUST LAW

THE COMMITTEE ON THE JUDICIARY

U.S. HOUSE OF REPRESENTATIVES

WASHINGTON, D.C.

JULY 15, 2014

H.R. , THE "FINANCIAL INSTITUTION BANKRUPTCY ACT OF 2014"

Thank you for inviting me to testify once again on the subject of the resolution of financial firms under the Bankruptcy Code. I am Donald S. Bernstein, co-chair of the Insolvency and Restructuring Group at Davis Polk & Wardwell LLP. I am on the Board of Editors of *Collier on Bankruptcy*, a Commissioner on the American Bankruptcy Institute's Commission on the Reform of Chapter 11, and a past Chair of the National Bankruptcy Conference. As I indicated during my testimony at this Subcommittee's oversight hearing on this topic in December, during the last few years, I have spent a significant portion of my time working on resolution plans for large financial firms under Section 165(d) of the Dodd-Frank Act – commonly known as Living Wills. I have also represented financial industry organizations, such as The Clearing House Association and SIFMA on issues related to the resolution of financial firms. I am, however, once again here in my individual capacity and not on behalf of any client, though I expect to be asked by clients to help them evaluate the bill we are discussing today. In any event, the views I express are my own, and not those of Davis Polk, any client or any organization with which I am affiliated.

As the Subcommittee is aware, in my testimony in December, I strongly endorsed the idea that the Bankruptcy Code should be amended to add tools to facilitate a whole-firm recapitalization approach to resolving systemically important financial firms similar to the "single point of entry" approach developed by the Federal Deposit Insurance Corporation under Title II of the Dodd-Frank Act (Orderly Liquidation Authority or OLA). I applaud the bi-partisan effort to develop amendments to the Bankruptcy Code along these lines, and in particular thank the members of this Subcommittee for convening these hearings to delve more deeply into the details of an excellent draft of what might become the Financial Institution Bankruptcy Act of 2014 (the "draft bill" or "draft House bill"). The draft bill embraces the idea of whole-firm recapitalization as a means of resolving SIFIs, which, as I and others have said,[1] is by far the best approach to resolving systemically important financial firms without taxpayer-funded bailouts.

General Background and My Prior Testimony

I want to begin by emphasizing a few of the points I made in my December testimony that will set the stage for my comments on the draft bill. I noted then that the unplanned failure of Lehman Brothers in 2008 was preceded by a run on liquidity that led to Lehman's bankruptcy, which in turn led to wholesale close-outs of open financial contracts, the selling of collateral into distressed markets and ultimately the sale of Lehman's businesses and remaining assets at fire-sale prices. This chaotic sequence of events led to fear in the markets that other firms might suffer the same fate – contagious panic. In the harsh light of these events and their aftermath, I strongly believe that the abrupt unraveling of financial firms must be avoided and that an efficient means must be

[1] *E.g., Too Big to Fail: The Path to a Solution*, A Report of the Failure Resolution Task Force of the Financial Regulatory Reform Initiative of the Bipartisan Policy Center (May 2013) (BPC Report); Federal Deposit Insurance Corporation & Bank of England, Joint Paper, *Resolving Globally Active, Systemically Important, Financial Institutions* (Dec. 10, 2012) (jointly proposing the single-point-of-entry approach); Martin J. Gruenberg, Chairman of the FDIC, & Paul Tucker, Deputy Governor for Financial Stability at the Bank of England, Op. Ed., *Global Banks Need Global Solutions When They Fail*, FINANCIAL TIMES (Dec. 10, 2012); Daniel K. Tarullo, Member, Board of Governors of the Federal Reserve System, *Toward Building a More Effective Resolution Regime: Progress and Challenges*, Remarks at the Federal Reserve Board and Federal Reserve Bank of Richmond Conference, Planning for the Orderly Resolution of a Globally Systemically Important Bank (Washington, D.C., Oct. 18, 2013) ("The single-point-of-entry approach offers the best potential for the orderly resolution of a systemic financial firm…"); William Dudley, President and Chief Executive Officer, Federal Reserve Bank of New York, Remarks at the Federal Reserve Board and Federal Reserve Bank of Richmond Conference, Planning for the Orderly Resolution of a Globally Systemically Important Bank, P. 1 (Washington, D.C., Oct. 18, 2013) ("I very much endorse the single-point-of-entry framework for resolution as proposed by the Federal Deposit Insurance Corporation (FDIC)."). For step-by-step diagrams illustrating the FDIC's single-point-of-entry resolution strategy, see BPC Report, pp. 23-32. *See also* FDIC, *Resolution of Systemically Important Financial Institutions: The Single Point of Entry Strategy*, 78 Fed. Reg. 76614 (Dec. 18, 2013).

found of speedily causing the distressed firm's losses to be absorbed by private shareholders and creditors so valuable components of the firms can continue in business under new ownership and management, or be wound down in an orderly manner as going concerns.

This is what whole-firm recapitalization – the "single point of entry" approach to the resolution of resolution financial firms – is designed to accomplish, and I believe that if the Bankruptcy Code were amended to add tools to facilitate such recapitalizations, it would help assure that appropriate values could be realized for the firms' assets, that disorderly liquidations and market panic could be avoided, and most importantly that taxpayers would not have to bail out distressed financial firms.

In 2008, regulators had a very limited set of tools with which to stem contagious panic and resolve distressed financial institutions without fire-sales of assets and the unraveling of maturity transformation – the main and economically essential business of financial institutions. As I stated in my prior testimony, the inadequacy of those tools and the lack of pre-failure resolution planning put taxpayers in the position of having to invest in financial firms to recapitalize them. Though the large financial institutions repaid those investments with interest, most observers believed that better tools were needed to deal with the failure of financial firms.

As I noted in my December testimony, Title II of the Dodd-Frank Act provides the essential tools to recapitalize failing firms without taxpayer funded bailouts by imposing a financial firm's losses on investors rather than taxpayers,[2] but some of the essential tools available under Title II are currently unavailable or not obviously available under the Bankruptcy Code.

The single-point-of-entry approach to resolution involves commencing resolution proceedings only with respect to the financial firm's top-level parent holding company, with all losses of the distressed financial firm being borne by shareholders and creditors of that entity and not by taxpayers. Operating entities, like the firm's banking or broker-dealer subsidiaries, would not be placed in insolvency or resolution proceedings, would be recapitalized using assets of the holding company and would continue as subsidiaries of a newly created debt-free bridge holding company. The old holding company's creditors and shareholders would be left behind either in bankruptcy proceedings or in an OLA receivership, and a viable recapitalized firm would be created the value of which would be preserved without requiring bankruptcy or a prolonged resolution process for the firm's operating entities. By recapitalizing the firm's operating subsidiaries with holding company assets at the outset of the process, the single-point-of-entry approach preserves the continuity and value of those operating businesses and pushes the firm's operating losses up to the old holding company to be absorbed by the holding company's shareholders and creditors. The holding company's stakeholders nevertheless benefit from the strategy because liquidation of the firm's valuable operating businesses and assets at fire-sale prices is avoided and the going concern value of the operating

[2] These tools include: (1) the power to create and transfer the failed holding company's assets to a bridge financial company; (2) a temporary stay on financial contract terminations and a temporary override of cross-defaults; (3) the ability to assume financial contracts and related guarantees; and (4) the availability of temporary secured liquidity.

subsidiaries is preserved. This value ultimately is available for distribution to the stakeholders at the end of the resolution process.

We are fortunate that, in the United States (unlike some other countries), large financial firms already utilize a holding company structure, and significant amounts of equity and long-term unsecured debt are issued by these holding companies and are structurally subordinated to deposits and other operating liabilities of financial subsidiaries. If a firm's equity becomes impaired as a result of losses, the layer of structurally subordinated loss absorbing debt at the holding company can be utilized to recapitalize the firm if the legal tools are available to speedily push the firm's operating losses up to holding company creditors while keeping systemically critical operating subsidiaries out of resolution proceedings.[3]

Financial firms, together with their primary regulators, are continuing to take steps to enhance the ability to resolve financial firms using this recapitalization model. The firms have undergone substantial changes since 2008 that improve their resiliency, including a substantial increase in capital and balance sheet liquidity to meet regulatory requirements and risk management needs,[4] the de-risking of the balance sheets of U.S.

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[3] The fact that the holding company structure facilitates whole-firm recapitalizations of this type is leading to recommendations that financial firms in other countries be restructured along the lines of the U.S. bank holding company model. *See* Paul Tucker, *The Resolution of Financial Institutions Without Taxpayer Solvency Support: Seven Retrospective Clarifications and Elaborations*, Remarks at European Summer Symposium in Economic Theory, Gerzensee, Switzerland (July 3, 2014), at 10.

[4] *See* Federal Reserve and OCC, Regulatory Capital Rules, 78 Fed. Rev. 62, 018 (Oct. 11, 2013) (to be codified at 12 C.F.R. Pts. 3, 5, 6, 165, 167, 208, 217, and 225); FDIC, Regulatory Capital Rules, 78 Fed. Reg. 55, 340 (Sept 10, 2013) (to be codified at 12.C.F.R. pts. 303, 308, 324, 327, 333, 337, 347, 349, 360, 362, 363, 364, 365, 390, and 391); Federal Reserve, OCC and FDIC, Liquidity Coverage Ratio: Liquidity Risk Measurement, Standards, and Monitoring (Proposed Rule), 78 Fed. Reg. 71, 818 (Nov. 29, 2013). According to the Federal Reserve, the largest U.S. bank holding companies have increased their common equity to more than twice the amount they had during the financial crisis of 2008. Specifically, the (....continued)

financial firms, and capital restructuring to address anticipated regulatory requirements for sufficient amounts of loss absorbing debt and assets in the holding companies of financial firms.[5]

Notably, other countries are amending their laws so that Special Resolution Regimes administered by local regulators can be used to recapitalize foreign financial

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weighted tier 1 common equity ratio, which is the ratio of common equity to risk-weighted assets, of the 18 bank holding companies that participated in the Federal Reserve's Comprehensive Capital Analysis and Review (CCAR) has more than doubled from 5.6% at the end of 2008 to 11.3% in the fourth quarter of 2012, reflecting an increase in common equity from $393 billion to $792 billion during the same period. *See* Federal Reserve, Press Release – Federal Reserve Announces Results of Comprehensive Capital Analysis and Review (CCAR) (Mar. 14, 2013), *available at* http://www.federalreserve.gov/newsevents/press/bcreg/20130314a.htm. The results of the Federal Reserve's 2013 Dodd-Frank and CCAR stress tests show that the largest U.S. bank holding companies have enough common equity to absorb all of their projected losses under the Federal Reserve's severely adverse stress scenario and still have enough common equity left to exceed the minimum risk-based and leverage capital requirements. *See* Federal Reserve, Comprehensive Capital Analysis and Review 2013: Assessment Framework and Results (Mar. 14, 2013), *available at* http://www.federalreserve.gov/newsevents/press/bcreg/ccar-2013-results-20130314.pdf. Besides a significant increase in levels of loss-absorbing capital, U.S. banks have also substantially improved their liquidity profiles. For example, U.S. banks' holdings of cash and high-quality liquid securities have more than doubled since the end of 2007 and now total more than $2.5 trillion. *See* Ben S. Bernanke, Chairman, Board of Governors of the Federal Reserve System, Stress Testing Banks: What Have We Learned? (Apr. 8, 2013), *available at* http://www.federalreserve.gov/newsevents/speech/bernanke20130408a.pdf.

[5] *See* Daniel K. Tarullo, Member, Board of Governors of the Federal Reserve System, *Toward Building a More Effective Resolution Regime: Progress and Challenges*, Remarks at the Federal Reserve Board and Federal Reserve Bank of Richmond Conference, Planning for the Orderly Resolution of a Globally Systemically Important Bank (Washington, D.C., Oct. 18, 2013) (announcing that the Federal Reserve expects to propose minimum long-term debt and eligible assets requirements applicable at the bank holding company level for the largest U.S. banking groups within the next few months in order to ensure they have sufficient loss-absorbing resources to facilitate a single-point-of-entry resolution). *See also* Paul Tucker, *The Resolution of Financial Institutions Without Taxpayer Solvency Support: Seven Retrospective Clarifications and Elaborations*, Remarks at European Summer Symposium in Economic Theory, Gerzensee, Switzerland, at 7-8 (July 3, 2014); International Monetary Fund, *Cross Border Bank Resolution: Recent Developments*, at 12 (June 2014); Mark Carney, Chairman, Financial Stability Board, *Financial Reforms Update on Progress*, at 2 (Apr. 4, 2014); *Progress and Next Steps Towards Ending "Too-Big-To-Fail" (TBTF)*, Report of the Financial Stability Board to the G-20 (Sep. 2, 2013) (announcing that the Financial Stability Board is developing minimum gone-concern loss-absorbing capacity requirements to ensure that global and domestic systemically important financial institutions have enough loss-absorbing capacity in the form of equity, long-term debt and assets to recapitalize the institutions without the need for taxpayer capital in the event of severe financial distress). *See also* Morgan Stanley Research North America, Large and Midcap Banks, *OLA: More Debt Sooner?* (Dec. 13, 2012); Goldman Sachs Research, *Loss Absorbency in Banks* (Dec. 2012); J.P. Morgan North America Credit Research, *Tarullo Speech Increases Momentum for Debt Buffers* (Dec. 6, 2012)

firms using the same whole-firm recapitalization model we are developing here in the United States, adapted to the structure of financial firms outside the U.S. Among other recent developments in this regard is the approval by the European Parliament of the Bank Recovery and Resolution Directive (BRRD), which, when finally implemented by EU member states, will provide for the "*bailing in*" of capital structure debt, the preservation of financial contracts and the power to recognize foreign resolution regimes.[6]

In addition, because of initiatives by regulators at the multinational level, including those of the Financial Stability Board and crisis management groups organized among key regulators of individual firms, there is increasing alignment among national regulatory authorities regarding the benefits of the recapitalization and bail-in approaches to dealing with distressed financial firms.[7] A single-point-of-entry recapitalization, for example, protects host-country interests by making resolution proceedings for host-country operations unnecessary. Since the counterparty credit exposures of the largest

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[6] *See Directive 2014/59/EU of the European Parliament and of the Council establishing a framework for the recovery and resolution of credit institutions and investment firms* (May 15, 2014). *See also* Andrea Thomas, *Germany Approves Plans to Force Creditors to Prop Up Struggling Banks*, THE WALL STREET JOURNAL (July 9, 2014)

[7] *See, e.g.*, International Monetary Fund, *Cross-Border Bank Resolution: Recent Developments* (June 2014); Financial Stability Board, *Key Attributes for Effective Resolution Regimes of Financial Institutions* (Oct. 2011) (endorsing recapitalization (bail-in) within resolution strategies and advocating the creation of legal tools to effect such strategies); Federal Deposit Insurance Corporation & Bank of England, Joint Paper, *Resolving Globally Active, Systemically Important, Financial Institutions* (Dec. 10, 2012) (endorsing and advocating single-point-of-entry resolution strategies for systemically important financial institutions); *Progress and Next Steps Towards Ending "Too-Big-To-Fail" (TBTF)*, Report of the Financial Stability Board to the G-20 (Sep. 2, 2013) (endorsing single-point-of-entry and multiple-point-of-entry resolution strategies and announcing plans for minimum gone-concern loss-absorbing capacity requirements to ensure the feasibility of such strategies).

U.S. financial firms are highly concentrated in a few jurisdictions, such as the UK,[8] coordination and alignment among the relevant authorities can readily occur if appropriate advance planning among regulatory authorities can be done. Key to these efforts is the fact that recapitalization and bail-in strategies allow the firms to continue their business and meet their operating obligations in the ordinary course in both home and host countries. As a result, local regulators should not feel compelled to take precipitous actions that can hinder the resolution of the overall group.

Regulators and private sector organizations like ISDA are also developing contractual approaches to facilitating the resolution of financial firms, including by limiting, subject to appropriate conditions, termination rights under certain types of financial contracts, so the new legislation in home countries can be enforced across international borders.

In the United States, the Dodd-Frank Act makes clear that the use of our Special Resolution Regime, OLA, is to be limited to situations where bankruptcy is not a viable resolution strategy,[9] and the FDIC has announced that it supports the idea that

[8] *See* FDIC Presentation to the FDIC Systemic Resolution Advisory Committee Meeting, Panel on International Resolution Strategy (Dec. 10, 2012) (over 90% of the total reported foreign activity for the top seven U.S. SIFIs is located in three foreign jurisdictions, with the UK having the largest footprint). Video available at http://www.vodium.com/MediapodLibrary/index.asp?library=pn100472_fdic_SRAC. Presentation slides from the meeting are available at http://www.fdic.gov/about/srac/2012/2012-12-10_international-resolution-strategy.pdf.

[9] Section 203(b) of the Dodd-Frank Act provides in relevant part that the Orderly Liquidation Authority of Title II of the Dodd-Frank Act may not be legally invoked unless the Secretary of the Treasury determines that "the failure of the financial company and its resolution under otherwise applicable Federal or State law [e.g., the Bankruptcy Code] would have serious adverse effects on financial stability in the United States" and "any action under section 204 [of the Dodd-Frank Act] would avoid or mitigate such adverse effects . . . ."

bankruptcy, not OLA, should be the presumptive resolution procedure.[10] As I noted in my prior testimony, however, because of the absence or lack of clarity regarding essential tools in the Bankruptcy Code to address the special circumstances of distressed financial firms, the resolution plans of financial firms submitted under Title I of the Dodd-Frank Act have typically adopted hybrid approaches, in which some operating businesses and entities continue and are sold or recapitalized, while others are allowed to wind-down in an orderly way.

Because of the clear benefits of the whole-firm recapitalization approach to resolving financial firms, in December I recommended that amendments be made to the Bankruptcy Code to add or improve the tools available to facilitate a single-point-of-entry approach to resolution in bankruptcy.[11] Specifically, I suggested that such amendments should (1) clarify that bank holding companies can recapitalize their operating subsidiaries prior to or in connection with bankruptcy proceedings, (2) clarify that the Bankruptcy Code can be used to accomplish the transfer of recapitalized entities to a new holding company using a bridge company structure, (3) include provisions that provide

[10] *See* Remarks by Martin J. Gruenberg, Chairman, Federal Deposit Insurance Corporation, on Implementation of the Dodd-Frank Act before the Volcker Alliance Program (October 13, 2013) *available at* http://www.fdic.gov/news/news/speeches/spoct1313.html; *See also* Statement of Martin J. Gruenberg, Chairman, Federal Deposit Insurance Corporation on Implementation of the Dodd-Frank Act before the Committee on Banking, Housing and Urban Affairs, United States Senate (December 6, 2011) ("If the firms are successful in their resolution planning, then the OLA would only be used in the rare instance where resolution under the Bankruptcy Code would have serious adverse effects on U.S. financial stability"), *available at* http://www.fdic.gov/news/news/speeches/chairman/spdec0611.html.

[11] *See* Thomas H. Jackson, *Bankruptcy Code Chapter 14: A Proposal*, in BANKRUPTCY NOT BAILOUT: A SPECIAL CHAPTER 14 (Hoover Institution, Kenneth E. Scott & John B. Taylor, eds., 2012); Thomas H. Jackson, *Building on Bankruptcy: A Revised Chapter 14 Proposal for the Recapitalization, Reorganization, or Liquidation of Large Financial Institutions*, Hoover Institution, The Resolution Project (Draft, July 9, 2014); Ken Scott, *The Context for Bankruptcy Resolutions* (Draft, July 9, 2014). *See also* BPC Report, pp. 11-14 (recommendations for amending the Bankruptcy Code to facilitate the execution of a single-point-of-entry strategy under the Bankruptcy Code).

for a short stay of financial contract close-outs and allow the assumption and preservation of financial contracts, overriding ipso facto (bankruptcy) defaults and cross-defaults that might impede the resolution process, and (4) provide some form of fully secured liquidity resource that makes backstop financing available if needed to help stabilize the recapitalized firm and prevent fire sales until access to market liquidity returns.

These recommendations, made seven months ago, offer an excellent starting point for providing reaction to the draft bill, which includes some, but not all of the amendments I suggested.

Thoughts on the Draft House Bill

The draft House bill strongly embraces whole-firm recapitalization as a tool for resolving "covered financial corporations" under the Bankruptcy Code. The bill includes key features to facilitate a recapitalization of a distressed financial firm in bankruptcy, and the overall approach of the bill is quite consistent with the thrust of the recommendations I made in December. I would like to offer comments on a few specific, and in my view important, provisions the bill, and request the opportunity to provide additional, more detailed, comments after the hearing.

1. *Commencement of Proceedings Under Subchapter V*

The bill provides for the commencement of Chapter 11 proceedings with respect to a bank holding company, either voluntarily by the distressed firm itself, or involuntarily by the Federal Reserve Board, and includes a set of procedures for a speedy hearing and appeals if an involuntary petition is contested.

My principal comment regarding these provisions is that the statute should do everything it can to encourage voluntary rather than involuntary proceedings. Voluntary proceedings will facilitate the firm's smooth transition into Chapter 11, and its recapitalization and reopening under the ownership of the newly created bridge company, as contemplated by the bill. Concerns about director liability for the simple act of commencing bankruptcy proceedings often unnecessarily delay or discourage boards of distressed companies from acting, and this risk is especially acute with respect to financial firms, which tend to be forced into failure only at the point of a collapse of their liquidity and after many assets have already been liquidated at fire-sale prices.

In order to encourage timely voluntary action by directors of failing financial firms, Title II of the Dodd-Frank Act insulates directors from liability for consenting to the appointment of the FDIC as receiver.[12] I concur with the recommendation of the National Bankruptcy Conference in its letter to the Subcommittee of January 29, 2014 (the "NBC Letter") that it would be advantageous to adopt a corresponding provision for the commencement of voluntary resolution proceedings under the Bankruptcy Code, such as those contemplated by the bill. Financial institution boards will remain accountable for their other pre-failure actions, but they should not have to concern themselves over the risk of liability to shareholders or creditors when they are invoking, presumably with the support of their primary regulators, provisions designed to resolve the failing firm, maximize its value to stakeholders and minimize systemic risk.

[12] Dodd-Frank Act § 207.

2. *Definition of Capital Structure Debt*

One of the key definitions in the bill is the definition of "capital structure debt." Under the provisions of the draft bill, in connection with authorizing a transfer of operating subsidiaries to a bridge company under Section 1185, the Bankruptcy Court is required to make a finding that no capital structure debt is being assumed by the bridge company. The companion Senate bill contains a similar provision, but the draft House bill defines "capital structure debt" differently from the definition proposed in the Senate bill. Specifically, the Senate bill defines "capital structure debt" as follows:

> The term 'capital structure debt' means debt, other than a qualified financial contract, of the debtor for borrowed money with an original maturity of at least a year.

In contrast, the draft House bill defines "capital structure debt" as follows:

> The term 'capital structure debt' means all unsecured debt of the debtor, other than a qualified [sic] contract, for which the debtor is primary obligor.

As can be seen from this language, the House bill removes the requirement that capital structure debt consist of "debt for money borrowed," adds the requirement that the debtor be the primary obligor in respect of the debt (presumably to exclude guarantees of operating company obligations from the definition) and removes the requirement that capital structure debt have an original maturity of at least a year.

The definition in the Senate bill appears to have been designed to anticipate the expected promulgation of regulations by the Federal Reserve Board requiring systemically important financial firms to maintain at least a threshold amount of "long term debt" that would be available to absorb losses by being "left behind" or "bailed-in" during a whole-firm recapitalization of the firm, either under OLA or under the Bankruptcy Code. Under the definition of capital structure debt in the Senate bill, shorter term obligations (with maturities of less than a year), which might be held by money market funds or other systemically sensitive holders, could in appropriate circumstances – presumably based on input to the Bankruptcy Court from the Federal Reserve Board and other regulators regarding systemic concerns – be assumed by the bridge company and paid. Notably, the definition in the Senate bill, which is limited to borrowed money, allows obligations to employees and critical vendors, as well as debts under assumed non-financial contracts of the debtor to be transferred to and assumed by the bridge company, as contemplated by Section 1407 of the Senate bill (retained in the draft House bill as Section 1187). Finally, guarantees of ongoing qualified financial contracts (QFCs) of affiliates could, under both the Senate and House definitions, be transferred to and assumed by the bridge company pursuant to Section 1408 of the Senate bill (retained as Section 1188 in the draft House bill) in order to avoid termination of the firm's QFCs by external counterparties, as discussed below.[13]

As revised in the House bill, however, the definition of "capital structure debt, coupled with the findings the Bankruptcy Court must make in connection with a Section 1185 transfer, appears to preclude the assumption by the bridge company of ordinary operating debts and short-term borrowings of the debtor in connection with a Section 1185 transfer. I am aware that the NBC Letter recommended that the definition of capital structure debt remove the exclusion of short term debt because of the NBC's concern that

[13] The clear reference in the House bill that limits the definition of capital structure debt to "primary obligations" is, however, an enhancement that provides clarity in this regard.

