STATEMENT OF

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BEFORE

THE SUBCOMMITTEE ON REGULATORY REFORM, COMMERCIAL AND ANTITRUST LAW

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THE UNITED STATES HOUSE OF REPRESENTATIVES

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HEARING ON

H.R. ____, THE "FINANCIAL INSTITUTION BANKRUPTCY ACT OF 2017"

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 Kirkland & Ellis LLP. While we primarily represent major corporations as company counsel in insolvency matters, my practice also includes representing creditors, equity holders, investors, and other third parties in a wide variety of highly complex distressed situations. I have served clients from a range of industries, including financial services, energy, telecommunications, gaming and hospitality, manufacturing, and real estate. My cases have included some of the largest and most challenging bankruptcies in history, including, most recently, Linn Energy (as debtors' counsel) and Peabody Energy (as counsel to the company's largest creditor).

Beyond my client representations, I teach a class each fall at the University of Pennsylvania to Law School and Wharton Business School students on distressed investing. Alongside an advisory board of approximately two dozen leading finance principals, professionals, and academics, I recently cofounded the University of Pennsylvania Institute for Restructuring Studies, a multidisciplinary think tank intended to address topical corporate insolvency issues and influence the public policy debate in a manner that has practical application for investors, practitioners, regulators, and scholars. From 2012-14, I served 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.

Please note the views expressed in my testimony, written and oral, are solely my own, and are not offered on behalf of my firm, any client, or other organization.

I have lectured and published on a number of insolvency topics, including, of most relevance, how to address most effectively the restructuring of a failing systemically important financial institution ("SIFI").[1] To that end, I am pleased to appear before this Subcommittee again regarding H.R. ____, the "Financial Institution Bankruptcy Act of 2017" ("FIBA"). It also was my privilege to testify in both July 2014 and July 2015 in favor of prior iterations of FIBA,[2] which were passed by the Judiciary Committee in September 2014 and March 2016, and by the full House in December 2014 and April 2016. I understand that FIBA has been or will soon be reintroduced in the House in substantively identical form.[3]

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[1] More specifically, I have written about and critiqued at length the authority provided by Congress within Title II of the Dodd-Frank Act. *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 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 DEAL (May 20, 2010).

In May 2011, I co-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 was 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. That document is available at https://www.federalreserve.gov/SECRS/2011/June/20110607/OP-1418/OP1418_053111_80002_310357154 312_1.pdf and a related interview from June 2011 is available at http://online.wsj.com/video/fatal-flaws-in-the-dodd-frank-act/7CEFEDBE-0240-4771-A463-83E32996BC92.html.

Lastly, I was an organizer of or participant in various conferences that examined related issues, including: "Resolution of Systemically Important Financial Institutions Under the Bankruptcy Code," December 7, 2016, at the Wharton School at the University of Pennsylvania; "The Rule of Law in Restructuring," October 28, 2016, and "Government Participation in Resolution Processes," March 11, 2016, both hosted by the Penn Restructuring Institute; "Cabining Contagion: Addressing SIFI Failure Through OLA and its Alternatives," October 24, 2012, at New York University Law School; and 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] My prior testimonies are available at https://judiciary.house.gov/wp-content/uploads/2016/02/Hessler-Testimony-1.pdf, and https://judiciary.house.gov/wp-content/uploads/2016/02/Hessler-Testimony.pdf, and are incorporated herein.

[3] For the purposes of this testimony, citations to FIBA will be to the provisions of H.R. 2947, the "Financial Institution Bankruptcy Act of 2016."

In my July 2014 testimony, I expressed my general support for FIBA, subject to limited reservations about certain of the bill's key provisions. And in my July 2015 testimony, following FIBA's subsequently beneficial amendments and my further study of the legislation,[4] I focused on updating my thoughts on those issues about which I previously stated the need for additional analysis—and reiterated my general support for the bill's enactment.

I have been informed that, although FIBA has twice passed the Judiciary Committee and House, in conjunction with the bill's present reintroduction, there are a handful of discrete yet important issues that may benefit from greater explanation. These include:

- Whether FIBA should shield a covered financial corporation's board of directors from potential liability for acting in good faith to authorize a filing and asset transfer;
- Whether FIBA should provide the Federal Government with the ability to initiate an involuntary case against a failing covered financial corporation; and
- Whether FIBA's incremental restructuring tools should be added to the Bankruptcy Code as a new Subchapter V of existing Chapter 11 or as a standalone new Chapter 14.

Accordingly, my testimony predominantly will discuss these three points—and is organized as follows. *First*, while not repeating my prior presentations (which provided a more detailed overview of FIBA), I will very quickly summarize how the legislation provides SIFI debtors with critical reorganization tools designed to address the unique exigencies of a major bank failure—and how FIBA does not disturb vital existing

[4] *See* Stephen E. Hessler, *Subchapter V—The Next Major Chapter 11 Reform?*, REORG RESEARCH (October 9, 2014). Further, on February 18, 2015, I presented on "Subchapter V: H.R. 5421—Financial Institution Bankruptcy Act of 2014," to the New York City Bar Association Committee On Bankruptcy & Corporate Reorganization.