"debt can be too easily structured to avoid characterization as capital structure debt if the definition is based on the original maturity date," but, while recommending this change, the NBC also acknowledged that flexibility would be required to let the bridge company assume some capital structure debt. Rejecting the idea of restricting the types of debts that the bridge company could assume, the NBC stated that "*the Bankruptcy Code should give the Federal Reserve Board and the special trustee flexibility in creating the optimum bridgeco.*" While the draft House bill uses a broad definition of capital structure debt similar to the one suggested by the NBC, it omits to give the Federal Reserve Board the ability to designate, and to provide the bankruptcy court with the authority to allow in connection with a Section 1185 transfer, capital structure debts to be assumed by the bridge company, even where necessary for reasons of systemic stability, operational stability or value maximization of the bridge company.

It is also notable that, although the NBC suggested that the definition of capital structure debt abandon the distinction between long and short term debt, the NBC's proposal would limit the definition of capital structure debt to debt *for money borrowed.* These words, which also appear the Senate bill's definition, are dropped in the proposed House bill.

The changes to the definition of capital structure debt and failure to adopt the NBC's suggestion of giving the Federal Reserve Board the authority to designate some capital structure debts to be assumed by the bridge company could make it difficult to address systemic, business continuity and value maximization concerns, even where the Federal Reserve Board feels urgently that some debts need to be paid to address those concerns. It is worth reemphasizing that the Federal Reserve Board has announced its intention to impose a long-term loss absorbing debt requirement for systemically important financial firms.[14] This will, as a practical matter, limit opportunities for structuring around the definition of capital structure debt if the definition in the Senate bill, including the distinction between long- and short-term debt, were adopted. There is a significant benefit to having a bright line test for debts that are likely to absorb losses when the bridge company is formed so the market can understand, price and monitor the risk.

Accordingly, I believe the Senate's definition of 'capital structure debt' is more consistent with the objectives of Subchapter V, and the expected action from prudential regulators to insure the sufficiency of loss absorbing long-term debt should allay the principal concerns expressed in the NBC Letter. In any event, whatever definition is adopted, the bill should provide the Federal Reserve Board with the flexibility in appropriate circumstances to designate some capital structure debts – especially short-term capital structure debts – to be assumed by the bridge company.

3. *Special Trustee*

The ability of the bridge company to be recapitalized and speedily reopen under private ownership and new management after the proverbial "resolution weekend" is especially important in bankruptcy proceedings, where regulators do not take over the

[14] *See* Daniel K. Tarullo, Member, Board of Governors of the Federal Reserve System, *Toward Building a More Effective Resolution Regime: Progress and Challenges*, Remarks at the Federal Reserve Board and Federal Reserve Bank of Richmond Conference, Planning for the Orderly Resolution of a Globally Systemically Important Bank, at 11 (Washington, D.C., Oct. 18, 2013); *see also* Financial Stability Board, *Progress and Next Steps Toward Ending "Too Big To Fail" (TBTF)* at 5 (Sept. 2, 2013) ("The FSB, in consultation with standard-setting bodies, will prepare proposals on the adequate of G-SIFI loss absorbing capacity in resolution.")

firm as they would in a receivership under the Federal Deposit Insurance Act or OLA. The idea of allowing the bridge company to be transferred to a private trustee, the "special trustee," a fiduciary for the benefit of the Chapter 11 estate, and of permitting the bridge company to continue its business, subject to reporting obligations and under close regulatory supervision, but without the need for Bankruptcy Court approval of its or the special trustee's actions, is an excellent way of accomplishing this result. It offers transparency to the Bankruptcy Court and left-behind creditors, as well as a hand-picked fiduciary to protect the estate's and stakeholders' interests. From the point of view of the markets and foreign regulators, it connotes the restoration of stability and normalcy to the recapitalized firm, and the confidence of U.S. regulators and the court in the viability of the firm. It also eliminates any concerns that the value of the company will be impaired by disputes among conflicting constituencies in the bankruptcy process.

I would, however, like to make an important technical point about the operation of the special trustee provisions.

If it is not already clear from the bill, once the stock of the bridge company is transferred to the special trustee, it will cease to be property of the Chapter 11 estate. This is a corollary to the idea, embodied in Section 1186 of the draft bill, that no Bankruptcy Court approvals are required for the special trustee to take actions with respect to the bridge company and its shares. It will be the express provisions of the Trust Agreement, as dictated by Section 1186 of the bill, and state law fiduciary duties to the bankruptcy estate, that govern the special trustee's actions. In light of this, a provision should be added to the draft bill making it clear that the shares of the bridge company cease to be property of the Chapter 11 estate once transferred to the special trustee. Of course, the beneficial interests in the trust created by the Trust Agreement and the rights of the bankruptcy estate under the Trust Agreement and as a beneficiary of the trust (including, most importantly, the right to direct the value of the bridge company under a plan of reorganization) become property of the estate at the time of creation of the trust.

4. *Qualified Financial Contracts*

One of the key provisions of the bill is designed to preserve the distressed financial firm's book of QFCs by suspending the right of contract counterparties to terminate and net their QFCs with the distressed financial firm based on "ipso facto" defaults, such as the commencement of bankruptcy proceedings by the parent holding company and the failure to meet credit ratings criteria by the bankrupt holding company as long as the QFCs are performed and, in the case of QFCs of non-bankrupt affiliates, as long as related guarantees by the debtor holding company are transferred to and assumed by the bridge company and certain other requirements to protect counterparties are met.

Despite the infrastructure in Section 1188 around QFCs of the debtor holding company, in fact most of the QFCs of financial firms are in the operating affiliates of financial firms, and not in their holding companies. Accordingly, one the most important provisions for the preservation of the recapitalized firm's QFCs is Section 1188(f), which limits counterparty termination rights in QFCs of the (non-bankrupt) affiliates based on events associated with the holding company's bankruptcy. Overriding cross-defaults in QFCs of affiliates of a covered financial corporation is crucial to a single point of entry recapitalization because affiliate QFCs are often guaranteed by the holding company and, if the holding company files for bankruptcy or loses its credit rating, termination rights may be triggered, even though the affiliate counterparty is healthy, well capitalized (having been recapitalized) and has not been placed into bankruptcy proceedings or receivership. These cross-defaults to the holding company's bankruptcy or downgrades accordingly need to be overridden by the statute if the external counterparty's termination rights are to be eliminated.

Owing to what is probably a scrivener's error in Section 1408(f) of the proposed Senate bill, which appears to have been carried over into the version of the draft House bill available at the time of this writing, Section 1188(f) of the draft bill refers to Section 1187(b) rather than 1187(c)(1), where the relevant cross-defaults would be picked up. As a result, the provision fails to address this critically important cross-default issue. This failure is likely the result of an inadvertent cross reference drop when sections were renumbered,[15] but the glitch, though technical, is a critical one and needs to be fixed if Section 1188(f) is to have its intended effect.[16]

5. *Avoidance Power Safe Harbor*

Section 1191 of the draft bill purports to provide a safe harbor from avoidance actions for the newly created bridge company and its subsidiaries. However, in its

[15] Notably the version of a Subchapter V bill attached to Professor Thomas Jackson's testimony before this Subcommittee last March included the bankruptcy and ratings triggers with respect to the debtor in Section 1187(b). It appears that the Senate moved the relevant ipso facto default references from 1187(b) [1407(b) in the Senate bill] to 1187(c)(1) [Section 1407(c)(1) in the senate bill], but they failed to change the cross reference in 1188(f) [1408(f) in the Senate bill] from 1187(b) [1407(b)in the Senate bill] to 1187(c)(1) [1407(c)(1) in the Senate bill].

[16] There is a similar, presumptively inadvertent, cross-reference error in Section 1188(c), which refers to Section 1187(a), but should also refer to Section 1187(c)(1).

current form the section can be read to do nothing but exempt from avoidance transfers in a court-approved transaction – the Section 1185 transfer. To achieve the objectives of single-point-of-entry recapitalization, it is essential to immunize the newly recapitalized bridge company from attack for any efforts made by the holding company, as a "source of strength," to recapitalize or provide liquidity to support subsidiary operations during the period prior to bankruptcy. It would defeat the main goal of single point of entry recapitalization if the newly recapitalized bridge company were to suffer an overhanging risk for a prepetition transaction intended to facilitate the recapitalization. Such an overhang would make it much more difficult for the recapitalized firm to stabilize its operations, find private sector sources of liquidity, and maximize its value – all critical goals of the Subchapter V process.

Section 1191 should accordingly be revised to address more clearly the holding company's actions prior to failure supporting, under regulatory supervision, the activities of its operating affiliates. Section 1191 might, for example, be modified to read as follows:

> "~~Except with respect to a capital structure debt, a~~ A transfer made or an obligation incurred by the debtor to an affiliate prior to or after commencement of the case, including any obligation released by the debtor or the estate, to or for the benefit of an affiliate, in contemplation of or in connection with a transfer under section 1185 is not avoidable under section 544, 547, 548(a)(1)(B), or 549, or under any similar nonbankruptcy law."

The exclusion for "capital structure debt" would be removed in recognition of the fact that capital structure debt may be owed to operating subsidiaries of the firm, and its repayment may on occasion be a means through which liquidity is provided by the holding company to operating subsidiaries prior to failure. The addition of a reference to actions in contemplation of a transfer under section 1185 would subsume actions prior to commencement of the Chapter 11 proceedings in furtherance of the recapitalization of the firm's operations and the creation of the bridge company, as contemplated under Subchapter V.

6. *Provisions Relating to Bankruptcy Judges*

In the NBC Letter, the NBC suggests that the criteria for the selection of the panel of sufficiently experienced bankruptcy judges for Subchapter V cases be clarified to include reference to appropriate training. Given that the failure of systemically important financial institutions should be a rare event, it may be difficult to find a sufficient number of judges with actual case experience relevant to Subchapter V proceedings. Accordingly, mandating training regarding financial firm failures and the operation of Subchapter V as a precondition to designation as a bankruptcy judge eligible to hear Subchapter V cases seems like a sensible requirement. It may accordingly make sense to include in the bill a mandate to relevant regulators and agencies to develop such a training program, with appropriate input and participation from the academy, experienced sitting and retired judges, financial firms and trade organizations.

7. *Other Issues to Consider*

There are two other tools that I believe Congress should consider addressing in the draft bill.

First, I share the concerns expressed in the NBC Letter about the desirability of lender-of-last resort liquidity to assure the success of whole-firm recapitalization under the Bankruptcy Code. Even well-capitalized banks and other financial firms can face panic liquidity runs, and the recognition of this possibility has long been the justification for the availability of central bank lender-of-last resort liquidity to solvent and otherwise healthy banks. The objective of recapitalizing a financial firm under proposed Subchapter V is to put it on a sound financial footing, stabilize it quickly, maximize its value and minimize systemic disruption. Once the distressed financial firm has been restored to sound capital levels through recapitalizing it, it shortchanges the objectives of Subchapter V not to then assure that the firm has access to secured liquidity until it stabilizes. This liquidity would not be risk capital. It would be provided only to solvent and otherwise healthy firms as loans on a fully secured basis and, as suggested by some commentators, with above market interest rates to discourage use and encourage repayment and replacement by private sector resources.[17] I can say from three-and-a-half decades of experience working with troubled companies, that the simple availability of a committed liquidity source is the best way to assure that the liquidity source is not needed. Once the market is comfortable that liquidity will be available when needed, the market does not hesitate to extend credit – making the use of the committed liquidity source unnecessary.

Second, the United States wants resolution of U.S. based financial firms under both the Bankruptcy Code and OLA to be recognized and enforced against non-U.S. parties under foreign law. The BRRD in Europe, when implemented by member states, is expected to include authority for local regulators and courts to give such recognition to

[17] *See* BPC Report, p. 19; *see also* Walter Bagehot, *Lombard Street: A Description of the Money Market* (1873) (developing classic principles that extensions of credit under lender-of-last-resort facilities must only be made to solvent entities on a fully secured basis at above-market cost.

U.S. resolution proceedings.[18] The addition of a reciprocal provision to U.S. law that permits U.S. regulators and courts to afford recognition to foreign resolution regimes should be considered. Such recognition provisions might require amendments both to Chapter 15 of the Bankruptcy Code and Title II of the Dodd-Frank Act, or to other laws.

Conclusion

As I stated the last time I appeared before this Subcommittee, no single resolution procedure will be perfect for all situations. Expanding the options available by continuing to develop resolution approaches under both the existing Bankruptcy Code and OLA will maximize the flexibility to resolve distressed financial firms in a manner that minimizes systemic risk and does not put taxpayers at risk while preserving due process and the rule of law. For these reasons, I strongly support the efforts being made to improve the Bankruptcy Code in this regard and also support retaining OLA as a back-up resolution option for large financial firms. We should want regulators and courts to have a variety of sensible tools in their toolkit so they can use the right one when the time comes, while preserving due process and the rule of law.

While the draft amendments to Bankruptcy Code in the proposed House bill remain a work in progress, once perfected (hopefully with some of the improvements I have suggested), I believe their enactment should help assure that U.S. taxpayer money will never again be needed to bail out distressed financial firms.

[18] *See Directive 2014/59/EU of the European Parliament and of the Council establishing a framework for the recovery and resolution of credit institutions and investment firms*, Article 94(May 15, 2014)

I want to thank the Subcommittee for allowing me this opportunity to present my views, and, once again, I would appreciate the opportunity to provide further comments on the draft bill to the Subcommittee's staff after the hearing.

I would of course be delighted to answer any questions you may have about my testimony.

Mr. BACHUS. Thank you.

What we are going to do at this point, we have 2 minutes, 50 seconds plus whatever time they give us to get to the floor. The opening statements, you know, instead of 5-minute opening statements on this, I would prefer to have, if you need 10 or 12 minutes, you have it, and that way we will—because we very much want your comments, and we are not just simply going through the motions.

So we will recess until the votes are through on the floor. The Committee staff can keep you appraised of that and give you a pretty good idea about when we will be returning. How many votes on the floor? Just two votes. So we should be back probably in 15, 20 minutes. We will resume. And then I think taking your testimony as opposed to asking questions is probably going to be the best way to do this.

We are in recess at this time. Thank you.

[Recess.]

Mr. FARENTHOLD [presiding]. The Committee will come to order. Chairman Bachus asked me to get started in his absence. He is on the floor with an amendment to the appropriations bill. He will return shortly, and I will return the gavel to him. But in the interests of getting everybody home in time to see their families tonight, we will recognize Mr. Jackson for the customary 5 minutes.

TESTIMONY OF THOMAS H. JACKSON, PROFESSOR, WILLIAM E. SIMON SCHOOL OF BUSINESS, UNIVERSITY OF ROCHESTER

Mr. JACKSON. Thank you.

Chairman Bachus, Ranking Member Johnson, Representative Farenthold, also Chairman Goodlatte and Ranking Member Conyers, this is my second time testifying before you this year on a subject near and dear to my heart, which is bankruptcy law, specifically the role bankruptcy law can and should play in the best possible resolution of a troubled financial institution, and how the bill under consideration, the Financial Institution Bankruptcy Act of 2014, is a solid starting point permitting that to happen, thus fulfilling the vision of the Dodd-Frank Act and the FDIC that bankruptcy should be the primary resolution mechanism, which it cannot be, I believe, in its current form.

It is clear from this bill that much has occurred since my March testimony, and I am grateful particularly to the staff for that.

First, what do I mean by the best possible resolution of a troubled financial institution? I mean a resolution process that meets three important tests: First, one that both minimizes losses and places them on appropriate pre-identified parties; second, one that minimizes systemic consequences; third, one that does not result in a government bailout. And I might add, for me, a fourth: One that is predictable in the sense of conforming to the rule of law in its myriad decisions.

At the time of the 2008 financial crisis, everyone seemed to acknowledge that bankruptcy law should play a major role, but there were also a general lack of confidence that it was up to the task. The resulting Dodd-Frank Act, while placing bankruptcy at the core of a resolution regime, also found it necessary to create an administrative backstop to it. And let me spend a minute on that, because it demonstrates, I think, the clear need for amendments to the Bankruptcy Code along the lines of the Financial Institution Bankruptcy Act of 2014.

The primary role bankruptcy law is expected to play, even under the Dodd-Frank Act, is reflected first in the requirement of resolution plans, the so-called living wills, under Title I of that act. These plans are specifically to be focused on and tested against bankruptcy. Thus, a resolution plan must be resubmitted if it, quote, "is not credible or would not facilitate an orderly resolution of the company under the Bankruptcy Code." And the firm must ultimately be reshaped so that its resolution plan will, quote, "facilitate an orderly resolution of such company under the Bankruptcy Code."

It is also reflected in the statutory requirements for implementing an administrative resolution proceeding, the orderly liquidation authority under Title II. Such a resolution proceeding cannot be commenced without a determination that the use of bankruptcy law would have a serious adverse effect on U.S. financial stability. It is widely acknowledged, I think, that bankruptcy law is or should be the preferred resolution mechanism. To quote from the FDIC when it released its single point of entry strategy paper in December, quote, "The statute makes clear that bankruptcy is the preferred resolution framework in the event of the failure of a SIFI."

But there is a disconnect between those premises and today's Bankruptcy Code. There is an emerging consensus that the best resolution system, one that meets the standards I indicated above, involves, A, loss-bearing capacity known in advance that, B, can be jettisoned in a rapid recapitalization of a financial institution. In the U.S., this system is represented by the FDIC's single point of entry proposal for the recapitalization via a bridge company of a SIFI holding company under Title II of the Dodd-Frank Act. Compared to this administrative resolution proposal, the current Bankruptcy Code is clearly found wanting.

The essence of this kind of recapitalization is, first, leaving behind equity and the loss-bearing debt—presumably long-term unsecured debt that has been required by the regulators, the Federal Reserve Board, to bear the loss; and, second, transferring everything else—assets, liabilities, rights and subsidiaries—to a bridge company that, because of the stripping off of the loss-bearing debt, is presumably both solvent and in a position to deal with the needs of its subsidiaries. And this must be done with great speed so as to restore market confidence without a contagion-producing run. Yet because of the exemption of qualified financial contracts from most of bankruptcy's provisions, including the automatic stay, and because of the lack of clear statutory language permitting the assignment of liabilities or the override of cross-default or change-of-control provisions, the current Bankruptcy Code cannot provide the necessary assurance of a rapid recapitalization. This will lead, in my view, either to ineffective resolution plans and/or the reality that the orderly liquidation authority under Title II will, contrary to the starting premises, become the default resolution mechanism.

The bill you are considering, the Financial Institution Bankruptcy Act of 2014, by adding a new Subchapter V to Chapter 11 of the Bankruptcy Code, and by paying attention to these concepts, neatly provides the necessary amendments to permit a rapid recapitalization that will, first, leave losses on previously identified parties, equity and long-term debt holders; and second, rapidly recapitalize the parent institution in a way that will make clear that it is solvent, its business has been kept together, and it is able to deal with the subsidiaries so as to restore market confidence and reduce contagion.

What is required? In addition to the specific loss-absorbency capacity known in advance that, as Don Bernstein indicated, the Federal Reserve Board is working on and is really a necessary ingredient in all of this, it requires explicit statutory authorization for a rapid transfer of the holding company's assets, liabilities, rights, and subsidiaries, minus the loss-absorbing debt and equity to a bridge institution, and that it would have stays and overrides of certain provisions to enable that to happen.

The bill you are considering does all of this and as well provides an important role in the process for the Federal Reserve Board and the FDIC in a proceeding run before preidentified bankruptcy judges, with appeals going to a predesignated appellate panel consisting of court of appeals judges.

While the details are many—and I am happy to get into them with staff in further discussions, and my written statement to some extent does this—and, yes, I think the Financial Institution Bankruptcy Act of 2014 is, as a result, necessarily somewhat complex at points, the concept is simple. Through what ends up being modest amendments to the Bankruptcy Code which would be effectuated by this bill, it indeed can be considered the primary resolution vehicle for SIFIs as envisioned by the Dodd-Frank Act. And because it is a judicial proceeding, it places primacy on the rule of law, on market-based solutions rather than agency control, and on a process that is fair and known in advance, indeed planned for via the living wills, the resolution plans that now can legitimately focus on a viable bankruptcy solution.

In your deliberations on the Financial Institution Bankruptcy Act of 2014, I believe some technical changes need to be made, and there is some other relatively small issues that I think warrant further consideration. Don Bernstein's written and oral statements, and I have had time to read his written statement, contains several, and I concur with them.

I have glanced at the suggestions of the other two witnesses that you will be hearing from today, and I believe a number of them probably warrant consideration as well. But importantly, none of them undermine the basic structure and importance of the bill before you.

So with that modest caveat that there are things I think need consideration and work, I want to emphasize what I think is an incredibly important step by your consideration of the Financial Institution Bankruptcy Act of 2014.

Again, I want to thank the Subcommittee for allowing me this opportunity to present my views, and even moreso for its wisdom and its consideration of the Financial Institution Bankruptcy Act of 2014. I would, of course, be delighted to answer any questions you may have about my testimony.

[The prepared statement of Mr. Jackson follows:]

STATEMENT OF

THOMAS H. JACKSON

DISTINGUISHED UNIVERSITY PROFESSOR & PRESIDENT EMERITUS

UNIVERSITY OF ROCHESTER

BEFORE

THE SUBCOMMITTEE ON REGULATORY REFORM, COMMERCIAL

AND ANTITRUST LAW

THE COMMITTEE ON THE JUDICIARY

U.S. HOUSE OF REPRESENTATIVES

WASHINGTON, D.C.

JULY 15, 2014

FINANCIAL INSTITUTION BANKRUPTCY ACT OF 2014

Thank you for inviting me to testify today. I am Thomas Jackson, Distinguished University Professor and President Emeritus at the University of Rochester. Prior to moving to the University of Rochester, I was a professor of law, specializing in bankruptcy, at schools of law at Stanford, Harvard, and the University of Virginia. I am the author of a Harvard Press book, *The Logic and Limits of Bankruptcy Law*, a bankruptcy casebook, and numerous articles on bankruptcy law. Recently, my work in the field of bankruptcy has focused on the use of bankruptcy in resolving systemically important financial institutions (SIFIs). In that capacity, I was co-chair of a Bipartisan Policy Center working group that produced, in May of 2013, *Too Big to Fail: The Path to a Solution*. I have also been, since 2008, a member of the Hoover Institution's Resolution Project, which has produced two books discussing how bankruptcy can be made more effective in terms of the resolution of SIFIs and has just posted a comprehensive proposal for a new chapter to the Bankruptcy Code (Chapter 14) to handle the resolution of SIFIs (at http://www.hoover.org/sites/default/files/rp-14-july-9-tom-jackson.pdf). And, since December 2013, I have been a member of the Federal Deposit Insurance Corporation's (FDIC) Systemic Resolution Advisory Committee. I am here today in my individual capacity, and the views I express are my own, not those of any organization with which I am affiliated.

I. Introduction: The Need for a Bill to Amend the Bankruptcy Code with Respect to Large Financial Institutions

I previously had the honor of testifying before this Subcommittee on March 26, 2014, at a hearing on "Exploring Chapter 11 Reform: Corporate and Financial Institution Insolvencies; Treatment of Derivatives." At that time, my written statement (and oral testimony) focused on ways in which bankruptcy law could and should be modified so as to make it an important player in the resolution of SIFIs and that *both* bankruptcy law *and* the Dodd-Frank Act could be made more effective as a result. Attached to that written statement was an appendix that contained a draft bill under the heading "Proposed Amendments to Facilitate the Resolution of Financial Institutions Under the Bankruptcy Code: Focused on a New Subchapter V to Chapter 11."[1] The draft bill in that appendix has many features in common with the bill under consideration today, entitled the "Financial Institution Bankruptcy Act of 2014" (the "Bill"), and thus it is no surprise that I am here today as an enthusiastic supporter of the Bill.

To see the importance of enacting amendments to the Bankruptcy Code along the lines of the Bill, it is worth dropping back to the context created by the Dodd-Frank Act and by the work done by the FDIC with respect to its "single point of entry" proposal for use in the orderly liquidation authority (OLA) under Title II of the Dodd-Frank Act. Together they show, in my view, the importance of enacting the Bill.

It starts by focusing on the provisions in the Dodd-Frank Act itself. In two key places, the Dodd-Frank Act envisions bankruptcy as the preferred mechanism for the resolution of SIFIs. The first occurs in Title I, with the provision for resolution plans under Section 165(d). Covered financial institutions are required to prepare, for review by the Board of Governors of the Federal Reserve System (Federal Reserve Board), the Financial Stability Oversight Council, and the FDIC, "the plan of such company for

[1] See http://judiciary.house.gov/index.cfm/2014/3/hearing-exploring-chapter-11-reform-corporate-and-financial-institution-insolvencies-treatment-of-derivatives.

rapid and orderly resolution in the event of material financial distress or failure . . . ."[2] If the Federal Reserve Board and the FDIC jointly determine that a submitted resolution plan "is not credible or would not facilitate an orderly resolution of the company under title 11, United States Code," the company needs to resubmit a plan "with revisions demonstrating that the plan is credible, and would result in an orderly resolution under title 11, United States Code . . . ."[3] The failure to submit a plan that meets these tests can lead to restrictions, and divestiture, "in order to facilitate an orderly resolution of such company under title 11, United States Code . . . ."[4] For present purposes, the important point is that effective resolution plans are tested against bankruptcy law, *not* OLA under Title II of the Dodd-Frank Act. Indeed, a credible plan that would not result in the "orderly resolution of the company" under the Bankruptcy Code would, according to the literal language of Section 165(d)(4) of the Dodd-Frank Act, be rejected. It therefore goes without saying—but is worth saying nonetheless—that the effectiveness of bankruptcy law in being able to resolve SIFIs in ways that do not unnecessarily destroy value (such as by liquidating a viable going concern) is critically important to the development of approvable resolution plans under Title I.

The second occurs in the context of the ability to initiate the OLA process under Title II of the Dodd-Frank Act. Invocation of Title II itself can only occur if the government regulators find that bankruptcy is wanting.[5] That is, by its own terms,

[2] Dodd-Frank Act § 165(d)(1).
[3] Dodd-Frank Act, § 165(d)(4)
[4] Dodd-Frank Act, § 165(d)(5)(A) & (B).
[5] Dodd-Frank Act, § 203(a)(1)(F) & (a)(2)(F); § 203(b)(2) & (3).

bankruptcy is designed by the Dodd-Frank Act to be the preferred resolution mechanism.[6] The FDIC has announced that it supports the idea that bankruptcy, not OLA under Title II of the Dodd-Frank Act, should be the presumptive resolution procedure.[7] The ability of bankruptcy law to fulfill its intended role as the presumptive procedure for resolution, of course, turns on the effectiveness of bankruptcy law in rising to the challenge of accomplishing a resolution that meets three important goals: One that (a) both minimizes losses and places them on appropriate, pre-identified, parties, (b) minimizes systemic consequences; and (c) does not result in a government bail-out.

In addition, much thinking and work has occurred since the enactment of the Dodd-Frank Act.[8] Increasingly, attention has turned, in Europe as well as in the United States, on a rapid recapitalization. Europe has focused on a "one-entity" recapitalization via bail-in[9] while the FDIC has focused, in its SPOE proposal, on a

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[6] Federal Deposit Insurance Corporation, *The Resolution of Systemically Important Financial Institutions: The Single Point of Entry Strategy*, 78 Fed. Reg. 76614 (Dec. 18, 2013) (hereafter "FDIC SPOE"), at 76615 ("the statute makes clear that bankruptcy is the preferred resolution framework in the event of the failure of a SIFI"); see Statement of Martin J. Gruenberg, Chairman, Federal Deposit Insurance Corporation on Implementation of the Dodd-Frank Act before the Committee on Banking, Housing and Urban Affairs, United States Senate (December 6, 2011), available at http://www.fdic.gov/news/news/speeches/chairman/spdec0611.html ("If the firms are successful in their resolution planning, then the OLA would only be used in the rare instance where resolution under the Bankruptcy Code would have serious adverse effects on U.S. financial stability.").

[7] See Remarks by Martin J. Gruenberg, Chairman, Federal Deposit Insurance Corporation, in Implementation of the Dodd-Frank Act before the Volker Alliance Program (October 13, 2013), available at http://www.fdic/gov/news/news/speeches/spoct1313.html.

[8] A useful discussion of whether and how well Title II of the Dodd Frank Act responded to the 2008 crisis—prior to the development of the SPOE proposal—is contained in David Skeel, *Single Point of Entry and the Bankruptcy Alternative* (forthcoming, Brookings 2014).

[9] Financial Stability Board, *Progress and Next Steps Towards Ending "Too-Big-to-Fail,"* Report of the Financial Stability Board to the G-20, available at www.financialstabilityboard.org/publications/r_130902.pdf (Sept. 2013); Thomas Huertas, Vice Chairman, Comm. Of European Banking Supervisors and Dir., Banking Sector, U.K. Fin. Services Auth., *The Road to Better Resolution: From Bail-out to Bail-in*, speech at The Euro and the Financial Crisis Conference (Sept. 6, 2010), available at

"two-entity" recapitalization rather than a formal bail-in.[10] Under the FDIC's approach,[11] a SIFI holding company (the "single point of entry") is effectively "recapitalized" over a matter of days, if not hours, by the transfer of virtually all its assets and liabilities, except for certain long-term unsecured liabilities, to a new bridge institution whose capital structure, because of the absence of those long-term unsecured liabilities, is both different and presumptively fiscally "sound." The bridge institution then forgives intercompany liabilities or contributes assets to recapitalize its operating subsidiaries. Because of the splitting off of the long-term unsecured debt, the bridge institution, in the FDIC's model, looks very much like a SIFI following a European-like "bail in"; the major difference is that in the "bail in," the entity is directly recapitalized (hence the "one-entity"), whereas in the FDIC's SPOE proposal the "recapitalized" bridge institution, a different legal entity, is formed first and effectively receives a "new" capital structure by virtue of having long-term unsecured debt left behind in the transfer to the bridge institution.[12]

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http://www.fsa.gov.uk/library/communication/speeches/2010/0906_th.shtml; Clifford Chance, *Legal Aspects of Bank Bail-Ins* (2011).

[10] FDIC SPOE, *supra* note 6. See Federal Deposit Insurance Corporation & Bank of England, Joint Paper, *Resolving Globally Active, Systemically Important, Financial Institutions* (Dec. 10, 2012), available at http://www.bankofengland.co.uk/publications/Documents/news/2012/nr156.pdf (jointly proposing the single-point-of-entry approach).

[11] Early signs of which were foreshadowed in Randall Guynn, *Are Bailouts Inevitable?*, 29 YALE J. ON REGULATION 121 (2012).

[12] In part, this difference is driven by different organizational structures common to U.S. SIFI's versus European SIFIs—our SIFIs are much more likely to use a holding company structure; in part this difference is driven by Title II's liquidation "mandate." Section 214(a) of the Dodd-Frank Act explicitly states: "All financial companies put into receivership under this subchapter shall be liquidated." As a bankruptcy scholar, I view this latter mandate, at least in the abstract, as unfortunate. A first-day lesson in a corporate reorganization course is that "understanding that financial and economic distress are conceptually distinct from each other is fundamental to understanding Chapter 11 of the Bankruptcy Code," Barry Adler, Douglas Baird & Thomas Jackson, BANKRUPTCY: CASES, PROBLEMS AND MATERIALS 28 (Foundation Press 4th ed. 2007). Avoiding a bailout requires that losses be borne by appropriate parties, identified in advance, not necessarily by liquidation of the underlying business, which may cause an unnecessary destruction of value. The

Thus, the important question for bankruptcy law is the effectiveness of the current Bankruptcy Code as a credible resolution mechanism for a SIFI in financial difficulty, measured today against the FDIC's SPOE proposal for how it would use Title II of the Dodd-Frank Act. While a focus on an effective recapitalization of the holding company removes some of the concerns about the current Bankruptcy Code—such as its exclusion of various operating entities a SIFI might own or control[13]—and while the current Bankruptcy Code contains many of the "bones" of a successful way to recapitalize a SIFI in accordance with the rule of law, there are several obstacles that effectively eliminate the current Bankruptcy Code as a viable alternative to the FDIC's SPOE proposal.

The essence of any "rapid recapitalization"—and this is true under the FDIC's SPOE proposal as well as under any bankruptcy alternative—is pre-identified long-term debt that is both (a) required and (b) subordinated to regular unsecured obligations. It is this debt that, consistent with known priorities, will be "left behind" (or converted to equity) in any recapitalization, whether that of a single-entity or that of two-entities. The relevant government agencies, in imposing capital requirements on SIFIs, need to ensure that some of the capital requirements are in the form of debt, not exclusively equity.[14] (Mandatory equity requirements are important because equity is

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FDIC's SPOE strategy formally complies with the statutory requirement, by liquidating the SIFI holding company after its assets have been liquidated via the transfer to the bridge company.

[13] Bankruptcy Code § 109(b)(2) & (3). To deal with the bankruptcy of an operating entity only, different provisions—such as those that are suggested in the July 9, 2014 proposal just posted by the Hoover Institution's Resolution Project, http://www.hoover.org/sites/default/files/rp-14-july-9---tom-jackson.pdf--might be considered. (In general, these provisions are ancillary to those in the Bill. Over areas that both cover, the Hoover proposal and the Bill are rarely out of sync.)

[14] The Board of Governors of the Federal Reserve System has stated that it will issue a proposed rule that would establish a minimum amount of long-term unsecured debt and other loss-absorbing resources. Daniel K. Tarullo, *Toward Building a More Effective Resolution Regime: Progress and*

the first "cushion." But any recapitalization requires the elimination of debt—and to eliminate debt consistent with established creditor priorities, it needs to be pre-identified as distinct from (and effectively subordinated to) other unsecured obligations. That is the only way, consistent with the rule of law embedded in the Bankruptcy Code, to "leave" that debt behind, and it is the only way the FDIC can accomplish its SPOE procedure consistent with pre-established creditor priorities.)

Thus—on the crucial assumption that such long-term debt will be both identified and required—the structural essence of a recapitalization is already in the Bankruptcy Code. While it is probably the case that the original "intent" of Section 363 of the Bankruptcy Code—a provision providing for the use, sale, and lease of property of the estate—at the time of its enactment in 1978 was to permit piecemeal sales of unwanted property, Chapter 11 practice began, over time, to move in the direction of both (a) pre-packaged plans of reorganization and (b) procedures whose essential device was a going-concern sale of some or all of the business (whether prior to or in connection with a plan of reorganization), leaving the original equity and much of the debt behind and with the proceeds of the sale forming the basis of the distribution to them according to the plan of reorganization and bankruptcy's priority rules.[15] Such sales have been used, repeatedly, as a way of continuing a business outside of bankruptcy while the claimants and equity interests, left behind, wind up as the owners of whatever was

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Challenges, at 11, Remarks at the Federal Reserve Board and Federal Reserve Bank of Richmond Conference, "Planning for the Orderly Resolution of a Globally Systemically Important Bank," Washington, D.C. (Oct 18, 2013); Statement of Daniel K. Tarullo before the Committee on Banking, Housing and Urban Affairs, at 11-12 (Feb. 6, 2014).

[15] David Skeel, Debt's Dominion: A History of Bankruptcy Law in America 227 (Princeton 2001); Barry Adler, Douglas Baird & Thomas Jackson, *supra* note 12, at 466-467 ("between [1983 and 2003] a sea change occurred through which an auction of the debtor's assets has become a commonplace alternative to a traditional corporate reorganization").

received by the bankruptcy estate in connection with the sale. And it, at least in rough contours, has structural features in common with the two-entity recapitalization that is envisioned under the FDIC's SPOE procedure.

That said, a Section 363 sale under the current Bankruptcy Code is a wholly inadequate competitor to a SPOE process under Title II of the Dodd-Frank Act as proposed by the FDIC. While both will require identification of long-term debt (or capital structure debt) that will be left behind—and presumably that may emerge from the current Federal Reserve Board consideration of this issue—a successful two-entity recapitalization essentially requires the bridge company to be able to acquire all of the remaining assets, contracts, permits, rights, and liabilities of the SIFI holding company, while preserving the businesses of the transferred, non-bankrupt, operating subsidiaries whose equity is transferred from the SIFI holding company to the bridge company.

This is virtually impossible to accomplish under the current Bankruptcy Code. First, because of a series of amendments designed to insulate qualified financial contracts—swaps, derivatives, and repos—from many of bankruptcy's provisions, most notably the automatic stay and the unenforceability of "ipso facto" clauses—there is no effective mechanism in the current Bankruptcy Code to preclude counterparties on qualified financial contracts from running upon the commencement of a bankruptcy case.[16] Importantly, even if most such contracts reside (as is usually the case) in non-

[16] Bankruptcy Code §§ 362(b)(6), (7), (17), (27), 546(e), (f), (g), (j), 555, 556, 559, 560, 561. (The FDIC SPOE proposal, consistent with statutory authorization, Dodd-Frank Act § 210(c)(8), (9), (10), (16), will override any such provisions in counterparty contracts (and subsidiary cross-default provisions); bankruptcy, being a judicial proceeding, cannot (and should not) do that without comparable statutory authorization which currently not only is missing but is expressly contradicted by

bankrupt operating subsidiaries of the bridge company, such creditors may have cross-default or change-of-control provisions triggered by the Chapter 11 filing of their former holding company that current bankruptcy law does nothing to mitigate. Nor would it be clear under existing bankruptcy law that operating licenses, permits, and the like could be transferred to the bridge company, either because it legally is a new company or because there has been a change of control of the holding company and its operating subsidiaries in derogation of change-of-control provisions or requirements applicable to individual entities. In my view, these problems are, essentially, fatal to any effort to use the current Bankruptcy Code to recapitalize a SIFI—and thus will inexorably lead, contrary to the clearly-identified preference for the primacy of bankruptcy law expressed by the Dodd-Frank Act and by the FDIC itself, to the routine invocation of Title II of the Dodd-Frank Act, so as to gain access to the SPOE procedures. The Bill, as I will point out, effectively solves each of these problems.

Moreover, while the Bankruptcy Code clearly contemplates an ability to move with necessary speed, including when a provision calls for a notice and hearing before any decision (such as under Section 363(b)),[17] the lack of clear statutory authority for a very rapid transfer to a bridge company may leave too much—for the comfort of a SIFI *or* a regulatory body—up to the discretion of a particular judge who first gets a SIFI

provisions that exist.) While my statement today focuses on changes that are necessary in these existing protective provisions for counterparties on qualified financial contracts in the Bankruptcy Code in order to permit an effective two-step recapitalization of a SIFI holding company, I believe these existing Bankruptcy Code provisions, and their relationship to bankruptcy law more generally, need to be rethought. See David Skeel & Thomas Jackson, *Transaction Consistency and the New Finance in Bankruptcy*, 112 COLUM. L. REV. 152 (2012).

[17] Bankruptcy Code § 102(1) provides that "after notice and a hearing" includes (B) "authoriz[ing] an act without an actual hearing if such notice is given properly and if . . . (ii) there is insufficient time for a hearing to be commenced before such act must be done, and the court authorizes such act . . . ."

holding company requesting such a transfer. Nor is there a clear necessity for notice to, or hearing by, a government regulator—whether the FDIC or Federal Reserve Board, in the case of the holding company, or a foreign regulator, in the case of a foreign subsidiary that is proposed to be transferred to a bridge company. These uncertainties, even with a robust resolution plan, may inspire enough lack of confidence by the FDIC and the Federal Reserve Board so as to view the commencement of an OLA proceeding under Title II of the Dodd-Frank Act to be the preferable course—or, alternatively, lack of sufficient confidence by foreign regulators so as to acquiesce in allowing the bankruptcy process to unfold without the regulator intervening at the foreign subsidiary level. Again, the Bill effectively addresses, insofar as possible,[18] each of these concerns.

II. The Essential Changes to the Bankruptcy Code—and How the Bill Effectively Would Implement Them

From this recitation, it is clear that the Bankruptcy Code needs tweaking—sometimes subtle, detailed, and complicated, but tweaking nonetheless—to permit it to be, in the vast majority of cases, a viable resolution mechanism of a SIFI, fully competitive with—and in some respects, superior to—the FDIC's SPOE proposal for Title II of the Dodd Frank Act.[19]

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[18] Cross-border issues are complex, and require agreements among countries that are outside the jurisdiction of either the FDIC or the Bill. Fortunately, there are solid signs that such international cooperation may be feasible.

[19] Reducing the size, and not just the complexity, of large financial institutions may be independently desirable, but that goal—if indeed it is one—should not be conflated with designing an appropriate mechanism for the effective resolution of a financial institution in distress. The Bill appropriately addresses issues of effective resolution, rather than using ineffective resolution mechanisms as a means to force smaller financial institutions. The latter should be addressed on its own merits, not as a behind-the-scenes objection to continue ineffective bankruptcy resolution procedures.

What are these changes? Given the necessarily intricate details of the Bill itself, let me discuss what I think, at a conceptual level, the needed changes are, and along the way provide references to provisions in the Bill that would accomplish these conceptual changes in a concrete and effective way.[20] The heart-and-soul of necessary changes center on a provision—Section 1185 of the new subsection V of Chapter 11 of the Bankruptcy Code proposed by the Bill—that substantially sharpens the nature and focus of a sale of assets under Section 363 of the Bankruptcy Code. This provision contemplates[21] a rapid transfer to and, in effect, recapitalization of, a bridge company[22] (effectively within 48 hours after the commencement of the case)[23] by a SIFI holding company (the debtor—the "covered financial corporation"), after which the bridge company can recapitalize, where necessary, its operating subsidiaries.[24] If the court approves the transfer, then the SIFI holding company's operations (and ownership of subsidiaries) shift to a new bridge company *that is not in bankruptcy*—and hopefully will be perceived as solvent by market-participants, including liquidity providers,[25]

[20] I have found a few places where I think cross-references may need to be changed in the Bill I have been referencing in preparing this statement and a few places where I think consideration of modestly-changed or different provisions would be useful. To the extent other statements submitted for this hearing do not make relevant suggestions along those lines, I will be happy to supply modest thoughts in this direction. For present purposes, however, I want to focus on why I believe this Bill is a major advance in addressing the issues I've already flagged.

[21] A bankruptcy case is commenced under subchapter V of Chapter 11 either under Section 301 of the Bankruptcy Code (by the debtor) or by the Federal Reserve Board under Section 303, upon the Federal Reserve Board's certification that (a) the institution is under defined financial stress and (b) the commencement of a bankruptcy case and a transfer to a bridge company is necessary to prevent imminent substantial harm to financial stability in the United States. Bill, Sec. 3, § 1183.

[22] Bill, Sec. 3, § 1185.

[23] Bill, Sec. 3, § 1185 doesn't specify when a transfer can occur (after the first 24 hours), but other provisions provide essential stays only for the first 48 hours, unless a transfer is approved. Bill, Sec. 3, §§ 1187(a)(3), 1188(a).

[24] The institutions that can use these new bankruptcy procedures are effectively those that can be placed into OLA under Title II of the Dodd-Frank Act. See Bill, Sec. 2(a).

[25] Recognizing that this liquidity is not a part of bankruptcy law, and thus not within the jurisdiction of this Subcommittee, I will not here enter into the debate over whether market-based liquidity to the bridge company, backed by existing Board lender-of-last-resort access under Federal Reserve Act

because it will be (effectively) recapitalized, as compared to the original SIFI, by leaving behind in the bankruptcy proceeding previously-identified long-term unsecured debt of the original SIFI. *After* the transfer, the debtor (i.e., the SIFI holding company) remains *in bankruptcy* but is effectively a shell, whose assets usually will consist only of an interest in a trust[26] that would hold the equity interests in the bridge company until they are sold or distributed pursuant to a Chapter 11 plan, and whose claimants consist of the holders of the long-term debt that is not transferred to the bridge company and the old equity interests of the SIFI holding company. This debtor in Chapter 11 has no real business to conduct, and essentially waits for an event (such as the sale or public distribution of equity securities of the bridge company by the trust) that will value or generate proceeds from its assets (all equity interests in the new, recapitalized entity) and permit a distribution of those equity interests or proceeds, pursuant to bankruptcy's normal distribution rules, to the holders of the long-term debt and original equity interests of the debtor (the original SIFI holding company).

Many of the remaining provisions that would need to be adopted as well—and are all contained in the Bill—are designed to permit the successful transfer of assets, contracts, liabilities, rights, licenses, and permits—of both the holding company and of the subsidiaries—to the bridge company.

§ 13(3)'s "program or facility with broad-based eligibility," in the event of a broader liquidity freeze, are sufficient. Without greater access to government liquidity—under the stringent standards set forth in John Bovenzi, Randall Guynn & Thomas Jackson, *Too Big to Fail: The Path to a Solution* (Bipartisan Policy Center, Failure Resolution Task Force May 2013)—however, I can envision cases where the government may commence an OLA proceeding under Title II of the Dodd-Frank Act, in preference to bankruptcy, for the primary purpose of gaining liquidity access via the Orderly Liquidation Fund, Dodd-Frank Act § 210(n).

[26] Bill, Sec. 3, § 1186.

First, there are provisions applicable to debts, executory contracts, and unexpired leases, including qualified financial contracts.[27] Conceptually, the goal of these provisions is to keep operating assets and liabilities "in place" so that they can be transferred to the bridge company (within a 48-hour window) and, thereafter, remain "in place" so that "business as usual" can be picked up the bridge company and its affiliates (such as operating subsidiaries) once it assumes the assets and liabilities. This requires overriding "ipso facto" clauses (of the type that would otherwise permit termination or modification based on the commencement of a bankruptcy case or similar circumstance, including credit-rating agency ratings, whether in the holding company or in its affiliates), [28] and it requires overriding similar provisions allowing for termination or modification based on a change of control, again whether in the holding company or in its affiliates, since the ownership of the bridge company will be different than the ownership of the debtor (the SIFI holding company) prior to the bankruptcy filing.[29] These provisions need to be broader than Section 365 of the Bankruptcy Code, for at least two reasons. First, perhaps because of the limited scope of the original

[27] Bill, Sec. 3, § 1187 (debts, executory contracts, and unexpired leases); § 1188 (qualified financial contracts and affiliate contracts).
[28] Bill, Sec. 3, § 1187(a)(1)(B), 1188(e) & (f). While § 1188(f) affects the contracts, permits, liabilities, and the like of entities (e.g., affiliates such as operating subsidiaries) not themselves in bankruptcy, I believe they are fully authorized (at least for domestic subsidiaries), if not by Congress' Article I bankruptcy power, then by application either of the commerce clause or the independent (albeit related) Congressional power pursuant to the "necessary and proper" clause of Article I, as interpreted since *McCulloch v. Maryland*, 4 Wheat. 316 (1819), see also *United States v. Comstock*, 560 U.S. ___ (2010), since the bankruptcy of the SIFI cannot successfully be concluded without these provisions that permit the unimpeded transfer of the operating subsidiary's ownership to the bridge company. (The question of foreign subsidiaries, while complex, is being actively discussion by U.S. and foreign regulators, and legislation is being discussed in Europe and elsewhere that is designed to help assure these results extend to non-U.S. operations in the case involving the resolution of a U.S.-based SIFI holding company.)
[29] Bill, Sec. 3, §§ 1187(b)(2) & (c)(1), 1188(e) & (f). This includes offsets and netting out under qualified financial contracts, § 1188(a)(2).

"purpose" of Section 363, bankruptcy law currently doesn't have a provision expressly allowing for the "transfer" of debt (although many debts are in fact transferred as a matter of existing practice under Chapter 11 "going concern sales"). Unlike executory contracts, which might be viewed as net assets (and thus something to "assume") or as net liabilities (and thus something to "reject"), debt is generally considered breached and accelerated (think "rejected") upon the filing of a petition in bankruptcy.[30] But, if there is going to be a two-entity recapitalization, the bridge company needs to take the liabilities it would assume "as if nothing happened." Thus, provisions designed to accomplish that need to be included—and the Bill does.[31] Second, Section 365 doesn't deal with change-of-control provisions; amendments need to add that and extend it to debt agreements as well—and, again, the Bill has provisions that accomplish that.[32]

With respect to qualified financial contracts, there should be provisions in addition to those just mentioned. Thus, the Bill provides that the stay on termination, offset, and net out rights should apply for the period from the filing until the transfer occurs, it is clear it won't occur, or 48 hours have passed.[33] Because of this interregnum, when there is a likelihood that the transfer will be approved, and all of these qualified financial contracts (and related guarantees, if any) go over "in their original form" to the bridge company, the Bill appropriately has a requirement that the debtor (the covered financial corporation) and its affiliates shall continue to perform payment and delivery obligations.[34] Conversely, because the counterparty may not

[30] See David Skeel & Thomas Jackson, *supra* note 16.
[31] Bill, Sec. 3, § 1187.
[32] Bill, Sec. 3, § 1187(b)(2) & (c)(1).
[33] Bill, Sec. 3, § 1188(a).
[34] Bill, Sec. 3, § 1188(b)(1).

know for sure what the outcome will be during this interregnum, the Bill also has a provision that the counterparty may promptly "cure" any unperformed payment or delivery obligations after the transfer.[35]

Just as the principle of having the bridge company have the same rights, assets, and liabilities drive the provisions regarding debts, executory contracts, and unexpired leases just discussed (including qualified financial contracts), a similar provision is necessary to keep licenses, permits, and registrations in place, and does not allow a government to terminate or modify them based on an "ipso facto" clause or a transfer to a bridge company—and the Bill includes such a provision.[36]

III. Conclusion

The Bill—as noted by the references to its provisions above—effectively accomplishes all of the changes necessary to make the Bankruptcy Code a viable alternative to the proposed SPOE procedure under Title II of the Dodd-Frank Act. It might be enough to note that the Bill would thus accomplish the original desire of the Dodd-Frank Act to have bankruptcy be the preferred mechanism (and the focus of effective resolution plans), and deserves enactment for that reason alone.

But there are reasons why, for the vast majority of cases, the Bill provides not just a "parallel" mechanism to accomplish a SPOE-like procedure outside of Title II, but a *superior* mechanism. First, the new company formed in the Section 1185 transfer of the Bill is neither (a) subject to the jurisdiction of a bankruptcy court[37] nor (b) subject to "control" by a

[35] Bill, Sec. 3, § 1188(b)(2).
[36] Bill, Sec. 3, § 1189.
[37] See Bill, Sec. 3, § 1186(d).

government agency, such as the FDIC, whereas the bridge company created in the SPOE process is effectively run, for a while at least, by the FDIC.[38] In this bankruptcy process, the bridge company, appropriately, faces market-discipline first and foremost; in Title II, there inevitably is a heavier layer of regulatory overlay and control. Second, and related, a bankruptcy process envisions at least the possibility that the market can determine the equity value of the new company (and thus the amount to be distributed to the creditors and old equity interests "left behind"), whereas the FDIC's SPOE proposal relies on expert valuations for those distributions.[39] Third, because of language in the Dodd-Frank Act,[40] the FDIC may push on its own initiative for the replacement of management (i.e., not permit management of the former SIFI holding company take similar positions in the bridge company).[41] In the bankruptcy process, the Board of Directors, and management, of the newly-created bridge-company would be identified with the input both of the SIFI's primary regulators as well as the beneficiaries of

[38] See, e.g., FDIC SPOE, *supra* note 6, p. 76617 ("The FDIC would retain control over certain high-level key matters of the bridge financial company's governance, including approval rights for . . . capital transactions in excess of established thresholds; asset transfers or sales in excess of established thresholds; merger, consolidation or reorganization of the bridge financial company; any changes in directors of the bridge financial company (with the FDIC retaining the right to remove, at its discretion, any or all directors); any distribution of dividends; any equity based compensation plans . . . . Additional controls may be imposed by the FDIC as appropriate."). Compare this with comparable provisions in the Bill, Sec. 3, § 1185(b)(3), where the trustee provides notice to the bankruptcy court in connection with similar actions.

[39] FDIC SPOE, *supra* note 6, p. 76618 ("the SPOE strategy provides for the payment of creditors' claims in the receivership through the issuance of securities in a securities-for-claims exchange. This exchange involves the issuance and distribution of new debt, equity and, possibly, contingent securities . . . to the receiver. The receiver would then exchange the new debt and equity for the creditors' claims. . . . Prior to the exchange of securities for claims, the FDIC would approve the value of the bridge financial company. The valuation would be performed by independent experts . . . selected by the board of directors of the bridge financial company. Selection of the bridge financial company's independent experts would require the approval of the FDIC, and the FDIC would engage its own experts to review the work of these firms and to provide a fairness opinion.").

[40] Dodd-Frank Act § 206(4) (the FDIC shall "ensure that management responsible for the failed condition of the covered financial company is removed"); see also Dodd-Frank Act § 206(5) (similar provision for members of a board of directors).

[41] See FDIC SPOE, *supra* note 6, p. 76617 ("As required by the statute, the FDIC would identify and remove management of the covered financial company who were responsible for its failed condition").

the transfer and, importantly, would be subject to the approval of the district court in an open and transparent process at the time of the transfer of the holding company's assets and liabilities to the bridge company.[42] Fourth, at various points, the FDIC has discretion that can amount to ex post priority determinations (such as whether liabilities other than pre-defined long-term unsecured debt gets transferred to the bridge company)—discretion that may be useful in extraordinary cases, but that is potentially a cause for undermining market confidence in the rule of law in other circumstances.[43] Fifth, Title II treats the bridge company created in an OLA under Title II as a government entity, exempt from taxes;[44] I think that provision is a serious mistake, preferring the bridge company to its non-protected competitors, and should not be replicated in any bankruptcy amendments, whose goal is to have the bridge company treated "just as" the holding company was before the two-step recapitalization. The Bill does not make this mistake. Sixth, I am concerned—as I suspect the FDIC is as well—that the actual use of SPOE under Title II of the Dodd-Frank Act will be subject to ex post criticism and investigation. Bankruptcy, with appropriate amendments as provided by the Bill, is in a more robust position to "do the right thing" in terms of fairly addressing the consequences of financial failure without having it necessarily lead to economic failure.

I want to thank the Subcommittee for allowing me this opportunity to present my views. As I hope I have made clear, I view this Bill to be an important substantive contribution to the

[42] Bill, Sec. 3, § 1185(d)(3).
[43] See, e.g., FDIC SPOE, *supra* note 6, p. 76618 (in addition to identified categories, the FDIC retains "a limited ability to treat similarly situated creditors differently.").
[44] Dodd-Frank Act § 210(h)(10) ("Notwithstanding any other provision of Federal or State law, a bridge financial company, its franchise, property, and income shall be exempt from all taxation now or hereafter imposed by the United States, by any territory, dependency, or possession thereof, or by any State, county, municipality, or local taxing authority.").

process of effective resolution of troubled SIFIs that began with the financial turmoil of 2008 that led to the enactment of the Dodd-Frank Act in 2010. It is an honor to appear before you today as you begin consideration of this welcome Bill. I would of course be delighted to answer any questions you may have about my testimony.

Mr. FARENTHOLD. Thank you very much, Professor Jackson.
Mr. Hessler, you are up.

TESTIMONY OF STEPHEN E. HESSLER, PARTNER, KIRKLAND & ELLIS LLP

Mr. HESSLER. Good afternoon, Chairman Bachus, Chairman Goodlatte, Ranking Member Johnson, Ranking Member Conyers, and Representative Farenthold. Thank you for inviting me to testify at today's hearing. My name is Steve Hessler, and I am a partner in the Restructuring Group of Kirkland and Ellis LLP. My practice primarily involves representing debtors, and my recent engagements include some of the largest and most complex corporate reorganizations in history.

I have also written at length about Title II of the Dodd-Frank Act, and I have specifically advocated that adopting relatively discrete amendments to Chapter 11 would better facilitate the orderly reorganization of systemically important financial institutions. To that end, I am pleased that Subchapter V incorporates many of the prescriptive alternatives that I have long favored.

The written materials that I have submitted include a lengthy comparative analysis of the various insolvency resolution frameworks at issue, but in my testimony this afternoon, I will focus on the most significant reasons that I believe, as a debtor practitioner, Subchapter V is the best-designed option so far, both structurally and philosophically, to maximize estate value for the benefit of stakeholders, while also protecting against the broader economic contagion that could result from the unmitigated failure of a financial corporation.

First, perhaps the signal benefit of Subchapter V is that a financial corporation case will be administered by a predetermined panel of experienced bankruptcy court judges within the established practice and precedent of the Bankruptcy Code instead of politically sensitive regulators within an untested nonjudicial process.

Second, Subchapter V amends the Bankruptcy Code to allow the Federal Government to file an involuntary petition and to commence a Chapter 11 case without the debtor financial corporation's consent. To echo the remarks of Mr. Bernstein, given that regulators already have various methods of essentially forcing a financial company to commence a voluntary case under the Code, making this ability explicit and subject to bankruptcy court approval hopefully will help further incentivize financial corporations to confront their problems early on and to diligently pursue responsible restructuring options.

Third, the Bankruptcy Code does presently provide that counterparties to qualified financial contracts are not subject to section 362's automatic stay against termination. This means a Chapter 11 filing by a financial corporation could be marked by chaos at the outset as counterparties proceed to terminate and enforce their rights in the debtor's assets. Subchapter V addresses this issue by subjecting qualified financial contracts to the automatic stay, but only for 48 hours. Although I have concerns that this time period may be too short to be viable, Subchapter V, unlike Title II, at least provides for debtor involvement and bankruptcy court approval of the contract assumption determinations.

Fourth, beyond Subchapter V's key amendments, I also want to focus on what I think is quite notable, which is the core provisions of Chapter 11 that Subchapter V does not modify, and I want to cite three key examples. The first is that the Bankruptcy Code requires debtors to adhere to the so-called absolute priority rule, which generally provides that creditors with similar legal rights must receive the same treatment, and that junior creditors may not receive any recovery until senior creditors are paid in full. Unlike Title II, which provides that similarly situated creditors may receive dissimilar treatment, Subchapter V does not disturb the primacy of the absolute priority rule, which is one of the most fundamental principles of Chapter 11, and is critical to ensuring the fair and equitable treatment of creditors of financial corporations.

Next, Subchapter V also does not amend a debtor's exclusive right to file a reorganization plan under section 1121. This means that the Federal Reserve and the FDIC, like all other parties in interest, would have standing to file a motion to terminate exclusivity for cause, but the government appropriately must first obtain bankruptcy court permission before abrogating a debtor's prerogatives on these fundamental restructuring decisions.

Thirdly, regarding directors and officers, in my experience their knowledge, expertise, and commitment is indispensable to effectuating a debtor's soft landing into and orderly passage through Chapter 11. In this regard, Subchapter V exercises, I believe, admirable restraint in not vilifying, much less disqualifying, a financial corporation's existing leadership from continuing to serve the debtor in possession postpetition, subject, of course, to already applicable Bankruptcy Code grounds for removal as justified.

Lastly, while I am very supportive of Subchapter V, I do want to note for the record there are certain provisions about which I have reservations, most significantly regarding the single point of entry approach that is central to Subchapter V. While the immediate separation and transfer of good bank assets in certain respects does mirror the so-called melting ice cube very fast section 363 asset sales that already are occurring under Chapter 11, Subchapter V codifies and accelerates these practices. That said, Subchapter V does also employ a number of safeguards on this front, including, critically, bankruptcy court approval under existing section 363 of the debtor's proposed transfer and plan distribution of trust assets.

I also believe there are certain issues around the procedures for commencing a Subchapter V case, especially in the highly compressed initial ruling deadlines, the record-sealing requirements, and limited judicial review. These provisions depart from standard bankruptcy principles of due process and transparency. So my preliminary reaction is to favor greater flexibility and openness. Here as well, however, I am very aware that the drafters of Subchapter V are striving very hard to balance those imperatives against the widely held views that the good assets of a financial corporation cannot withstand the prolonged public scrutiny of a typical Chapter 11 filing. To that end, I look forward to further careful consideration and further discussions with the Subcommittee staff on these key issues.

I thank the Subcommittee for allowing me to share my views on this important legislation, and I welcome the opportunity to answer any questions about my testimony.

[The prepared statement of Mr. Hessler follows:]

STATEMENT OF

STEPHEN E. HESSLER

PARTNER, KIRKLAND & ELLIS LLP

BEFORE

THE SUBCOMMITTEE ON REGULATORY REFORM, COMMERCIAL AND ANTITRUST LAW

THE COMMITTEE ON THE JUDICIARY

THE UNITED STATES HOUSE OF REPRESENTATIVES

JULY 15, 2014

HEARING ON

H.R. _____, THE "FINANCIAL INSTITUTION BANKRUPTCY ACT OF 2014"

Overview

Introduction

Mr. Chairman and members of the Subcommittee, thank you for inviting me to testify at today's hearing. My name is Steve Hessler, and I am a partner in the Restructuring Group of the law firm Kirkland & Ellis LLP. Although Kirkland's Restructuring Group primarily represents large and midmarket companies in insolvency matters, our practice also involves representing equity holders, creditors, investors, and other parties in a wide variety of highly complex distressed situations. I have counseled clients across a broad range of industries, including financial institutions, energy, telecommunications, gaming, hospitality and real estate, and manufacturing. My recent engagements have included some of the largest and most complicated Chapter 11 cases in history, including Calpine Corporation, Charter Communications, and, at present, Energy Future Holdings Corporation. The views expressed in my testimony, written and oral, are my own, and are not offered on behalf of my firm, any client, or other organization.

Beyond my client representations, I have lectured and published a number of articles on restructuring-related topics. I currently serve as the Co-Chairman of the Advisory Board on Administrative Claims, Critical Vendors, and Other Pressures on Liquidity for the American Bankruptcy Institute's Commission to Study the Reform of Chapter 11. I also teach a class each fall at the University of Pennsylvania to Law School and Wharton Business School students on distressed investing.

I also have written about and critiqued at length the authority provided by Congress within Title II of the Dodd-Frank Act for the "orderly liquidation" of systemically important financial institutions.[1] Most significantly, in May 2011, along

[1] *See* Stephen E. Hessler & James H.M. Sprayregen, *Too Much Discretion Exacerbates 'Too Big To Fail,'* WHO'S WHO LEGAL (July 2011); James H.M. Sprayregen & Stephen E. Hessler, *Orderly Liquidation*

with my Kirkland Restructuring partner James H.M. Sprayregen, I wrote a white paper, "Too Much Discretion To Succeed: Why A Modified Bankruptcy Code Is Preferable To Title II Of The Dodd-Frank Act," that we submitted to the Federal Reserve in response to its request for comments relating to the Dodd-Frank Act's Section 216 study regarding the resolution of financial companies under the Bankruptcy Code.[2] That white paper stated:

> Title II is an inferior alternative to the well-established legal landscape of the Bankruptcy Code as applied by Bankruptcy Court judges. Based on our experience, we favor the adoption of certain relatively discrete modifications or clarifications to the existing provisions of Chapters 7 and 11 that would facilitate the orderly liquidation or reorganization of systemically-important financial companies.[3]

To that end, I am pleased to note that H.R. ____, the "Financial Institution Bankruptcy Act of 2014"—which I will refer to herein by its colloquial name, "Subchapter V"—proposes to modify Chapter 11 by incorporating in full or at least in part many of the prescriptive alternatives to Title II that I have long-favored. These include, most significantly:

- Utilize Bankruptcy Court judges as the arbiters of financial corporation cases under Chapter 11, though limited to a predetermined set of especially capable jurists who are most experienced handling cases of analogous size and complexity;

Authority Under the Dodd-Frank Act: The United States Congress's Misdirected Attempt to Ban Wall Street Bailouts, INSOL WORLD (Third Quarter 2010); James H.M. Sprayregen & Stephen E. Hessler, *Failing to Be Too Big to Fail*, THE DAILY DEAL (May 21, 2010). I also was a member of the steering committee that organized the conference "Cabining Contagion: Addressing SIFI Failure Through OLA and its Alternatives," held on October 24, 2012, at New York University Law School, and I was an invited participant in the "Financial Firm Bankruptcy Workshop," conducted by The Federal Reserve Banks of Richmond and Philadelphia, on July 25-26, 2011 in Charlotte, North Carolina.

2 The white paper is available at http://www.federalreserve.gov/SECRS/2011/June/20110607/OP-1418/OP-1418_053111_80002_310357154312_1.pdf and a related interview is available at http://online.wsj.com/video/fatal-flaws-in-the-dodd-frank-act/7CEFEDBE-0240-4771-A463-83E32996BC92.html.

3 *Id.* at 2.

- Make explicit the Federal Government's direct ability to commence an involuntary Chapter 11 case against a financial corporation;
- Provide standing to the primary regulators of financial corporations to raise issues within their oversight purview;
- Authorize Bankruptcy Courts to consider the public interest (in accordance with the governing terms of the primary regulator's statutory mandate) when reviewing a debtor financial corporation's reorganization decisions;
- Effectively eliminate the safe harbors from the automatic stay for counterparty rejection rights of qualified financial contracts; and
- Reiterate that core Chapter 11 provisions—such as the absolute priority rule, the debtor's exclusive right to file a plan of reorganization, and directors' and management's ongoing post-petition role with the debtor in possession—remain applicable to financial corporation cases.

My testimony is organized as follows. *First*, to contextualize the financial institution insolvency regimes at issue, I will summarize the interplay between Subchapter V and Title II, and their related but distinct imperatives. I also will make some brief general observations, from my perspective as a practitioner who frequently represents debtors, about the comparative advantages of Chapter 11 (as modified by Subchapter V) to facilitate more effectively the entirely laudable goals that underlie Title II. *Second*, I will highlight and explain my general support for—and limited reservations about—the key provisions of Subchapter V.

I. Reorganization First Principles

Put simply, of the potential insolvency resolution regimes at issue—Chapter 11 in its current form, Chapter 11 as modified by Subchapter V, and Title II—Subchapter V is the best designed option, both structurally and philosophically, to advance the private and public policies that animate the reorganization of a systemically important financial institution. Put differently, Subchapter V is most likely to maximize estate value for the benefit of stakeholders, while safeguarding against the broader economic contagion that could result from the unmitigated failure of a major bank.

A. Operation

A threshold item is determining which financial institutions are subject to which insolvency resolution framework. Subchapter V largely adopts Title II's touchstone concept of "covered financial companies," which are United States-incorporated bank holding companies, or nonbank financial corporations predominantly engaged in activities that the Federal Reserve has determined are financial in nature or incidental to such financial activity. But while Title II and Subchapter V both apply to the same entities, they are mutually exclusive proceedings. One of the central tenets of the Dodd-Frank Act is that, once a Title II proceeding has been instituted, liquidation of the financial company shall proceed exclusively under Title II, and no provision of the Bankruptcy Code shall apply.[4] And, conversely, for financial companies not subject to liquidation under Title II, solely the provisions of the Bankruptcy Code or other applicable insolvency laws, but not Title II, shall govern.[5]

Importantly, a proceeding under Title II is commenced by the Federal Government—specifically, upon a determination by the Treasury Department, the Federal Reserve, and the Federal Deposit Insurance Corporation (FDIC) that the financial company is in default or danger of default on its obligations, with no viable private sector remedy, and its failure and resolution under otherwise applicable state or federal law (namely, the Bankruptcy Code) would have "serious adverse effects on financial stability

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4 12 U.S.C. § 5382(c)(1).

5 12 U.S.C. § 5382(c)(2).

in the United States," whereas liquidation under Title II would avoid or mitigate detrimental impact on "the financial system, the cost to the general fund of the Treasury, and the potential to increase excessive risk taking on the part of creditors, counterparties, and shareholders in the financial company."[6]

In partial contrast, under Subchapter V, a case may be commenced voluntarily by the covered financial corporation—or involuntarily by the Federal Reserve Board, upon its determination that the covered financial corporation is (or will soon be) insolvent, "such that the immediate commencement of a case under this subchapter is necessary to prevent imminent substantial harm to financial stability in the United States."[7]

Accordingly:

- a conventional case under the Bankruptcy Code may be commenced (voluntarily or involuntarily) by a relatively limited universe of parties in interest (a debtor or its creditors) for the relatively limited purpose of enforcing ***their own*** respective rights and obligations;
- a proceeding under Title II is initiated by a third party (the Federal Government) for the very broad purposes of liquidating the failing financial company ***and*** protecting the financial stability of the United States ***and*** discouraging problematic economic behavior of market participants; and
- a case under Subchapter V may be filed by the debtor or the Federal Government for the also broad purposes of reorganizing the failing financial corporation ***and*** preventing imminent harm to the United States' financial stability—***but*** without explicit consideration of the concomitant effect(s) on the risk taking of nondebtor parties.

These distinctions between Title II and Subchapter V matter, because, as discussed below, Subchapter V's narrower focus, and its placement within the well-

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6 12 U.S.C. § 5383(b).

7 Section 1183(a).

established environs of Chapter 11, actually increase the likelihood that the shared aims of both statutes will be achieved.

B. Efficacy

Subchapter V will provide superior protection against another financial crisis. The signal weakness of Title II is that it imbues the FDIC with barely limited discretion to exercise its "orderly liquidation authority." Insofar as Title II does require that "[a]ll financial companies put into receivership under [Title II] shall be liquidated" and "[n]o taxpayer funds shall be used to prevent the liquidation of any financial company under this title,"[8] it does follow that public dollars will not be used (or at least not directly) to "bail out" a failing financial company. But lenders care primarily (if not exclusively) about being repaid; they are not concerned with whether the borrower survives or which entity, private or public, funds the repayment.

Described generally, the "moral hazard" targeted by the Dodd-Frank Act results when creditors are incentivized to make risky loans because legal and regulatory regimes effectively operate to privatize gains but socialize losses. Investors will engage in increasingly speculative behavior if they are reasonably assured they will enjoy outsize profits if an investment succeeds, but the government will shield them from outsize harms if it fails. Title II expressly authorizes the dissimilar treatment of similarly situated creditors.[9] And because any excess costs of liquidation will be funded by assessments on third-party financial companies,[10] the Dodd-Frank Act essentially authorizes regulators to

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8 12 U.S.C. § 5394(a).

9 12 U.S.C. § 5390(b)(4).

10 12 U.S.C. § 5390(o)(1)(B).

pay creditors whatever amounts are deemed necessary to stabilize the economy, according to the economic (and political) priorities of the prevailing Administration.

The hallmark of an optimal resolution regime for distressed financial firms must be clear and established rules, administered by an impartial tribunal. To that end, Subchapter V is a financial company-specific supplement to the existing corporate reorganization provisions of Chapter 11 of the Bankruptcy Code. Thus Subchapter V builds upon the decades of practice and precedent that have refined the Code and that otherwise provide a well-tested, and demonstrably successful, reorganization framework for major corporations, including systemically important financial institutions. So understood, Subchapter V is an appropriately modest and viable construct, as opposed to Title II, which replaces wholesale any application at all of the Bankruptcy Code.

II. Subchapter V—Key Provisions

The following testimony explains my general support for, and limited reservations about, key provisions of Subchapter V.

A. Bankruptcy Court Judges

Among the most significant benefits of Subchapter V is its mandate that financial corporation Chapter 11 cases will be administered by Bankruptcy Court judges—as opposed to Title II, which utilizes politically sensitive regulators to decide issues that should be ruled upon by neutral arbiters. Although Subchapter V largely (but not entirely) maintains the Chapter 11 status quo in this respect, these provisions are a critical comparative advantage to Title II.

The United States Code establishes that bankruptcy cases are filed in the applicable Federal District Court, which may then "refer" the cases to the Bankruptcy

Court in that judicial district.[11] As a matter of course, every Federal District Court has a standing order that all bankruptcy cases filed therein are automatically referred to that jurisdiction's Bankruptcy Courts (except for certain limited issues or in certain limited circumstances).

While this construct generally works exceptionally well, I do support Subchapter V's provisions that assign covered financial corporation Chapter 11 cases to a predetermined panel of not fewer than ten Bankruptcy Court judges "who have significant experience with cases under title 11 in which a financial institution or a company with assets or liabilities exceeding $1,000,000,000 is a debtor."[12] Ensuring Subchapter V cases are heard by a defined subset of jurists who are most knowledgeable about how to administer a financial corporation reorganization under the Bankruptcy Code is a reasonable and justified accommodation to the exigent circumstances at issue in cases of this distinct size and nature.

Likewise, as to appellate review, Subchapter V provides that "the Chief Justice of the United States shall designate not fewer that 3 judges of the court of appeals in each circuit to serve on an appellate panel to be available to hear" covered financial corporation case appeals.[13] This also is a departure from the status quo, which involves Federal District Courts serving as the initial appellate bodies to review Bankruptcy Court decisions. However, given that Chapter 11 litigants already have the right to seek direct appeal of Bankruptcy Court rulings to the relevant Court of Appeals,[14] and given the

[11] 28 U.S.C. § 157.

[12] Section 298(b)(1).

[13] Section 298(a).

[14] 28 U.S.C. § 158(d)(2).

highly time-sensitive ruling requirements imposed by Subchapter V (discussed below), this is a justified amendment to current practice.

B. Enhanced Government Role

1. Ability to Commence Involuntary Case

As noted above, Subchapter V amends the Bankruptcy Code to allow the Federal Reserve to file an involuntary petition, thus commencing a Chapter 11 case without the debtor financial corporation's consent. Given that regulators already have myriad methods of effectively requiring that a financial company commence a voluntary case under the Bankruptcy Code, making this ability explicit—and, importantly, subject to a determination by the Bankruptcy Court that the Federal Reserve has shown by a preponderance of the evidence that doing so "is necessary to prevent imminent substantial harm to financial stability in the United States"—should help motivate financial corporations to confront their problems early and diligently pursue responsible restructuring options.[15]

2. Standing & Consideration of the Public Interest

The Bankruptcy Code does not presently provide an expansive grant of standing to the Federal Government to participate in Chapter 11 cases. Section 1109(b) states "[a] party in interest, including the debtor, the trustee, a creditors' committee, an equity security holders' committee, a creditor, an equity security holder, or any indenture trustee, may raise and may appear and be heard on any issue in a case under this chapter."[16] The Code does include a limited right to be heard to the Securities and

[15] Section 1183(a)(2)(A)(iv).

[16] 11 U.S.C. § 1109(b).

Exchange Commission,[17] but otherwise, unless the Federal Government has a claim against or equity interest in the debtor, regulatory bodies generally do not have standing to appear, in their capacity as regulators, and advance their public interest mandates in financial corporation cases under Chapter 11.

Subchapter V addresses this shortcoming by providing that the Federal Reserve and FDIC "may raise and may appear and be heard on any issue in any case or proceeding under" Subchapter V.[18] A helpful further modification would be to expressly authorize the Bankruptcy Court to consider the "public interest" in reviewing a financial corporation debtor's proposed actions in Subchapter V cases. There is precedent for doing so, as the Bankruptcy Code already includes the "public interest" as an applicable factor in the Bankruptcy Court's review of most of the debtor's key restructuring decisions in railroad cases.[19] This is an apt parallel, in light of the integral importance of the railroads to the American economy at the time those provisions were enacted. Today, the orderly resolution of systemically important financial companies, as with the railroads in prior generations, is likewise vital to protecting the public interest.

C. Automatic Stay Safe Harbors for Qualified Financial Contracts

The Bankruptcy Code currently provides that counterparties to qualified financial contracts (such as repurchase or swap agreements) are not subject to the automatic stay

17 Section 1109(a) states "[t]he Securities and Exchange Commission may raise and may appear and be heard on any issue in a case under this chapter, but the Securities and Exchange Commission may not appeal from any judgment, order, or decree entered in the case." 11 U.S.C. § 1109(a).

18 Section 1184.

19 Section 1165 requires that "[i]n applying sections 1166, 1167, 1169, 1170, 1171, 1172, 1173, and 1174 of this title, the court and trustee shall consider the public interest in addition to the interests of the debtor, creditors, and equity security holders." 11 U.S.C. § 1165. Those sections involve, for instance, the ability to change wages or working conditions established by collective bargaining agreement, lease rejection or abandonment of a railroad line, and confirmation of a reorganization plan or liquidation.

imposed by section 362 that otherwise bars conventional contract counterparties from relying on an *ipso facto* clause in an agreement to terminate the contract and exercise rights to enforce any security interests in the debtor's collateral.[20] Put simply, when a debtor files for bankruptcy, most contract counterparties are stayed from terminating their agreement with the debtor and/or engaging in self-help remedies against estate assets,[21] but these pro-debtor protections do not apply to qualified financial contract counterparties.[22] As a result, a Chapter 11 filing by a financial corporation with significant qualified financial contracts could be marked by chaos at the outset as counterparties, unimpeded by the automatic stay, proceed to terminate these contracts and enforce their rights in the debtor's assets.

Subchapter V addresses this issue by subjecting qualified financial contracts to the automatic stay—albeit only for 48 hours.[23] I have previously criticized Title II for imposing a similarly brief stay, only until 5:00 p.m. (eastern time) on the business day following the date of the FDIC's appointment as receiver, or after the counterparty receives notice the qualified financial contract has been transferred to a bridge financial company.[24] My concerns primarily were twofold. *First*, this was a problematic grant of discretion to the FDIC to pick winners and losers, through its determination of which counterparties would have their qualified financial contracts transferred to a solvent

[20] 11 U.S.C. § 362. An *ipso facto* clause typically provides, among other things, that the commencement of a voluntary or involuntary case under the Bankruptcy Code is an automatic breach of contract.

[21] 11 U.S.C. § 365(e)(1).

[22] *See, e.g.*, 11 U.S.C. §§ 555, 556, 559, 560, and 561.

[23] Section 1187(a)(3)(A)(i).

[24] 12 U.S.C. § (c)(10)(B)(i)(I).

bridge company (thus presumably maintaining the full economic benefits of the agreement), and which contracts will remain with the insolvent debtor (thus presumably providing those counterparties with only the liquidation value of their claims). And, *second*, it seems highly unrealistic that, within one full business day of its appointment, the FDIC would be sufficiently prepared to make informed transfer determinations (much less effectuate those determinations) for a major financial company's entire book of qualified financial contracts.

Subchapter V partly solves the first point regarding discretion. Section 1185(a) provides that the trustee (*i.e.*, the debtor in possession) or the Federal Reserve may request the transfer of estate property to a bridge company, including qualified financial contracts to be assumed, and this request is subject to Bankruptcy Court approval. Ideally Subchapter V would further be clarified to specify the actual decisionmaking authority as to which qualified financial contracts are transferred and assumed remains with the debtor. But because the debtor is at least coequally involved in those determinations, and because those determinations must be authorized by the Bankruptcy Court, the unchecked regulatory discretion in Title II is not present here.

Subchapter V does not, however, directly resolve the second issue regarding whether it is commercially viable essentially to require a debtor to make transfer and assumption decisions almost immediately upon a filing. In my experience, even with months to prepare for the petition date, the first 48 hours (at least) after the commencement of a major Chapter 11 case are already an incredibly hectic period for management and their advisors, and to add to that burden that a financial corporation debtor must review its entire portfolio of qualified financial contracts, and determine for each one whether assumption or rejection is in the best interests of the debtor's estate, does not seem commercially pragmatic.[25] That said, since passage of the Dodd-Frank Act in 2010, financial corporations have had four years to draft and revise their "living wills," and perhaps the enactment of Subchapter V, which also would reinforce the need to make qualified financial contract assumption decisions nearly immediately, would further prompt the relevant managers to plan responsibly for potential insolvency contingencies.[26]

[25] For example, when Congress amended the Bankruptcy Code to impose a maximum time limit of 210 days for a debtor to determine whether to assume commercial leases, 11 U.S.C. § 365(d)(4)(B), restructuring experts widely believe this limitation made it prohibitively difficult for retail debtors to revise their business plans and make informed lease assumption and rejection decisions quickly enough—and the result was a spate of retail debtor liquidations.

[26] Although my default position is these safe harbors should not exist at all, I acknowledge it may be possible there are some types of financial products that are specially deserving of a safe harbor—with the following caveats.

First, because an exemption from the automatic stay is an extraordinary right, it should be limited to a very narrow class of qualified financial contracts for which an inability to terminate promptly, at the counterparty's election, would pose a demonstrated credible threat of severe harm to the counterparty, as balanced against the harm that termination would inflict upon the debtor (and the public interest).

Second, to disincentivize qualified financial contract drafters from responding to this reform by structuring all manner of non-deserving contracts in the guise of exempt agreements, the safe harbor should only become available 60 days after the petition date. *Cf.* 11 U.S.C. § 1110 (providing the automatic stay under section 362 expires 60 days after the petition date for creditors with a security interest in certain aircraft vessels and equipment, unless the debtor within that period obtains court authority to assume and cure any defaults under the agreement).

Qualified financial contract counterparties, like secured lenders upon the advent of the Bankruptcy Code a few decades ago, will protest that eliminating the safe harbors will decimate their markets. But these highly sophisticated parties, just as they learned to draft all manner of commercial transactions as qualified financial contracts (so as not to be subject to the automatic stay), can be expected to adapt their documentation and other practices accordingly, and the resulting benefit (restoring a Chapter 11 filing as a viable option for financial corporations with major qualified financial contracts exposure) will outweigh the detriment (subjecting qualified financial contract counterparties to the same treatment under the Bankruptcy Code as other secured creditors).

Lastly, it bears reiterating that, like all parties in interest, any counterparty that hypothetically could demonstrate an inability to terminate its qualified financial contract immediately after the petition date would pose a credible threat of material harm to the counterparty, as balanced against the injury that termination would inflict upon the debtor, already has the right under section 362 to petition the court to lift the stay immediately. 11 U.S.C. § 362(d).

D. Other Core Provisions

Beyond Subchapter V's key amendments, also notable are certain core provisions of Chapter 11 that Subchapter V quite importantly does ***not*** modify.

1. Absolute Priority Rule

Stated generally, the Bankruptcy Code requires debtors to adhere to the so-called "absolute priority rule," which generally provides that claims with rights of a similar legal nature be placed in the same class and that no class of junior creditors may receive any recovery unless and until each class of senior creditors receives payment in full (but no more than that) of its claims.[27]

In stark contrast, Title II expressly provides that similarly situated creditors may receive dissimilar treatment, without regard for seniority. Specifically, the FDIC "may take any action" that "does not comply" with the absolute priority rule, if it determines that doing so is necessary to maximize value and minimize loss, provided that similarly situated creditors receive "not less than" they would have in a Chapter 7 or state law liquidation.[28] But so long as that minimum threshold is satisfied for legally coequal claimants, the FDIC may favor certain creditors over others.

That Subchapter V does not disturb the primacy of the absolute priority rule, which is among the most fundamental principles of Chapter 11, is critical to ensuring the traditionally fair and equitable treatment of creditors in these otherwise atypical financial corporation cases.

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27 *See* 11 U.S.C. § 1129.

28 12 U.S.C. § 5390(b)(4)(B).

2. Plan Exclusivity

Subchapter V also does not amend a debtor's exclusive right to file a reorganization plan under section 1121.[29] In other words, the Federal Reserve and FDIC, like all parties in interest, have standing to file a motion to terminate exclusivity for "cause" (including for the reason that allowing the financial corporation's regulator to propose a plan furthers the public interest). But the Federal Reserve and FDIC appropriately remain required to first obtain Bankruptcy Court permission before usurping a Chapter 11 debtor's prerogatives on these critical restructuring decisions.

3. Directors & Management

Chapter 11 applies the concept of a "debtor in possession" retaining the ability to manage its businesses post-petition—not to shield executives from the consequences of their stewardship, but to ensure that decisionmakers of distressed corporations are not disincentivized from pursuing the difficult but necessary restructuring decisions that may involve or lead to a Chapter 11 filing.[30]

Title II, on the other hand, directs that "management responsible for the condition of the financial company will not be retained" and the FDIC and other agencies "will take all steps necessary and appropriate" to ensure that management "bear losses consistent with their responsibility" for the failure of the covered financial company.[31] More specifically, the FDIC may recover from any culpable current or former senior executive or director "any compensation" received within two years of the FDIC appointment

[29] 11 U.S.C. § 1121. Subchapter V does otherwise require that "[t]he special trustee shall distribute the assets held in trust ***in accordance with the plan*** on the effective date of the plan." Section 1186(c) (emphasis added).

[30] 11 U.S.C. §§ 1107, 1108.

[31] 12 U.S.C. § 5384(a).

date.[32] The FDIC also may seek to ban directors or executives from participating in the "affairs of any financial company," for a period of no less than two years, for violating any laws or breaching their fiduciary duties.[33]

To be sure, if the leadership of a Chapter 11 debtor (including a covered financial corporation) has acted in a manner that justifies its removal, the Bankruptcy Code already provides ample tools for doing so.[34] But the reality of most restructurings is that the knowledge, expertise, and commitment of existing directors and officers is indispensable to effectuating a debtor's soft landing into and orderly passage through Chapter 11. To that end, Subchapter V exercises admirable restraint in not reflexively vilifying (much less disqualifying) directors and management.[35]

E. Reservations

While I am overall very supportive of Subchapter V, there are certain issues about which I have reservations. An exploration of all points that I believe should be studied in greater detail is beyond the limited scope of my testimony, but I do want to preview the following high-level thoughts.

1. SPOE

Although not expressly defined as such in Subchapter V, a central feature of the legislation is the "single point of entry" (or SPOE) approach that allows the debtor to

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[32] 12 U.S.C. § 5390(s).

[33] 12 U.S.C. § 5393(c)(1).

[34] *See* 11 U.S.C. §§ 1104, 1105, 1106.

[35] The only incremental requirements that Subchapter V appears to establish on this front are: the bridge company that is the recipient of a transfer of estate assets shall obtain court approval of its governing documents, including the initial directors and senior officers of the corporation—and that the trust agreement governing the trust (that holds the equity of the bridge company) shall provide that the special trustee (appointed to administer the trust) shall provide notice to the Bankruptcy Court of any change in a director or senior officer of the bridge company. Sections 1185(d)(3); 1186(b)(3)(A).

effect a quick separation of "good" assets from "bad" assets, via transfer of the good assets to a bridge financial company whose equity is held by a trust that is managed by a special trustee for the benefit of creditors—with liquidation of the bad assets in the bankruptcy process, also for the benefit of creditors—with both the transfer and liquidation subject to Bankruptcy Court approval.[36]

My preliminary view is the SPOE construct merits very careful consideration and perhaps further modification. While the contemplated transfer in many respects mirrors the lightning fast "melting ice cube" section 363 assets sales that already are occurring under Chapter 11—including, most relevantly, in the sale of most of Lehman's operations to Barclays within less than a week of its petition date—there are a number of provisions of Subchapter V that codify and seemingly accelerate these practices. These include, most prominently:

- The transfer of a financial corporation's assets to a bridge company shall occur not less than 24 hours after the commencement of the Subchapter V case;[37]
- Notice of the proposed transfer shall be provided only to a limited group of creditors, including the holders of the 20 largest secured claims, the 20 largest unsecured claims, and the counterparties to any qualified financial contracts to be assumed by the bridge company;[38] and
- After the transfer of good assets has occurred, the special trustee shall be subject only to applicable nonbrankuptcy law, and the actions and conduct of the special trustee shall not be subject to court approval.[39]

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36 Sections 1185, 1186, 1187, 1188, 1189, 1191.

37 Section 1185(a).

38 Section 1185(b).

39 Section 1186(d).

That said, there also are a number of safeguards that Subchapter V establishes around SPOE, including:

- The provisions of existing section 363 apply to the transfer of good assets to the bridge company[40]—a critical protection, in my view;
- The bridge company must obtain Bankruptcy Court approval of its governing documents;[41]
- The Bankruptcy Court must approve the trust agreement governing the trust;[42] and
- Perhaps most importantly, the distribution of the trust assets (including, presumably, the equity in the bridge company) shall be done in accordance with otherwise applicable Chapter 11 plan of reorganization confirmation requirements and protections.[43]

2. Commencement Procedures

Secondarily, I believe there are a handful of remaining issues, surrounding certain of the procedures and deadlines for commencing a Subchapter V case, that also deserve additional study.

Described summarily, Subchapter V provides that, upon the Federal Reserve filing an involuntary proceeding, the Bankruptcy Court shall hold a hearing on whether to uphold the filing within 12 hours, without notice to or attendance by any creditors, with transcripts that shall remain sealed for at least three months.[44] The Bankruptcy Court must issue its ruling on the Federal Reserve's involuntary petition within 14 hours of the petition being filed—and, upon the Bankruptcy Court's ruling, the covered financial

40 Section 1185(a).

41 Section 1185(d)(3).

42 Section 1186(a)(2)(A).

43 Section 1186(c).

44 Section 1183(b)(1)-(2).

corporation shall file any appeal within one hour.[45] The appellate panel shall hear the appeal within 12 hours, and shall issue its ruling within 14 hours, of the Bankruptcy Court's decision.[46] The decision of the appellate panel shall be final and not further appealable.[47]

To state the obvious, these are highly compressed time periods, with atypical sealing requirements, and limited judicial review. These provisions depart from standard Bankruptcy Code principles of due process and transparency, and thus my threshold reaction is greater flexibility and openness may be advisable. That said, I am also quite aware that the drafters of Subchapter V are grappling with widespread, expert views that the good assets of a financial corporation cannot withstand the prolonged public scrutiny inherent in normal Chapter 11 cases. So these extraordinary elements may justifiably be needed due to the unique time and awareness sensitivities of a Chapter 11 case of a covered financial corporation, and thus I look forward to further careful consideration of these important issues.

Conclusion

It is a privilege to appear before you today. I thank the Subcommittee for allowing me to share my views. And I welcome the opportunity to answer any questions about my testimony.

45 Section 1183(b)(4); 1183(c)(1).

46 Section 1183(b)(4); 1183(c)(2).

47 Section 1183(c)(3).

Mr. FARENTHOLD. Thank you very much.
We will now go to Professor Lubben.

TESTIMONY OF STEPHEN J. LUBBEN, PROFESSOR, SETON HALL UNIVERSITY SCHOOL OF LAW

Mr. LUBBEN. Thank you very much.

Mr. FARENTHOLD. Could you make sure your microphone is on and close to your mouth, please, sir?

Mr. LUBBEN. Thank you very much, Chair Bachus, distinguished Members of the Subcommittee. My name is Steven J. Lubben. I hold the Harvey Washington Wiley Chair in Corporate Governance and Business Ethics at Seton Hall University School of Law in Newark, New Jersey.

When considering financial institution failure, to my mind context is key. The context in which the failure happens is key. You need a range of options to address the failure of a financial institution, ranging from current Chapter 11 practices to the orderly liquidation authority. And I commend the proposed Subchapter V as a new addition to the regulatory toolbox. And accordingly, it applies the approach that was successfully used in the automotive bankruptcy cases to the case of financial institutions, and thus gives the regulators and financial institutions another approach to deal with possible failure.

I also commend the bill for utilizing the experienced bankruptcy judges to conduct the proceedings. One of the key benefits of the American approach to corporate reorganization is the use of specialized knowledgeable bankruptcy judges, and I do, again, commend the bill for utilizing those judges for resolving financial institutions.

I do believe that the bill could be improved in a few ways, however, and I will focus on three of those in my comments today. First of all, unlike some prior witnesses, I have some doubts about the utility of the special trustee concept. At heart, I think the special trustee concept confuses the debtor's ownership of the shares of the bridge company with the ongoing operations of the bridge company. It is an issue that could be addressed more straightforwardly and less confusingly. In particular, I think that the special trustee provisions add unneeded complexity and uncertainty to Subchapter V, and I would urge a rethink of those.

Next, I would urge the Subcommittee to give further thought to the fate of the debtor after the sale of the assets to the bridge company. Understandably, the bill focuses primarily on the successful movement of the debtor's assets, which is primarily going to be the equity and the operating subs, to the bridge company, but it doesn't really address the question of what happens next. This may seem a bit overly technical, but the debtor's creditors may rightly argue that leaving them to recover claims in an unfunded liquidation proceeding of the remaining debtor amounts to appropriation of their claims. Presumably that makes the investment decision to invest in bank holding company debt somewhat difficult, which we probably don't want to do.

At the very least, I think we need a mechanism to convert the case from Subchapter V to a liquidation under Chapter 7, but, as my comments suggest, the Subcommittee may want to consider, if conversion is not the likely outcome in many cases, if there is no mechanism for reorganizing the debtor or even coming to a liquidation plan.

Specifically, we need to think about ways to fund the case after the transfer of the asset has happened, and precisely what is going to happen, and what role regulators will play in that new case.

Third, I suggest the Subcommittee should consider what will happen if a Subchapter V proceeding fails. In other words, if you do transfer the assets to the new bridge institution, and the institution continues to experience a run, what is going to happen at that point? Can the bridge company itself be put into a Dodd-Frank orderly liquidation authority proceeding? At the very least, you may want to make it explicit that the bridge company succeeds to whatever eligibility its former self had.

In addition, does the bankruptcy court have an ability to convert a Subchapter V proceeding to some other sort of insolvency proceeding? And does the court have an ability to coordinate with regulators?

Likewise, does the bankruptcy court have an ability to block regulatory actions that might undermine a Subchapter V proceeding. For example, what if a State insurance regulator or a State banking regulator decides to take action against an operating subsidiary that undermines the viability of the Subchapter V process? Does the bankruptcy court have an actual ability to stay them?

Presumably, if they have such a power, it is not going to extend to foreign regulators, which I think then highlights the reality that solving the "too big to fail" problem is as much about the structure of financial institutions as it is about the specifics of any insolvency process. Insolvency, in other words, is a very small piece of a much larger regulatory structure.

Thank you very much.

[The prepared statement of Mr. Lubben follows:]

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Testimony of Professor Lubben before U.S. House Judiciary Committee Subcommittee on Regulatory Reform, Commercial and Antitrust Law regarding Financial Institution Bankruptcy Act of 2014

Washington, D.C. -- July 15, 2014

Chair Bachus and Distinguished Members of this Subcommittee:

I hold the Harvey Washington Wiley Chair in Corporate Governance & Business Ethics at Seton Hall University School of Law in Newark, N.J. I have been at Seton Hall since entering academia in 2002, and I teach Bankruptcy, Corporate Finance, and Financial Institutions at the Law School. I also write the *In Debt* column for the New York Times' *DealBook*, and I write about corporate bankruptcy for *Credit Slips*.

Before entering academia, I was an associate for several years with the law firm of Skadden, Arps, Slate, Meagher & Flom in New York and Los Angeles, where I specialized in corporate reorganization and debt restructuring. But my comments today only reflect my own opinions, and not those of any current or former employer or client.

I was asked by minority staff to comment on a draft bill entitled the "Financial Institution Bankruptcy Act of 2014."

As an initial matter, I commend the draft bill as an important and promising first step. As a general matter, resolution of financial institutions must take into account the wide range of contexts in which the institution might encounter financial distress.

Some financial institutions might well be resolved under the extant Bankruptcy Code. But for many institutions, traditional chapter 11 lacks the needed speed. In addition, the so-called "safe harbors," which exempt derivatives from vital parts of the Code, make a filing extremely unattractive.

Moreover, save for the SEC – which has a role in chapter 11 cases for historical reasons – most regulators do not clearly have a way into a bankruptcy case. And no regulator has the ability to commence a bankruptcy proceeding in the face of objections from a financial institution's board.

Despite these problems, Dodd-Frank reflects Congress' strong preference for use of the Bankruptcy Code whenever possible. A modified version of chapter 11, like that proposed in the present bill, represents an important step in realizing this preference.

I also appreciate that the proposal utilizes the experienced bankruptcy judges to conduct the proceedings. One of the key benefits of the American approach to corporate restructuring is the use of experienced, specialized judges.

There are ways in which the bill could be improved, however, and I will address those in the remainder of my comments. In particular, I will highlight three big-picture concerns I have with the draft before turning to a series of smaller, more discrete issues.

First, I have my doubts about the utility of the "special trustee." Under the legislation, such a trustee may be appointed to hold the shares of the bridge company, until the shares are distributed under the debtor's plan. Once appointed, the trustee is largely immune from any oversight by the debtor or the bankruptcy court, but the trustee does have some reporting requirements.

The key question is why have this trustee at all?

Is there any good reason the debtor could not hold the sale consideration, as it typically does in chapter 11 following a 363 sale? And even if we could imagine that in some cases the debtor should not be trusted with this responsibility, is there any reason to think that the traditional remedy for a mistrusted debtor – appointment of a trustee – would not suffice?

Indeed, given the posture of a case under subchapter V, it should be expected that such a trustee will be appointed save for when old management has already been replaced.

The special trustee provisions add unneeded complexity and uncertainty, and thus cost, to a case under subchapter V.

The real goal of the special trustee provisions seems to be to take managerial power of the operating subsidiaries away from the debtor-in-possession. That could seemingly be achieved by directly appointing a manager of the bridge company – the Federal Reserve or some other appropriate regulator should be vested with this power. The regulator could compensate the manager and then be provided with a priority claim in the debtor's bankruptcy case to reimburse the expense.

There is no real need for the debtor's sole asset to be placed into a complex trust arrangement, with equally complex reporting requirements, to achieve these ends. At heart, the special trustee concept seems to confuse the debtor's ownership of the shares of the bridge company with the ongoing operations of the bridge company and its subsidiaries.

Next, I would urge the Subcommittee to give further thought to the fate of the debtor after the sale of its assets to the bridge company.

Understandably, the bill focuses primarily on the successful movement of the debtor's assets – the equity in its operating subsidiaries – to the bridge company. But what happens next?

The bill intimates that a plan will follow, and thus distribute the shares of the bridge company to creditors. But how will that plan be drafted and votes solicited thereon? The bankruptcy process is not self-sufficient, and drafting and negotiating even a liquidation plan requires the work of compensated professionals.

The debtor might be compelled to transfer less than all of the group's operating cash to the bridge company, thus retaining some ability to fund its own liquidation process. The trick, of course, will be to balance the debtor and the bridge company's competing claims to the cash.

Perhaps the debtor could borrow against the value of the bridge company to fund its case, which provides another argument for the debtor, and not the special trustee, to have control over the shares. And proposed section 1185 would seem to prevent such financing in any event.

This may seem a bit picayune, but the debtor's creditors might rightly argue that leaving them to recover their claims in an unfunded liquidation proceeding is little different from direct appropriation of their claims. At the very least there should be a mechanism for converting the case from subchapter V to a traditional chapter 7 liquidation. Indeed, the Subcommittee might well consider if conversion to chapter 7 is not the likely outcome in every case under the terms of the bill as currently drafted.

Moreover, the debtor's professionals, or the bankruptcy trustee, will need access to the debtor's historical financial records if any sensible distribution to creditors is to happen. The management of the bridge company should have some express obligation to accommodate such needs. Otherwise the post-transfer windup of the debtor again becomes an impossibility.

In short, without a viable mechanism to get the bridge company shares into the hands of creditors, the bill is apt to create a morass of litigation that will linger for years after the financial institution's failure.

I similarly urge the Subcommittee to consider what might happen if a subchapter V proceeding failed. Specifically, what happens when the transfer of the operating companies to a bridge and the "bail in" of those companies by the bridge entity fail to halt a run on the operating companies?

Could the bridge company itself be placed into an OLA receivership under title II of Dodd-Frank? Does the bankruptcy court have any ability to convert a subchapter V proceeding into some other type of insolvency proceeding?

Likewise, does the bankruptcy court have any ability to block regulatory actions that might undermine the subchapter V process? For example, what if a state regulator takes action against an operating subsidiary that undermines the viability of the financial institution as a going concern?

Presumably any such power would not extend to foreign regulators – which highlights the reality that solving the "too big to fail" problem is as much about the structure of financial institutions as it is about the specifics of any insolvency process.

* * *

I conclude with a series of more specific, technical comments on the bill:

1. At present the bill provides a role for the Federal Reserve and the FDIC. As noted, the SEC is given a general role in chapter 11, and presumably that would also apply in a subchapter V proceeding. What about the CFTC, state banking and insurance regulators, and the OCC? Alternatively, if the intent is to streamline the process, then it should be made clear that the SEC's role under section 1109 does not extend to this subchapter.

2. Is there any reason to limit the definition of "capital structure debt" to unsecured debt? The current definition could encourage the issuance of bonds secured by the debtor's equity in its subsidiaries, as such bonds might be treated differently in a subchapter V proceeding.

3. The bill is vague as to whether the bridge company would be chartered under state or federal law. While state corporate law is familiar, given the duties of the bridge company's management to mitigate systemic risks, a special federal charter might more appropriately address the fiduciary duties of management.

4. The bill should include express statements that (a) termination rights do not exist against the bridge company and its successors unless they themselves default and (b) that the transfer of assets to the bridge is entirely free and clear of all claims, no matter how contingent or uncertain, including claims arising under state successor liability doctrines.

5. I also suggest further consideration of the proposal to appoint ten bankruptcy judges, each with "big case" experience, per circuit to the pool of judges that might handle cases under the new subchapter V. In particular, I doubt this will always be workable. For example, the Tenth Circuit has just over twenty bankruptcy judges in total. It is not clear that half of those judges have substantial experience with large chapter 11 debtors. Moreover, outside of the Second Circuit, it is not obvious that any other circuit would need anything close to ten bankruptcy judges "at the ready."

I appreciate the opportunity to appear before the Subcommittee today to share my views and look forward to any questions.

Mr. FARENTHOLD. Thank you very much.

I appreciate all of your testimonies. And we will begin with some questions.

I will be the first to admit that I am not the expert in bankruptcy. I practiced law for a while, took one bankruptcy class. So just really getting up to speed on this Committee, and I appreciate you-all's help with that.

With that in mind, I want to step back and start with a 30,000-foot view for those who will be reading this record who are not as expert as you guys are. I just want to get everybody's 30,000-foot opinion. Do you agree that the Bankruptcy Code could be improved to facilitate the resolution of financial institutions? I think that I got a yes from everybody's testimony. Does anybody disagree with that statement?

All right. I think we are good. All our panelists seem to be nodding their head in the affirmative.

Can you all also generally agree, subject to some of the revisions that is in your written testimony, that you could support the Financial Institution Bankruptcy Act? Anybody have any reservations beyond what is in their testimony?

I think we got all affirmative nods there, too. I like it when we can get everybody to agree here.

All right. Professor Jackson, let me ask you, do you believe the enactment of Subchapter V would reduce the necessity for regulators to initiate Title II resolution proceedings?

Mr. JACKSON. I do. I believe, as Don Bernstein indicated, Title II should be there as a backstop. The world is an uncertain place. But I believe that enactment of a bill along these lines, with some of the amendments people have talked about, will significantly reduce the need for invocation of Title II of Dodd-Frank, because, again, in order to invoke it, you have to find a bankruptcy is wanting. I think this largely fixes the problems that currently exist that would make bankruptcy wanting. So the short answer to your question is yes.

Mr. FARENTHOLD. Anybody else want to weigh in on that? Mr. Hessler, or Professor Lubben, Mr. Bernstein?

All right. Mr. Hessler, I will ask you, why do you believe the Federal Reserve should be provided with the authority to commence involuntary Subchapter V proceedings?

Mr. HESSLER. There is two reasons. One is practical; one is a little more theoretical. First, the practical reason is there are various regulatory maneuvers that regulators, including the Fed, could take that would otherwise effectively make it inevitable that a financial corporation had to file for bankruptcy in any event.

But from a more important, I think, theoretical perspective, and it was echoing some remarks of Mr. Bernstein as well, the fact that there is the explicit ability for an involuntary to be commenced against a financial corporation hopefully will incentivize them to, as early as possible, as they approach the zone of insolvency, to begin to responsibly explore what would be alternative or viable restructuring alternatives instead of otherwise turning a blind eye to the problem for as long as possible, safe in the awareness that nobody can force them into bankruptcy until things are truly dire.

Mr. FARENTHOLD. Mr. Bernstein?

Mr. BERNSTEIN. I think there is one additional reason, which is if the Fed believes that the company, if the firm needs to be in a resolution procedure, if we didn't have this provision, its only recourse would be to consult with the FDIC and Treasury and do a Title II procedure. So this gives them another option.

Mr. FARENTHOLD. All right. Mr. Hessler, let's talk a little bit about the importance of retaining existing management for like newly formed bridge companies or holding companies. The concern is that if the financial institution got in trouble to begin with, and we are hanging onto some of the same management, you know, there is a potential problem. Does the Bankruptcy Code provide sufficient methods to remove these bad managers?

Mr. HESSLER. It does. It does. First of all, just some background context from that. As I said, in my experience the overwhelming majority of cases, the overwhelming number of Chapter 11 cases, were not caused by bad actions by management. They tend to be balance sheet restructurings either having to do with macroeconomic effects that were unanticipated, or potentially entirely justifiable business decisions that turned out to be wrong, but not the type of malfeasance or other type of actions that would otherwise warrant, as Title II would upon the invocation of proceedings, simply cleaning the slate and removing all of the top directors and officers.

So like I said, in my experience that would actually be disastrous if you did that, because you would have a rudderless ship going into bankruptcy. And what Title II anticipated was not just regulatory help, but the employment of various consultants and third parties to otherwise assist in what is going to be a very rapid transfer of assets and then liquidation. It is extremely impractical, in my opinion, that that could be effected that quickly in a way that doesn't otherwise cause massive chaos and confusion.

And the last thing I would add to your direct question is the Bankruptcy Code already provides that creditors or other parties in interest can seek the appointment of a trustee. And the trustee has the powers to otherwise relieve the debtors of directors and officers if, in fact, that is warranted by the circumstances.

Mr. FARENTHOLD. I see, Professor Jackson, you have got your hand up. You want to weigh in here?

Mr. JACKSON. One other concurring comment with respect to that. The system assumes that there may be utility to continuing the management. The management may or may not have been responsible. In the case of the 2008, it was sort of a systemic-wide use of the mortgages that everybody did. But the Bankruptcy Code, whether through the trust or through the ownership—remember, the ownership of the—the beneficial owners of this new entity, this bridge company, are the people left behind, the old long-term debt and equity interests that are left behind, and the debtor, and like any corporation that is functioning, they ultimately have the control and ability to replace both the board and management, and I think that is as it should be. They may decide to, and they may decide not to, but they are the right people to be making that decision.

Mr. FARENTHOLD. All right. I see my time is up.

We will now recognize the Ranking Member of the Subcommittee, the gentleman from Georgia.

Mr. JOHNSON. Thank you.

Well, let's suppose that a Federal Government backstop as a creditor of last resort is a mechanism in place should this legislation be signed into law, passed and signed into law. And let's assume that the Federal Government then uses taxpayer money to assist or bridge the chasm between when the bankruptcy is filed to a more stable period, thus avoiding a catastrophic meltdown. Let's say that that is in place.

Does this legislation insulate the bad actors, namely those who control a large unaccountable business, that brought the business to that point? Does this legislation insulate that kind of malfeasance, which could border upon willful behavior that could even implicate some criminal law violations? But does this legislation insulate those types of bad actors and shield them from accountability?

Mr. BERNSTEIN. Representative Johnson, I don't think it shields anyone from liability. And, in fact, remember that if this bank is going to be continuing in business, it still is a regulated entity. So whatever actions need to be taken with respect to any sort of malfeasance of the kind that you are talking about are still available.

Mr. HESSLER. Just to add to that, to echo Mr. Bernstein, the legislation in no way places any limitations on the ability to otherwise address those issues.

The other thing I would just note, the Federal Government, both the legislators as well as regulators, are entirely understandably and entirely justifiably focused on remedial actions for fraud, mismanagement, and things like that that would occur.

The one thing I would just, you know, highlight or reiterate is nobody is more motivated to address those issues than creditors, because they are the ones who are even more directly impacted. So there is already an enormous amount of incentivization and investigatory powers that creditors have to make sure that, to the extent those circumstances exist, that they are remedied. And creditors do not hesitate to go and seek the appointment of a trustee and the removal of management and directors and officers if, in fact, there is any credible evidence of the type of malfeasance or even criminal actions that you just mentioned.

Mr. LUBBEN. If I could add, Representative Johnson, I did want to say——

Mr. FARENTHOLD. Get a little closer to the microphone.

Mr. LUBBEN. Okay. I did want to say that I do think that if the circumstances arise that you indicate, where the Federal Government is providing funding to a failed financial institution, the Federal Government should have the rights of any other—that any other DIP lender would have in that circumstance. And therefore, I do have some concerns with the special trustee provisions in this bill, that they complicate the ability for the Federal Government, for example, to demand an equity stake in the bridge entity. If taxpayer money is at risk in the reorganization of a financial institution, the taxpayers, to my mind, should have some stake in the upside of that financial institution, too.

Mr. JOHNSON. Professor Jackson?

Mr. JACKSON. I basically concur with the statements that have already been made. The only place there would be any insulation at all, as Don Bernstein suggested, you might insulate the trustee, the directors of the company for the filing of the bankruptcy case itself, which I think is a wise thing. But other than that, they are subject to regulatory authority, they are subject to rule of law, they are subject to criminal prosecution. And I think importantly to note, they are subject to the debtor, which is going to have the long-term debt holders, and they would have an incentive not only to remove the management that they think may have done something, but actually seek funds from them, because that may be some of the funding that they could get in terms of their own reorganization of the debtor or whatever, liquidation of the debtor. So I think there is lots of incentives here not to let bad actors get away with it.

Mr. JOHNSON. To date are any of you aware of anyone who has been prosecuted for their role in causing the great recession? It looks like there is no—none of our witnesses can speak on that, so I assume that that means nobody knows of anyone who has been prosecuted. I will refrain from asking whether or not you think that there is anyone who should be prosecuted, but I will ask this question: Will this legislation work without a Federal Government——

Mr. BACHUS [presiding]. Would they be under immunity if they did offer that somebody ought to be prosecuted?

Mr. JOHNSON. They probably have some legislative immunity since they are testifying, but we won't put them in that spot.

But would this legislation work without a Federal Government backstop as a creditor of last resort?

Mr. LUBBEN. The legislation will work. It would obviously work, I think, much better with the Federal Government providing liquidity, because in the context of a financial crisis, you probably cannot depend on the free market, the private market providing the degree of liquidity a large financial institution is going to require.

Mr. JOHNSON. Mr. Hessler, would you disagree with that?

Mr. HESSLER. I would not disagree with that.

Mr. JOHNSON. Professor Jackson?

Mr. JACKSON. No. And I actually have a pragmatic concern that since the orderly liquidation fund is available under Title II of Dodd-Frank, if something comparable to that is not available to the bridge company in a bankruptcy proceeding, there may still be powerful reasons to use Title II of Dodd-Frank to access the orderly liquidation fund, where I would rather have the bankruptcy proceeding take precedence.

Mr. JOHNSON. Thank you.

Mr. BERNSTEIN. I agree with everything the others have said.

Mr. JOHNSON. All right. Thank you. With that, I will yield back.

Mr. BACHUS. Thank you.

Let me start off saying lender of last resort, or whether that is the government or someone else, we think that is maybe something for the Financial Services Committee to address, and we have tried to structure this text to avoid going there. But it is something that is worthy of consideration. I do understand that.

And I will start with Mr. Bernstein. The Financial Institution Bankruptcy Act deploys a very quick process where assets are transferred in a time frame that can be as short as 24 hours. Do you believe this expediency is necessary, or can a financial institution endure a longer bankruptcy process?

Mr. BERNSTEIN. Mr. Chairman, I do believe it is necessary. I will make a reference to the movie "It's a Wonderful Life" with Jimmy Stewart. You remember what happened at the building and loan when there was a run on the bank, and he was able to get everybody in the room and say, you are a depositor, but don't take your money out because your money is in your neighbor's house.

Well, that is what banks do. They are in the business of maturity transformation, and they can't liquify their assets in the face of a run. And if you end up having a prolonged bankruptcy proceeding, and they aren't fixed very quickly, which this bill permits you to do because of the recapitalization it allows, you end up having a run that becomes unmanageable; whereas if you fix it, and you are able to go back into the market and get credit, the bank will stabilize. And that is really the objective here, and you can only do that if it is fast.

Mr. BACHUS. Thank you.

And, Professor Jackson, I might ask you the same question. Do you have any input on that response?

Mr. JACKSON. No. I agree with the response. The comment I would make is that you need the rapidity for two reasons. One, you need to restore market credibility, otherwise I think it will spread to other institutions.

The second reason is you are staying a lot of players in order to have this happen. You are staying all the qualified financial contracts. You are staying a lot of things because you want to keep everything in place for the transfer. And it seems to me that that itself is a powerful reason to call for rapid, essentially 48-hour, resolution of this. It would be nice if it could be longer, but I just don't think it is practical.

Mr. BACHUS. Yeah. I think the text we are using is 48 hours, or 2 days. If the Financial Institution Bankruptcy Act were enacted today, or in law today, and you had a Lehman-style insolvency a year from now, say, would the bill improve the resolution process for that firm, and would the result be better than the result we had in the Lehman bankruptcy?

Mr. BERNSTEIN. Mr. Chairman, I think the bill, plus some of the other things that have been going on, would make it a lot better. First of all, financial firms are a lot better capitalized today than they were when Lehman Brothers failed. In addition, the Federal Reserve is going to impose a long-term debt requirement, which is going to create loss-absorbing debt at the holding company level. And once you have got those two things, you then have a situation where this legislation could really make a difference and permit a company to actually be resolved very efficiently.

Mr. BACHUS. Professor Jackson?

Mr. JACKSON. One other thing to add to that. And I actually think Lehman Brothers was—Harvey Miller's work for them was magical under the circumstances. Remember, they had done no prebankruptcy planning whatsoever. The board had not even considered it. One of the great features of Title I of Dodd-Frank is the resolution plan living wills that are focused on bankruptcy so that you are not going to have a situation again in which a company like Lehman Brothers needs to enter bankruptcy, not having a clue what it is going to do once it is in bankruptcy. So I think the living wills are also an important part of the background here.

Mr. BACHUS. Right. And at this time I am going to interrupt my questioning and let the former Chairman of the full Committee Mr. Conyers start his questions.

Mr. CONYERS. Thank you for your generosity, Chairman Bachus.

I merely wanted to raise this aspect in the granting of Subchapter V relief in terms of the very short windows of time for these decisions to be made. On page 6 it is 12 hours; on page 7 it is 14 hours; page 8 it is 14 hours. And I am just wondering can we be assured that the judicial role is meaningful when you have to be looking at your watch at the same time that you are making humongous kinds of decisionmaking? Could you talk with me about that for a little while, gentlemen?

Mr. JACKSON. I will take a stab at it. It is a difficult question. Obviously, all of us would like a judicial process to have more time, but it is offset by some need for speed.

A couple of just sort of background comments. Yes, I don't think there is time for a whole lot of consideration, but it does bring in the important regulators, the Federal Reserve Board and the FDIC, whose perspective—if their perspective is contrary to that of the debtor, for example, who files, I think that will be a very interesting hearing before the bankruptcy judge. The bankruptcy judge does not have to approve the transfer.

But the second point I would make is once you have filed, it is almost a self-fulfilling prophecy that you need to resolve this firm. This firm is not going to easily get out of bankruptcy on its own because of the market signal it sent by being in bankruptcy. So once the case is commenced, I am not sure there is a whole lot of people who are harmed by the speed in which this happens as long as you have well-established, preidentified parties who get left behind. Everybody else goes with the company and presumably will not be harmed. And the equity and the whatever the debt, the long-term debt, whatever, the capital structure debt, are people who know ahead of time that they are going to be left behind, they know their priority, and it seems to me under those circumstances their ex-post remedies are probably the best we can do under these circumstances.

Mr. CONYERS. Any other comments on this?

Mr. HESSLER. I would tend to agree with that. And I addressed in both my written testimony, as well as I spoke of today, that it is highly unusual. And as a debtor practitioner, I can imagine how chaotic that would be to be dealing with those time periods.

I would note as a practical matter that I think there is a high likelihood that if a debtor is on the brink of being told that an involuntary is going to be commenced against it, that there is a high likelihood—it would probably go ahead and commence its own voluntary proceeding so as to continue to maintain control of its case. And if a debtor itself opted to commence that voluntary proceeding, these very compressed time periods for the appeal, they are irrelevant at that point in time because no one is going to be challenging the debtor's determination that, given its insolvency, a bankruptcy proceeding is appropriate under the law.

Mr. CONYERS. Yes, sir.

Mr. BERNSTEIN. I agree with what has been said. I also want to make one other point. We have to look at what the outcome of the proceeding is. Unlike other cases where you are doing a section 363 transfer very quickly, this asset is not being transferred away to a third party, so there is no question of whether there is an adequate price or not. It makes the decision much easier for the court because the asset is being preserved for the benefit of the estate.

So not only with respect to the time periods for an involuntary filing, and I agree with everything that has been said about how likely it is, once there is an involuntary filing, people are not going to be prejudiced because you really need to be in the proceeding. But more importantly, the consequence of that is going to be the asset is going to be protected through the process of moving it to a place where it is safe and can continue to maintain its value rather than being transferred away.

Mr. CONYERS. My second question was dealing with the requirement that the pleadings be filed under seal. And I take it that this would also prevent runs and panic and so forth from happening.

So I am going to go to my last question, which is by allowing a failed bank holding company to spin off its subsidiaries so they can continue to function, does this present a possible issue of moral hazard? Because they are going on unimpeded, and they are really in big trouble, but maybe nobody knows it.

Mr. BERNSTEIN. May I answer that, Representative Conyers? It is Don Bernstein.

There are two things that are going on here. One is, yes, the company is continuing in business, but there is a group of creditors and shareholders who are going to be left behind and are going to be suffering the losses. And the question of moral hazard is going to surround making sure that they understand that prior to any failures so that they do proper monitoring and risk management, and they know that they are going to suffer the losses if this happens. So I think there is, you know, actually some positive impact of this in terms of the ability of the market to regulate these companies.

Mr. CONYERS. Professor?

Mr. LUBBEN. I might be somewhat more skeptical about the moral-hazard issue. I think the moral-hazard issue might still well prevail. But I think that goes back to my comment in my opening remarks, that the insolvency process has to be a small piece of a much larger regulatory approach. And probably moral hazard is not best addressed through the insolvency process; it is best addressed through the financial institution regulators more directly.

Mr. CONYERS. Mr. Chairman, that concludes my questions, and I thank you for your generosity.

And I thank the witnesses. This has been a very, very special panel, as far as I am concerned.

Mr. BACHUS. Thank you, Mr. Conyers. As you know, I have the greatest respect for you over the last 22 years, and you served as my Chairman when I first arrived here on the Hill. So thank you.

Mr. CONYERS. Thank you.

Mr. BACHUS. I am going to ask some questions.

We were talking about Lehman Brothers, and, of course, Lehman Brothers, because of Bear Stearns, I think most people expected Lehman to receive a government assistance. And I think there was a reliance by Lehman, to a certain extent, that that was coming, and it never came.

But it did serve a benefit, in that I think it highlighted some needed changes in the Bankruptcy Code if you were going to choose that as opposed to a government-assisted resolution. So I think we may have benefited from that. Certainly, the Lehman shareholders did.

I am going to ask Professor Jackson, can Subchapter V be used to resolve financial institutions that have international operations and subsidiaries? And I think Mr. Conyers sort of mentioned that.

Mr. JACKSON. Yes, it can, but, obviously, a limitation of any U.S. Law, whether it be bankruptcy law or whether it be Title 2 of Dodd-Frank, is that it cannot directly impact foreign operations that are incorporated in other countries. It can set out a template, and it can give confidence to the foreign regulators that the rule of law will be followed, but I think that what you need in addition—and I think it is taking place—is international conversations and coordinations around this issue.

I think it is hugely helpful that the European Union and the FDIC have agreed that single-point-of-entry-like proceedings are the appropriate way to go. I have a lot of confidence that they will work on these issues of cross-country collaborations, which I don't think we can solve on our own.

I would just make the point that whatever the problems exist for bankruptcy law, they are going to exist for Title 2 of Dodd-Frank, as well. The one difference is maybe foreign regulators would prefer seeing a regulator do this than a bankruptcy judge do this, but I think a lot of that depends on the FDIC's confidence in the bankruptcy process. And if they give their imprimatur to the process, then I think there will be very little distinction between whether it is Title 2 of Dodd-Frank or section 5 of Chapter 11 under this proposed bill.

Mr. BACHUS. Right.

And I guess the fact that it is only the top holding company that files the bankruptcy, it does maybe lessen some of those complications.

Mr. JACKSON. Somewhat.

Mr. BACHUS. But not——

Mr. JACKSON. The problem is—and the bill effectively addresses this, but of course it cannot address it effectively extraterritorially—is a lot of the contracts that you want to keep in place at the operating subsidiary levels, like the qualified financial contracts and others, may have cross-default provisions, may have change-of-control provisions that you don't want them to be able to enforce, and so we are still going to need help from the foreign regulators in keeping those things in place.

Mr. BACHUS. All right.

Mr. Bernstein, do you——

Mr. BERNSTEIN. No, I don't have really anything to add. There is also work under way to develop contractual solutions so that if you do go through an appropriate proceeding and, for example, a bridge company were created that assumed the guarantee and what have you, that the contracts would remain in place even in foreign countries.

Mr. BACHUS. All right.

And any suggestions you all have on whether there ought to be any statutory language in this bill or in a financial services bill or companion bill, perhaps?

Professor Jackson, do you believe that enactment of Subchapter V into law would reduce the necessity for regulators to initiate a Title 2 resolution proceeding?

Mr. JACKSON. Quite clearly, yes.

Mr. BACHUS. And, Mr. Hessler, do you agree?

Mr. HESSLER. I do agree, as well.

Mr. BACHUS. Okay.

I have been told that Mr. Farenthold asked you questions concerning the Federal Reserve and some other questions, so I am not going to repeat those.

My final question, for Professor Lubben: In your written testimony, you indicated that it may be better to keep the equity of the newly formed bridge company in the possession of the debtor. Are there any risks associated with this proposed approach, particularly with the perception of the bridge company existing in, rather than out of, the bankruptcy process?

Mr. LUBBEN. This goes to the question of separating the management of the bridge company from the ownership of the equity of the bridge company.

I think there would be ways to make it clear that management is distinct from share ownership and that it would still allow the debtor, the old debtor, to access the value of those shares if they needed to fund their bankruptcy case. And I think, as I suggested in my written testimony, these may be a little bit more clear-cut.

So the risk is just not making that distinction clear, but I think it could be made clear. So I think it is a solvable problem.

Mr. BACHUS. Well, I think there was some mention earlier by Mr. Bernstein or Professor Jackson, I think, that if you allowed, you know—that particularly the filing of a bankruptcy would not lead to any liability on the part of the board of directors.

Mr. BERNSTEIN. Yeah, we both mentioned that. We think that is an important feature so that you encourage voluntary, as opposed to the involuntary, proceedings.

And if I might just comment on the question that Professor Lubben just discussed, one of the difficulties, which was mentioned by Professor Jackson, is the lack of understanding by foreign regulators of the bankruptcy process and moving the bridge company back into private ownership, albeit a trustee, but not ownership by the bankrupt holding company, and having it back in an environment where it is dealing directly with its primary regulators and the primary regulators are in control, and those are the people who are talking to the foreign regulators, may go a long way to stabilizing the new company's relationship with the regulators so they don't take precipitous action.

Mr. BACHUS. All right.

Mr. HESSLER. If I could just add one quick thought on that, what happens at present under just a conventional Section 363 sale, even one that happens quickly where most of the debtor's assets are sold, you know, to somebody entirely outside of bankruptcy, in those circumstances what typically happens is nearly all of the management and certainly all of the management that is tied to the operations of the assets that are being transferred go with the assets. And I expect that that would happen here once the transfer happens under the single-point-of-entry approach.

To Professor Lubben's point, also, about potential disjunction between, you know, sort of, creditor access to the assets, you know, where the management otherwise lines up, my instinct is that creditors would be very supportive of management going over into the bridge company along with the assets, given that it is their economic interest in the equity being held in the trust that is ultimately going to come to them through the plan distribution. So, you know, my instinct is that creditors actually would be heartened that this approach contemplates that.

Mr. BACHUS. All right. Thank you.

I might ask this. You know, the Senate bill has been mentioned. They actually have Chapter 14 as opposed to a Subchapter 11, but is there any—is that a matter of substance, or is that just——

Mr. JACKSON. Not really a matter of substance. I actually think Subchapter V of Chapter—my Hoover counterparts may not like me to say this, but I think Subchapter V of Chapter 11 is the cleaner way to go.

Mr. BACHUS. Uh-huh. Thank you.

Mr. LUBBEN. And I would actually concur on that. And I think there actually may be a subtle substantive reason to do it this way—namely, it makes clear that the other parts of Chapter 11 still apply to——

Mr. BACHUS. Yeah. And I think that was our reasoning, that it is a part of—it is not a separate——

Mr. BERNSTEIN. I agree with that.

Mr. BACHUS. Thank you.

Mr. HESSLER. As do I.

Mr. BACHUS. I was afraid to ask that, but I am glad I did. But, you know, it obviously is something you want to know. And I don't think they have any objection to that either.

This concludes today's hearing, and thanks to all our witnesses for attending. It is always good for you to hear compliments about your abilities. Witnesses don't always get that from the panel, but there was unanimous recognition of all of your qualifications, experience, and abilities. And we appreciate you giving your valuable time to us. I am glad you are not billing at your normal hourly rate, for the attorneys.

But, without objection, all Members will have 5 legislative days to submit additional written questions for witnesses or additional materials for the record.

This hearing is adjourned. And I thank you for your patience.

[Whereupon, at 6:06 p.m., the Subcommittee was adjourned.]

APPENDIX

MATERIAL SUBMITTED FOR THE HEARING RECORD

[DISCUSSION DRAFT]

113TH CONGRESS
2D SESSION

H. R. ____

To amend title 11 of the United States Code in order to facilitate the resolution of an insolvent financial institution in bankruptcy.

IN THE HOUSE OF REPRESENTATIVES

M__. ____________ introduced the following bill; which was referred to the Committee on ____________________________

A BILL

To amend title 11 of the United States Code in order to facilitate the resolution of an insolvent financial institution in bankruptcy.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE.

This Act may be cited as the "Financial Institution Bankruptcy Act of 2014".

SEC. 2. GENERAL PROVISIONS RELATING TO COVERED FINANCIAL CORPORATIONS.

(a) DEFINITION.—Section 101 of title 11, United States Code, is amended by inserting the following after paragraph (9):

"(9A) The term 'covered financial corporation' means any corporation incorporated or organized under any Federal or State law, other than a stockbroker, a commodity broker, or an entity of the kind specified in paragraph (2) or (3) of section 109(b), that is—

"(A) a bank holding company, as defined in section 2(a) of the Bank Holding Company Act of 1956; or

"(B) predominantly engaged in activities that the Board of Governors of the Federal Reserve System has determined are financial in nature or incidental to such financial activity for purposes of section 4(k) of the Bank Holding Company Act of 1956.".

(b) APPLICABILITY OF CHAPTERS.—Section 103 of title 11, United States Code, is amended by adding at the end the following:

"(l) Subchapter V of chapter 11 of this title applies only in a case under chapter 11 concerning a covered financial corporation.".

(c) WHO MAY BE A DEBTOR.—Section 109 of title 11, United States Code, is amended—

(1) in subsection (b)—

(A) in paragraph (2), by striking "or" at the end;

(B) in paragraph (3)(B), by striking the period at the end and inserting "; or"; and

(C) by adding at the end the following:

"(4) a covered financial corporation."; and

(2) in subsection (d)—

(A) by striking "and" before "an uninsured State member bank";

(B) by striking "or" before "a corporation"; and

(C) by inserting ", or a covered financial corporation" after "Federal Deposit Insurance Corporation Improvement Act of 1991".

(d) INVOLUNTARY CASES.—Section 303 of title 11, the United States Code, is amended by adding at the end the following:

"(k) Notwithstanding any other provision of this section, an involuntary case may be commenced under subchapter V of chapter 11 only in accordance with section 1183.".

SEC. 3. LIQUIDATION, REORGANIZATION, OR RECAPITALIZATION OF A COVERED FINANCIAL CORPORATION.

Chapter 11 of title 11, United States Code, is amended by adding at the end the following:

"SUBCHAPTER V—LIQUIDATION, REORGANIZATION, OR RECAPITALIZATION OF A COVERED FINANCIAL CORPORATION

"§ 1181. Inapplicability of other sections

"Sections 321(c) and 322(b) do not apply in a case under this subchapter concerning a covered financial corporation.

"§ 1182. Definitions for this subchapter

"In this subchapter, the following definitions shall apply:

"(1) The term 'Board' means the Board of Governors of the Federal Reserve System.

"(2) The term 'bridge company' means a newly-formed corporation the equity securities of which are transferred trust under section 1185(a).

"(3) The term 'capital structure debt' means all unsecured debt of the debtor, other than a qualified contract, for which the debtor is the primary obligor.

"(4) The term 'contractual right' means a contractual right of a kind defined in section 555, 556, 559, or 560.

"(5) The term 'qualified financial contract' means any contract of a kind defined in paragraph (25), (38A), (47), or (53B) of section 101, section 741(7), or paragraph (4), (5), (11), or (13) of section 761.

"§ 1183. Commencement of a case concerning a covered financial corporation

"(a) A case under this chapter concerning a covered financial corporation may be commenced by the filing of a petition with the bankruptcy court—

"(1) under section 301; or

"(2) section 303 by the Board only if the Board certifies in the petition that it has determined that—

"(A) the covered financial corporation—

"(i) has incurred losses that will deplete all or substantially all of the capital of the covered financial corporation, and there is no reasonable prospect for the covered financial corporation to avoid such depletion;

"(ii) is insolvent;

"(iii) is not paying, or is unable to pay, the debts of the covered financial corporation (other than debts subject to a bona fide dispute as to liability or amount) as they become due; or

"(iv) is likely to be in a financial condition specified in clause (i), (ii), or (iii) sufficiently soon such that the immediate commencement of a case under this subchapter is necessary to prevent imminent substantial harm to financial stability in the United States;

"(B) the commencement of a case under this title and the effect of a transfer under section 1185 is necessary to prevent imminent substantial harm to financial stability in the United States; and

"(C) the bankruptcy court determines, after a hearing described in subsection (b), that the Board has shown by a preponderance of the evidence that the requirements under subparagraphs (A) and (B) have been satisfied.

"(b)(1) A hearing described in this subsection is a hearing held not later than 12 hours after the Board files a petition under subsection (a)(2), with notice only to—

"(A) the covered financial corporation;

"(B) the Federal Deposit Insurance Corporation; and

"(C) the Secretary of the Treasury.

"(2) Only the Board and the entities specified in paragraph (1) and their counsel may attend or participate in a hearing described in this subsection. Transcripts of such hearing shall be sealed until the earlier of—

"(A) 3 months after the commencement of a bankruptcy case; and

"(B) 18 months after the conclusion of the hearing.

"(3) All pleadings, transcripts, and orders shall be filed under seal during the 24-hour period beginning when the case is commenced and may be available to only the bankruptcy court, appellate panel, the covered financial corporation, the Federal Deposit Insurance Corporation, the Secretary of the Treasury, and the Board. Notwithstanding paragraph (2), if the case is dismissed, all court documents, including pleadings, transcripts, and orders, shall be expunged. If the case is not dismissed, the court documents shall be made available to the entities specified in section 1186(b) immediately and shall be sealed with respect to all other entities until the expiration of the 90-day period beginning on the date the case is commenced.

"(4) The bankruptcy court shall enter, not later than 14 hours after the filing of the Board's petition under section 303, an order either dismissing the case or ordering relief against the covered financial corporation.

"(c)(1) The covered financial corporation or the Board may file an appeal in the court of appeals for review by the appellate panel of a determination made by the bankruptcy court under subsection (a)(2)(C) not later than 1 hour after the bankruptcy court makes such determination, with notice only to the entities specified in subsection (b)(1) and the Board.

"(2) The appellate panel specified under section 298(c)(1) of title 28 for the judicial circuit in which the case is pending shall hear the appeal under paragraph (1) and review within 12 hours of the determination of the bankruptcy court under subsection (a)(2)(B) such determination for abuse of discretion. The appellate panel shall enter an order determining the matter that is the subject of the appeal not later than 14 hours after the appeal is filed.

"(3) Notwithstanding sections 158 and 1292 of title 28, the determination of a decision by a appellate panel under this section is final and may not be appealed further.

"(d)(1) The commencement of a case under subsection (a)(1) constitutes an order for relief under this subchapter.

"(2) In a case commenced under subsection (a)(2), the bankruptcy court shall promptly order relief under this subchapter if—

"(A) the bankruptcy court makes a determination under subsection (a)(2)(C) that the requirements of subsections (a)(2)(A) and (a)(2)(B) have been satisfied; and

"(B)(i) the period for appeal under subsection (c)(1) has expired without an appeal having been filed; or

"(ii) the appellate panel affirms the determination of the bankruptcy court under subsection (c)(2).

"(3) Notwithstanding paragraph (2), the bankruptcy court shall order relief immediately in a case commenced under subsection (a)(2) if the debtor consents to the Board's petition under subsection (a)(2).

"§ 1184. Regulators

"The Board and the Federal Deposit Insurance Corporation may raise and may appear and be heard on any issue in any case or proceeding under this subchapter.

"§ 1185. Special transfer of property of the estate

"(a) On request of the trustee or the Board, and after notice and a hearing that shall occur not less than 24 hours after the commencement of the case, the court may order a transfer under this section of property of the estate to a bridge company. Except as provided under this section, the provisions of section 363 shall apply to a transfer under this section.

"(b) Unless the court orders otherwise, notice of a request for an order under subsection (a) shall consist of electronic or telephonic notice of not less than 24 hours to—

"(1) the debtor;

"(2) the trustee;

"(3) the holders of the 20 largest secured claims against the debtor;

"(4) the holders of the 20 largest unsecured claims against the debtor;

"(5) counterparties to any qualified financial contract requested to be transferred under this section;

"(6) the Board;

"(7) the Federal Deposit Insurance Corporation;

"(8) the Secretary of the Treasury;

"(9) the United States trustee or bankruptcy administrator; and

"(10) each primary financial regulatory agency, as defined in section 2(12) of the Dodd-Frank Wall Street Reform and Consumer Protection Act, with respect to any affiliate that is proposed to be transferred under this section.

"(c) The court may not order a transfer under this section unless the court determines, based upon a preponderance of the evidence, that—

"(1) the transfer under this section is necessary to prevent imminent substantial harm to financial stability in the United States;

"(2) the proposed transfer does not provide for the assumption of any capital structure debt by the bridge company; and

"(3) the Board certifies to the court that the Board has determined that the bridge company provides adequate assurance of future performance of any executory contract or unexpired lease assumed and assigned to the bridge company, and of payment of any debt assumed by the bridge company, in the transfer under this section.

"(d) The bridge company that is the recipient of a transfer under this section shall—

"(1) not have any property, executory contracts, unexpired leases, or debts, other than any property acquired or executory contracts, unexpired leases, or debts assumed when acting as a transferee of a transfer under section 1185;

"(2) have equity securities that solely are property of the estate, which may be sold or distributed solely in accordance with section 1185; and

"(3) obtain court approval of the governing documents of the bridge company, including the initial the directors and senior officers of the corporation.

"§ 1186. Special trustee

"(a) On request of the trustee or the Board, the court may order the trustee to transfer to a trust all of the equity securities in the bridge corporation that is the recipient of a transfer under section 1185 to hold in trust for the sole benefit of the estate if—

"(1) the trust is a newly-formed entity that shall be formed at the direction of the trustee and shall exist for the sole purpose of holding and administering the securities of the bridge company in accordance with the trust agreement; and

"(2) the court approves—

"(A) the trust agreement governing the trust; and

"(B) the appointment of a trustee to administer such trust (in this subchapter referred to as the 'special trustee') .

"(b) The trust agreement governing the trust shall provide—

"(1) for the payment of the costs and expenses of the special trustee from the assets of the debtor's estate;

"(2) that the special trustee provide—

"(A) periodic reporting to the estate and the bankruptcy court; and

"(B) information about the bridge company as reasonably requested by a party in interest to prepare a disclosure statement for a plan providing for distribution of any securities of the bridge company if such information is necessary to prepare such disclosure statement;

"(3) that the special trustee provide notice to the bankruptcy court in connection with—

"(A) any change in a director or senior officer of the bridge company;

"(B) any modification to the governing documents of the bridge company; and

"(C) any material corporate action of the bridge company, including—

"(i) recapitalization;

"(ii) a liquidity borrowing;

"(iii) termination of an intercompany debt or guarantee;

"(iv) a transfer of a substantial portion of the assets of the bridge company; or

"(v) the issuance or sale of any securities of the bridge company;

"(4) that the proceeds of the sale of any equity securities of the bridge company by the special trustee be held in trust for the benefit of or transferred to the estate; and

"(5) that the property held in trust by the special trustee is subject to distribution in accordance with the plan and subsection (c).

"(c) The special trustee shall distribute the assets held in trust in accordance with the plan on the effective date of the plan and, as soon thereafter as practicable, thereafter the office of the special trustee shall terminate, except as may be necessary to wind up and conclude the business and financial affairs of the trust.

"(d) After a transfer under section 1186, the special trustee shall be subject only to applicable nonbankruptcy law, and the actions and conduct of the special trustee shall no longer be subject to approval by the court in the case under this subchapter.

"§ 1187. Temporary and supplemental automatic stay; assumed debt

"(a)(1) A petition filed under section 1183 operates as a stay, applicable to all entities, of the termination, acceleration, or modification of any debt, lease, or agreement of the kind described in paragraph (2), or of any right or obligation under any such debt, contract, lease, or agreement, solely because of—

"(A) a default by the debtor under any such debt, contract, lease, or agreement;

"(B) a provision in such debt, contract, lease, or agreement, or in applicable nonbankruptcy law, that is conditioned on—

"(i) the insolvency or financial condition of the debtor at any time before the closing of the case;

"(ii) the commencement of a case under this title concerning the debtor;

"(iii) the appointment of or taking possession by a trustee in a case under this title concerning the debtor or by a custodian before the commencement of the case;

"(iv) a credit rating agency rating, or absence or withdrawal of a credit rating agency rating—

"(I) of the debtor at any time after the commencement of the case;

"(II) of an affiliate during the 48 hours after the commencement of the case; or

"(III) while the special trustee is a direct or indirect beneficial holder of more than 50 percent of the equity securities of—

"(aa) the bridge company; or

"(bb) an affiliate, if all of the direct or indirect interests in the affiliate that are property of the estate are transferred under section 1185.

"(2) A debt, contract, lease, or agreement described in this paragraph is—

"(A) any debt (other than capital structure debt), executory contract (other than a qualified financial contract), or unexpired lease of the debtor;

"(B) any agreement under which the debtor issued or is obligated for debt (other than capital structure debt);

"(C) any debt, executory contract (other than a qualified financial contract), or unexpired lease of an affiliate; or

"(D) any agreement under which an affiliate issued or is obligated for debt.

"(3) The stay under this subsection terminates—

"(A) for the benefit of the debtor, upon the earliest of—

"(i) 48 hours after the commencement of the case;

"(ii) assumption of the debt, contract, lease, or agreement under an order authorizing a transfer under section 1185; or

"(iii) a final order of the court denying the request for a transfer under section 1185; and

"(B) for the benefit of an affiliate, upon the earliest of—

"(i) entry of an order authorizing a transfer under section 1185 in which the direct or indirect interests in the affiliate that are property of the estate are not transferred under section 1185;

"(ii) a determination by the court denying the request for a transfer under section 1185; or

"(iii) 48 hours after the commencement of the case if the court has not ordered a transfer under section 1185.

"(4) Subsections (d), (e), (f), and (g) of section 362 apply to a stay under this subsection.

"(b) A debt, executory contract (other than a qualified financial contract), or unexpired lease of the debtor, or an agreement under which the debtor has issued or is obligated for any debt, may be assumed by a bridge company in a transfer under section 1185 notwithstanding any provision in an agreement or in applicable nonbankruptcy law that—

"(1) prohibits, restricts, or conditions the assignment of the debt, contract, lease, or agreement; or

"(2) terminates or modifies, or permits a party other than the debtor to terminate or modify, the debt, contract, lease, or agreement on account of—

"(A) the assignment of the debt, contract, lease, or agreement; or

"(B) a change in control of any party to the debt, contract, lease, or agreement.

"(c)(1) A debt, contract, lease, or agreement of the kind described in subparagraph (A) or (B) of subsection (a)(2) may not be terminated or modified, and any right or obligation under such debt, contract, lease, or agreement may not be terminated or modified, as to the bridge company solely because of a provision in the debt, contract, lease, or agreement or in applicable nonbankruptcy law—

"(A) of the kind described in subsection (a)(1)(B) as applied to the debtor;

"(B) that prohibits, restricts, or conditions the assignment of the debt, contract, lease, or agreement; or

"(C) that terminates or modifies, or permits a party other than the debtor to terminate or modify, the debt, contract, lease or agreement on account of—

"(i) the assignment of the debt, contract, lease, or agreement; or

"(ii) a change in control of any party to the debt, contract, lease, or agreement.

"(2) If there is a default by the debtor under a provision other than the kind described in paragraph (1) in a debt, contract, lease or agreement of the kind described in subparagraph (A) or (B) of subsection (a)(2), the bridge company may assume such debt, contract, lease, or agreement only if the bridge company—

"(A) cures, or provides adequate assurance to the court in connection with a transfer under section 1185 that the bridge company will promptly cure, the default;

"(B) compensates, or provides adequate assurance to the court in connection with a transfer under section 1185 that the bridge company will promptly compensate, a party other than the debtor to the debt, contract, lease, or agreement, for any actual pecuniary loss to the party resulting from the default; and

"(C) provides adequate assurance to the court in connection with a transfer under section 1185 of future performance under the debt, contract, lease, or agreement.

"§ 1188. Treatment of qualified financial contracts and affiliate contracts

"(a) Notwithstanding sections 362(b)(6), 362(b)(7), 362(b)(17), 362(b)(27), 362(o), 555, 556, 559, 560, and 561, a petition filed under section 1183 operates as a stay, during the period specified in section 1187(a)(3), applicable to all entities, of the exercise of a contractual right—

"(1) to cause the liquidation, termination, or acceleration of a qualified financial contract of the debtor or an affiliate;

"(2) to offset or net out any termination value, payment amount, or other transfer obligation arising under or in connection with a qualified financial contract of the debtor or an affiliate;

"(3) under any security agreement or arrangement or other credit enhancement forming a part of or related to a qualified financial contract of the debtor or an affiliate.

"(b)(1) During the period specified in section 1187(a)(3), the trustee or the affiliate shall perform all payment and delivery obligations under a qualified financial contract of the debtor or the affiliate, as the case may be, that become due after the commencement of the case. The stay provided under subsection (a) terminates as to a qualified financial contract of the debtor or an affiliate immediately upon the failure of the trustee or the affiliate, as the case may be, to perform any such obligation during such period.

"(2) A counterparty to any qualified financial contract of the debtor that is assumed and assigned in a transfer under section 1185 may perform any unperformed payment or delivery obligation under the qualified financial contract promptly after the assumption and assignment with the same effect as if the counterparty had timely performed such obligations.

"(c) A qualified financial contract between an entity and the debtor may not be assigned to or assumed by the bridge company in a transfer under section 1185 unless—

"(1) all qualified financial contracts between the entity and the debtor are assigned to and assumed by the bridge company in the transfer under section 1185;

"(2) all claims of the entity against the debtor under any qualified financial contract between the entity and the debtor (other than any claim that, under the terms of the qualified financial contract, is subordinated to the claims of general unsecured creditors) are assigned to and assumed by the bridge company;

"(3) all claims of the debtor against the entity under any qualified financial contract between the entity and the debtor are assigned to and assumed by the bridge company; and

"(4) all property securing or any other credit enhancement furnished by the debtor for any qualified financial contract described in paragraph (1) or any claim described in paragraph (2) or (3) under any qualified financial contract between the entity and the debtor is assigned to and assumed by the bridge company.

"(d) Section 365(b)(1) does not apply to a default under a qualified financial contract of the debtor that is assumed and assigned in a transfer under section 1185 if the default—

"(1) is a breach of a provision of the kind specified in section 1187(a)(1)(B)(iv); or

"(2) in the case of a breach of a provision of the kind specified in section 1187(a)(1)(B)(iv)(III), occurs while the bridge company is a direct or indirect beneficial holder of more than 50 percent of the equity securities of the affiliate.

"(e) Notwithstanding any provision of a qualified financial contract or of applicable nonbankruptcy law, a qualified financial contract of the debtor that is assumed or assigned in a transfer under section 1185 may not be terminated or modified, and any right or obligation under the qualified financial contract may not be terminated or modified, at any time solely because of a condition described in section 1187(a), after the entry of the order under section 1185 until such time as the special trustee is no longer the direct or indirect beneficial holder of more than 50 percent of the equity securities of the bridge company.

"(f) Notwithstanding any provision of any agreement or in applicable nonbankruptcy law, an agreement of an affiliate (including an executory contract, an unexpired lease, or an agreement under which the affiliate issued or is obligated for debt) and any right or obligation under such agreement may not be terminated or modified, solely because of a condition described in section 1187(b), at any time after the commencement of the case if—

"(1) all direct or indirect interests in the affiliate that are property of the estate are transferred under section 1185 to the bridge company within the period specified in subsection (a);

"(2) the bridge company assumes—

"(A) any guarantee or other credit enhancement issued by the debtor relating to the agreement of the affiliate; and

"(B) any right of setoff, netting arrangement, or debt of the debtor that directly arises out of or directly relates to the guarantee or credit enhancement; and

"(3) any property of the estate that directly serves as collateral for the guarantee or credit enhancement is transferred to the bridge company.

"§ 1189. Licenses, permits, and registrations

"(a) Notwithstanding any otherwise applicable nonbankruptcy law, if a request is made under section 1185 for a transfer of property of the estate, any Federal, State, or local license, permit, or registration that the debtor or an affiliate had immediately before the commencement of the case and that is proposed to be transferred under section 1185 may not be terminated or modified at any time after the request solely on account of—

"(1) the insolvency or financial condition of the debtor at any time before the closing of the case;

"(2) the commencement of a case under this title concerning the debtor; or

"(3) the appointment of or taking possession by a trustee in a case under this title concerning the debtor or by a custodian before the commencement of the case.

"(b) Notwithstanding any otherwise applicable nonbankruptcy law, any Federal, State, or local license, permit, or registration that the debtor had immediately before the commencement of the case that is included in a transfer under section 1185 shall be valid and all rights and obligations thereunder shall vest in the bridge company.

"§ 1190. Exemption from securities laws and special tax provisions

"For purposes of section 1145, a security of the bridge company shall be deemed to be a security of a successor to the debtor under a plan if the court approves the disclosure statement for the plan as providing adequate information (as defined in section 1125(a)) about the bridge company and the security.

"§ 1191. Inapplicability of certain avoiding powers

"Except with respect to a capital structure debt, a transfer made or an obligation incurred by the debtor, including any obligation released by the debtor or the estate, to or for the benefit of an affiliate in a transfer under section 1185 is not avoidable under section 544, 547, 548(a)(1)(B), or 549, or under any similar nonbankruptcy law.".

SEC. 4. AMENDMENTS TO TITLE 28, UNITED STATES CODE.

(a) AMENDMENT TO CHAPTER 13.—Chapter 13 of title 28, United States Code, is amended by adding at the end the following:

"§ 298. Judge for a case under subchapter V of title 11

"(a) Notwithstanding section 295, the Chief Justice of the United States shall designate not fewer than 3 judges of the court of appeals in each circuit to serve on an appellate panel to be available to hear an appeal under section 1403 in a case under title 11 concerning a covered financial corporation.

"(b)(1) Notwithstanding section 295, the Chief Justice of the United States shall designate a panel of not fewer than 10 bankruptcy judges, who have significant experience with cases under title 11 in which a financial institution or a company with assets or liabilities exceeding

$1,000,000,000 is a debtor, to be available to hear a case under subchapter V of title 11.

"(2) Notwithstanding section 295, a case under subchapter V of title 11 shall be heard under section 157 by a bankruptcy judge designated under paragraph (1), who shall be assigned to hear such case by the chief judge of the court of appeals for the circuit embracing the district in which the case is pending.

"(3) If the bankruptcy judge assigned to hear a case under paragraph (2) is not assigned to the district in which the case is pending, the bankruptcy judge shall be temporarily assigned to the district.

"(c)(1) Notwithstanding section 295, in an appeal under section 158(a) in a case under title 11 concerning a covered financial corporation shall be heard by—

"(A) 3 judges selected from the appellate panel designated under subsection (a); or

"(B) if the 3 judges of such panel are not immediately available to hear the case, 3 judges from another appellate panel designated under subsection (a) from another circuit and assigned by the Chief Justice of the United States to hear the case;

"(2) If the appellate panel specified in paragraph (1) is not assigned to the district in which the case is pending, the appellate panel shall be temporarily assigned to the district.

"(3) A case under subchapter V of title 11, and all proceedings in the case, shall take place in the district in which the case is pending.

"(d) In this section, the term 'covered financial corporation' has the meaning given that term in section 101(9A) of title 11.".

(b) AMENDMENT TO SECTION 1334.—Section 1334 of title 28, United States Code, is amended by adding at the end the following:

"(f) This section does not grant jurisdiction to the district court after a transfer pursuant to an order under section 1185 of title 11 of any proceeding related to a special trustee appointed, or to a bridge company formed, in connection with a case under subchapter V of title 11, and after a transfer pursuant to an order under section 1185 of title 11, the district courts in the district in which a case under title 11 concerning a covered financial corporation (as defined in section 101 of title 11) is pending shall not have jurisdiction over the property held in trust by the special trustee, the bridge company, or the property of the bridge company.".

(c) TECHNICAL AND CONFORMING AMENDMENT.—The table of sections for chapter 13 of title 28, United

States Code, is amended by adding at the end the following:

"298. Judge for a case under subchapter V of title 11.".

Questions for the Record from
Mr. Johnson and Mr. Conyers
for the Hearing on H.R. ____, the "Financial Institution Bankruptcy Act of 2014"
July 15, 2014

Questions for Mr. Bernstein

1. Should the bankruptcy court be authorized to convert a subchapter V case to a case under chapter 7 under certain circumstances?

2. The National Bankruptcy Conference questions whether the expedited time frames for the bankruptcy court's determination of whether or not to grant subchapter V relief in a contested involuntarily commenced case as well as the appellate review process sufficiently ensure that the judicial role is meaningful, especially given the import of the findings that the court has to make.

   What is your response?

3. The bill requires the subchapter V petition, Federal Reserve certification in support thereof, the hearing transcript, and all pleadings to filed under seal. While this requirement is clearly intended to limit the adverse impact that a failing financial institution may have on the Nation's financial marketplace, it would appear to violate the general principles of transparency and accountability with respect to judicial proceedings.

   What is your response?

4. If subchapter V was in existence when Lehman failed, would it have achieved a better result with respect to the case's impact on the Nation's financial marketplace?

5. How would subchapter V interface with the living wills requirement of the Dodd-Frank Wall Street Reform and Consumer Protection Act (DFA)?

6. Professor Lubben questions the utility of the bill's "special trustee" provisions and wonders if they are needed at all.

   What is your response?

7. Professor Lubben raises a practical concern about funding for the debtor's resolution in bankruptcy after it has transferred all of its assets to the bridge company.

   What is your response?

8. What happens if the bridge company itself fails? Should it be placed into DFA's title II for orderly liquidation?

Note: The Subcommittee did not receive a response to these questions at the time of the printing of this hearing record.

9. Professor Lubben suggests that in addition to the Federal Reserve and the FDIC, other regulators should be permitted to intervene in a subchapter V case. These other regulators include the SEC, CFTC, state banking and insurance regulators, and the Office of the Comptroller of the Currency.

What is your response?

Questions for the Record from
Mr. Johnson and Mr. Conyers
for the Hearing on H.R. ____, the "Financial Institution Bankruptcy Act of 2014"
July 15, 2014

<u>Questions for Professor Jackson</u>

1. Should the bankruptcy court be authorized to convert a subchapter V case to a case under chapter 7 under certain circumstances?

The discussion draft under consideration authorizes the court to convert the case to Chapter 7, using the procedures of existing Section 1112, subject to the limitation that the conversion is only permissible if the Section 1185 transfer has been consummated (and a special trustee appointed under Section 1186). (This limitation is in the interplay between Section 2(c)(1) and Section 2(d) of the discussion draft.) A conversion under these circumstances may make sense, as the debtor, after the Section 1185 transfer, has no assets (other than the rights to the equity of the bridge company), and the distribution procedures of Chapter 7 are wholly adequate in those circumstances. Whether or not a Chapter 7 conversion is possible, it is always possible to file and confirm a liquidating plan under Chapter 11.

2. The National Bankruptcy Conference questions whether the expedited time frames for the bankruptcy court's determination of whether or not to grant subchapter V relief in a contested involuntarily commenced case as well as the appellate review process sufficiently ensure that the judicial role is meaningful, especially given the import of the findings that the court has to make.

   What is your response?

The rapid time frame is undoubtedly not ideal, but is driven by the need to accomplish the "recapitalization" (transfer to the bridge company) over a weekend, while the markets are closed—which involves a wholly separate hearing (with different participants) than a hearing on the propriety of the filing of an involuntary petition. Moreover, there are, in my view, several important mitigating factors. First, the only entity that can file an involuntary petition is the Federal Reserve Board, which must make certain allegations in connection with such a filing. Unlike traditional bankruptcy law, creditors cannot commence a subchapter V proceeding through the filing of an involuntary petition. Given the enormous powers the Federal Reserve Board has over such financial institutions, in my view it will almost always be the case that the holding company will decide to file a voluntary petition. (Moreover, the Board, with other federal actors, has the power to commence a Title II proceeding under Dodd-Frank with even less review—and would likely pursue that path in the face of resistance to the commencement of a bankruptcy case.) Second, once bankruptcy law has been modified as proposed in the discussion draft, it is possible to imagine successful Title I "living wills" that address a number of issues involving bankruptcy. Third, if a case is actually filed involuntarily, it will be very difficult to see how the holding company can just "get out" of bankruptcy (by a dismissal of the petition) without significant harm. There is also the possibility of ex post remedies against an abusive filing. If that direction were to be pursued, one might want to contemplate amending Section 106 of the Bankruptcy Code to provide for a waiver of sovereign immunity in the case of an involuntary filing, and provide the standard for ex post review of any possible damage action.

Alternatively, one could simply eliminate the ability to file anything other than a voluntary petition. The Board would be left with its "persuasive" powers over the holding company, and would remain able—with other federal actors—to commence a Title II proceeding under Dodd-Frank. Those powers may be sufficient, and thus may obviate the need for the Board to, in addition, have the ability to file an involuntary petition to commence a subchapter V case—and thus obviate the concerns about the adequacy of deliberation, decision, and review of the propriety of the filing in such a compressed time frame.

3. The bill requires the subchapter V petition, Federal Reserve certification in support thereof, the hearing transcript, and all pleadings to filed under seal. While this requirement is clearly intended to limit the adverse impact that a failing financial institution may have on the Nation's financial marketplace, it would appear to violate the general principles of transparency and accountability with respect to judicial proceedings.

   What is your response?

As indicated, there are clear reasons for the temporary filing under seal (with availability to specified parties). Importantly, for judicial review, all of these records are available to the appellate court. Moreover, if the case proceeds—and while there is some tension (or inconsistency) between Section 1183(b)(2) and the final sentence of Section 1183(b)(3) in the discussion draft—the records are sealed only for 90-days in the situation of a case that isn't dismissed, thus ensuring ultimate public accountability.

4. If subchapter V was in existence when Lehman failed, would it have achieved a better result with respect to the case's impact on the Nation's financial marketplace?

While I think the bankruptcy work in Lehman was remarkable under the circumstances, I strongly believe we would have been in a better situation had bankruptcy law been revised along the lines of the discussion draft <u>and</u> Lehman had prepared a living will under Title I of Dodd-Frank focused on bankruptcy resolution. That said, at least a part of the issue with Lehman was the market "surprise" that, following Bear-Stearns, the Board was willing to allow Lehman to "fail." Revision of bankruptcy law wouldn't necessarily remove that kind of "shock"; but at the same time, revision of bankruptcy law may make it much easier to contemplate allowing a large financial institution to be resolved without government intervention—that is, the prior "rescue" of Bear-Stearns may not have been seen as necessary.

5. How would subchapter V interface with the living wills requirement of the Dodd-Frank Wall Street Reform and Consumer Protection Act (DFA)?

I view legislation along the lines of the discussion draft—and thus subchapter V of Chapter 11—as essential to the consummation of successful "living wills" under Title I of Dodd-Frank. Otherwise, there is a "Catch-22" in the system. Given that Title I's "living wills" focus on resolution plans that will "work" under bankruptcy law (not Title II), and given that current bankruptcy law—because of provisions such as the exemption of qualified financial contracts from most of the important features of bankruptcy law (such as the automatic stay)—is almost certainly not able to "resolve" a large financial institution without some form of liquidation (which may be enormously destructive of value), living wills can never be approved, consistent with the statutory mandate. This will inevitably require the break-up of those financial institutions unable to provide statutorily-compliant living wills, presumably until they are of a size where their liquidation under bankruptcy law will no longer have systemic consequences (and thus current bankruptcy law would be viewed as "adequate"). While there may be reasons to reduce the size and complexity of the nation's largest financial institutions, it seems to me to be perverse to require that because of a "Catch-22" between Title I's "living wills" provisions and current bankruptcy law. Once subchapter V is enacted, it is entirely possible to envision successful living wills; indeed, I view the living wills as, symmetrically, helping with the rapid recapitalization contemplated by subchapter V through advanced planning.

6. Professor Lubben questions the utility of the bill's "special trustee" provisions and wonders if they are needed at all.

What is your response?

I understand Professor Lubben's argument. In the abstract, it seems that the special trustee provisions are an unnecessary complication. But, in reality, without a special trustee, it will be the estate of the debtor in bankruptcy that "holds" the equity interests of the bridge company. This, first, creates the perception of a "link" in the sense that it appears that the bridge company—emphatically not in bankruptcy—is nonetheless controlled by an entity that is in bankruptcy and, second, may require the automatic replacement of the debtor in possession with a trustee (since the management of the holding company, now debtor, may also be management of the bridge institution). Interposing a special trustee between the bridge company and the debtor greatly reduces both of these issues.

7. Professor Lubben raises a practical concern about funding for the debtor's resolution in bankruptcy after it has transferred all of its assets to the bridge company.

What is your response?

I agree with his observation. Some provision for the payment of administrative expenses and the like in the debtor's subchapter V proceeding following the transfer of assets to the bridge company would be enormously helpful.

8. What happens if the bridge company itself fails? Should it be placed into DFA's title II for orderly liquidation?

If the bridge company itself fails, it is likely that it will require liquidation (since it will—at least for a period—not have sufficient capital structure debt for a successful recapitalization). If that were to occur, the focus should be on preserving the solvent operating subsidiaries. This could be done either pursuant to a traditional Chapter 11 bankruptcy proceeding (including a liquidating plan of reorganization) or under Title II of Dodd-Frank. In the latter case, the FDIC's "presumptive path" of single-point-of-entry would be unlikely (for the same reason that the holding company is unlikely to have sufficient capital structure debt). Both scenarios, in short, would be looking at a liquidation of the holding company and a focus on whether operating subsidiaries should be sold as going concerns or themselves liquidated.

9. Professor Lubben suggests that in addition to the Federal Reserve and the FDIC, other regulators should be permitted to intervene in a subchapter V case. These other regulators include the SEC, CFTC, state banking and insurance regulators, and the Office of the Comptroller of the Currency.

What is your response?

There is provision for notice to most such additional regulatory authorities in connection with the hearing involving a special transfer under Section 1185, see Section 1185(b)(10). Beyond that, while I do not have an objection in principle to additional regulatory agencies intervening, I question whether it is necessary or appropriate. The entity that is in bankruptcy is the holding company, not the subsidiaries. Apart from the impact of the Section 1185 special transfer, it isn't clear to me that the other regulatory authorities have a direct interest in the proceedings in bankruptcy involving the holding company.

Questions for the Record from
Mr. Johnson and Mr. Conyers
for the Hearing on H.R. ____, the "Financial Institution Bankruptcy Act of 2014"
July 15, 2014

Questions for Mr. Hessler[1]

1. Should the bankruptcy court be authorized to convert a subchapter V case to a case under chapter 7 under certain circumstances?

RESPONSE

My understanding is the latest version of the draft legislation does include provision that a subchapter V case may be converted to a chapter 7 proceeding—after a section 1185 transfer has occurred; a section 1186 special trustee has been appointed; and the bankruptcy court has found, upon notice and a hearing, that conversion is in the best interests of the estate—and I agree this is a helpful addition, consistent with the optionality available in conventional (*i.e.*, non-financial corporation) chapter 11 corporate reorganizations.

2. The National Bankruptcy Conference questions whether the expedited time frames for the bankruptcy court's determination of whether or not to grant subchapter V relief in a contested involuntarily commenced case as well as the appellate review process sufficiently ensure that the judicial role is meaningful, especially given the import of the findings that the court has to make.

   What is your response?

RESPONSE

As I stated in my written and oral testimony, the proposed time periods for the commencement and appellate review of an involuntary subchapter V case are compressed, and implicate fundamental Bankruptcy Code principles of due process. And although I acknowledge the expert views that the good assets of a financial corporation may not be able to withstand the prolonged public scrutiny of a typical chapter 11 case, in my experience, bankruptcy and appellate courts need more than mere hours to adequately hear and rule upon massively complex issues of fact and law. To that end, providing for reasonably greater time for the respective courts' consideration of an involuntary subchapter V petition would allow for a more meaningful judicial role.

3. The bill requires the subchapter V petition, Federal Reserve certification in support thereof, the hearing transcript, and all pleadings to filed under seal. While this requirement is clearly intended to limit the adverse impact that a failing financial

[1] As with my previously submitted written and oral testimony, the views expressed herein are my own, and are not offered on behalf of my firm, any client, or other organization.

institution may have on the Nation's financial marketplace, it would appear to violate the general principles of transparency and accountability with respect to judicial proceedings.

What is your response?

RESPONSE

Here as well, in my written and oral testimony, I noted the sealing provisions of proposed subchapter V are atypical with chapter 11 precedent and practice. That said, again, there is considerable expert opinion that the good assets of a financial corporation cannot withstand prolonged public scrutiny at the outset of a chapter 11 filing. Further, my understanding is the latest version of the draft bill provides that only an unsuccessful involuntary petition would remain sealed indefinitely—and, otherwise, the breadth and duration of the sealing provisions will be appropriately limited.

4. If subchapter V was in existence when Lehman failed, would it have achieved a better result with respect to the case's impact on the Nation's financial marketplace?

RESPONSE

Yes. I have previously written that the economic turmoil that followed Lehman's filing was not primarily a result of the Bankruptcy Code's perceived deficiencies to administer effectively the chapter 11 case of a major financial institution. Instead, it was due more so to the federal government's determination not to provide a bailout to Lehman, in midst of ad hoc and inconsistent decisions to provide taxpayer funded rescues to other financial institutions (*e.g.*, Bear Stearns, Fannie Mae and Freddie Mac, AIG, *etc.*). On this front, the availability of an orderly subchapter V filing will further incentivize the directors and officers of a financial corporation that is approaching (or is in) the zone of insolvency to begin planning as early and prudently as possible for a potential soft landing into chapter 11.

5. How would subchapter V interface with the living wills requirement of the Dodd-Frank Wall Street Reform and Consumer Protection Act (DFA)?

RESPONSE

Requiring financial corporations to engage in comprehensive and careful contingency planning should facilitate better prepared and more orderly subchapter V filings. Beyond that general assumption, however, I have not studied the living will provisions of the Dodd-Frank Act extensively enough to comment further.

6. Professor Lubben questions the utility of the bill's "special trustee" provisions and wonders if they are needed at all.

What is your response?

RESPONSE

I am not aware of the full extent of Professor Lubben's criticisms on this front. But I would note generally that appointing a fiduciary with duties to manage the trust (that holds all of the equity securities of the bridge company) for the benefit of the chapter 11 estates' creditors, with reporting and other obligations to the debtor(s), should be a helpful feature of the "single point of entry" approach that underlies subchapter V.

7. Professor Lubben raises a practical concern about funding for the debtor's resolution in bankruptcy after it has transferred all of its assets to the bridge company.

What is your response?

RESPONSE

Here as well, I am not aware of the full extent of Professor Lubben's concerns. But I generally agree it is imperative that financial corporation debtors have sufficient funding to administer their subchapter V cases and confirm and consummate their chapter 11 plans.

8. What happens if the bridge company itself fails? Should it be placed into DFA's title II for orderly liquidation?

RESPONSE

The failure of a bridge company would indicate there continues to be a dislocation between the prevailing fair market value of the relevant assets and the ability of the bridge company to utilize that value to satisfy its liquidity needs. It does not necessarily follow, however, that the bridge company should be placed into a Title II liquidation. A subsequent subchapter V case would be akin to a not uncommon "chapter 22," which is a second chapter 11 proceeding to further restructure the debtors' obligations.

9. Professor Lubben suggests that in addition to the Federal Reserve and the FDIC, other regulators should be permitted to intervene in a subchapter V case. These other regulators include the SEC, CFTC, state banking and insurance regulators, and the Office of the Comptroller of the Currency.

What is your response?

RESPONSE

In my prior writings, and in my testimony, I have advocated that regulatory bodies should have standing to appear, in their capacity as regulators, and advance their public interest mandates in financial corporation cases under chapter 11. To the extent the entities specified by Professor Lubben (and perhaps additional relevant regulators) fall within this rubric, I agree it is helpful to include them within subchapter V section 1183.

Questions for the Record from
Mr. Johnson and Mr. Conyers
for the Hearing on H.R. ____, the "Financial Institution Bankruptcy Act of 2014"
July 15, 2014

<u>Questions for Professor Lubben</u>

1. Should the bankruptcy court be authorized to convert a subchapter V case to a case under chapter 7 under certain circumstances?

Yes. Certainly after the debtor's assets have been transferred to a bridge, it might be impossible to reorganize the company, or conduct a structured liquidation under chapter 11. In such a case, chapter 7 should be an option.

2. The National Bankruptcy Conference questions whether the expedited time frames for the bankruptcy court's determination of whether or not to grant subchapter V relief in a contested involuntarily commenced case as well as the appellate review process sufficiently ensure that the judicial role is meaningful, especially given the import of the findings that the court has to make.

   What is your response?

There is clearly a delicate balance between meaningful judicial review and the avoidance of systemic distress. That said, I take the view that some judicial review is better than no judicial review. Moreover, I have faith that the bankruptcy judges have experience in conducting meaningful hearings on an expedited basis.

Of course, this issue would benefit from Congressional action on the status of the bankruptcy judges in light of the Supreme Court's decision in Stern v. Marshall, 564 U.S. 2 (2011), but I appreciate that will likely have to await a future day.

3. The bill requires the subchapter V petition, Federal Reserve certification in support thereof, the hearing transcript, and all pleadings to filed under seal. While this requirement is clearly intended to limit the adverse impact that a failing financial institution may have on the Nation's financial marketplace, it would appear to violate the general principles of transparency and accountability with respect to judicial proceedings.

   What is your response?

4. If subchapter V was in existence when Lehman failed, would it have achieved a better result with respect to the case's impact on the Nation's financial marketplace?

To my mind, the key problem with Lehman was the lack of advanced planning – large real economy corporations never filed unplanned chapter 11 petitions, so why the Lehman board and the relevant regulators thought it was a good idea for a large financial institution to do so remains something of a mystery. That said, subchapter V might have provided a useful tool for regulators to use in the face of opposition from Lehman's board.

5. How would subchapter V interface with the living wills requirement of the Dodd-Frank Wall Street Reform and Consumer Protection Act (DFA)?

Presumably subchapter V would make the living wills requirement of Dodd-Frank more viable. I have recently written on this problem for the New York Times' Dealbook page:

http://dealbook.nytimes.com/2014/08/11/do-living-wills-for-banks-even-make-sense/

6. Is it possible that a bridge company, as envisioned under this bill, could fail? If so, how should its resolution be handled?

Yes. If the problems that caused the initial chapter 11 filing were not cured by moving the holding company assets to the bridge – perhaps because of a run on a subsidiary – it might be necessary to allow for either (a) a subchapter V or OLA filing by the subsidiary or (b) an OLA filing by the bridge.

7. Can subchapter V operate as intended if there is no lender of last resort, such as the federal government?

In cases of isolated financial institution failure, I think it can work. In such cases, private funding might well be available. On the other hand, in cases of broader, systemic problems, the lack of a funding mechanism in subchapter V cases might tend to favor the use of OLA.

8. Are any regulatory requirements needed to ensure that subchapter V works?

A certain degree of "buy in" from the members of FSOC would be important to ensure that a subchapter V filing did not trigger a competing OLA proceeding.