Chapter 11 protections. *Second*, I will address the above-specified issues—board liability preclusion, government filing ability, and legislative drafting placement. And *finally*, I will again briefly revisit the comparative benefits of the insolvency resolution regimes at issue, and explain why FIBA presents the most viable (and needed) bankruptcy reform option.

I. FIBA—In Summary

Again, while I refer the Subcommittee to my prior testimonies, which described at much greater length FIBA's operational design, for this hearing record, the following is a very high-level description of how it works—including what FIBA adds to Chapter 11, and what it retains.

A. Incremental Tools

The central feature of FIBA is the "single point of entry" approach that would allow a failing covered financial corporation to file for Chapter 11 to effect a quick separation of "good" assets from "bad" assets. This would happen through the rapid postpetition transfer of the good assets to a non-debtor bridge financial company whose equity is held by a trust that is managed by a special trustee for the benefit of creditors. The bad assets would then be liquidated by the debtor within the Chapter 11 case—and both the transfer and liquidation are subject to Bankruptcy Court approval.[5]

Importantly, FIBA provides these cases will be administered by a jurist selected from a pool of predetermined experienced Bankruptcy Court judges, within the established practice and precedent of the Bankruptcy Code.[6]

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[5] Sections 1185-90, 1191.

[6] Section 298(a)(1).

Lastly, the Bankruptcy Code presently exempts counterparties to qualified financial contracts ("QFCs," such as derivatives, swaps, repos, *etc*.) from section 362's automatic stay against termination[7]—which means a Chapter 11 filing by a covered financial corporation could be marked by chaos at the outset if QFC counterparties are able to terminate and enforce immediately their rights in the debtor's assets. FIBA addresses this issue by subjecting QFCs to the automatic stay for 48 hours.[8]

B. Retained Chapter 11 Protections

Beyond FIBA's key additions to Chapter 11, equally important are the core debtor protections of Chapter 11 that FIBA does not disturb. These include, most prominently:

- *Absolute Priority Rule*. In contrast to Title II, which allows for similarly situated creditors to receive dissimilar economic treatment,[9] FIBA does not alter the absolute priority rule, a bedrock principle of Chapter 11 that ensures the fair and equitable treatment of creditors by requiring that stakeholders with similar legal rights must receive the same treatment, and that junior creditors or interest holders may not receive any recovery until senior creditors are paid in full.[10]

- *Exclusivity*. FIBA also does not impair a Chapter 11 debtor's exclusive right to file a plan of reorganization.[11] This means the Federal Reserve, the Federal Deposit Insurance Corporation ("FDIC"), and other regulators to which FIBA confers standing,[12] like all parties in interest, have the right

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7 11 U.S.C. § 362.

8 Section 1187(a)(3)(A)(i). While it is fair to inquire whether it is commercially viable to require a debtor to make transfer and assignment decisions about a covered financial corporation's entire book of QFCs essentially immediately upon a filing, I am persuaded that FIBA proposes a workable construct on this front, for the following reasons: the post Dodd-Frank Act development of "living wills," the fact that the broader asset transfer decision itself must be made within 48 hours, the expectation that all QFCs will be transferred to the bridge company, and that FIBA's 48-hour stay actually offers more robust protection than both the present Bankruptcy Code automatic stay safe harbors and Title II.

9 12 U.S.C. § 5390(b)(4)(B).

10 *See* 11 U.S.C. § 1129.

11 *See* 11 U.S.C. § 1121(d)(1).

12 Section 1184.

to object to a debtor's requests for exclusivity extensions, or to file a motion to terminate exclusivity for "cause,"[13] but the Federal Government appropriately must first obtain Bankruptcy Court permission before abrogating a debtor's prerogatives on these fundamental restructuring decisions.

- *Management Continuity*. Chapter 11 embodies the concept of a "debtor in possession" maintaining the authority to operate the company postpetition.[14] Although I describe below the proper scope of protections for a covered financial corporation's senior executives, suffice to say that FIBA, unlike Title II, does not mandate the post-filing firing of directors and officers, which is key to ensuring stability and thereby maximizing the value of the estate before and during its restructuring.[15]

II. Addressing Key Issues

As noted above, I am aware of three points in particular that deserve further attention—board liability under FIBA, the ability of the federal government to initiate a case under FIBA, and whether FIBA's provisions should be codified as a subsection of Chapter 11 or as a new Chapter 14 to the Bankruptcy Code. Below I address each of these issues in turn.

A. Director & Officer Liability

Section 1183(c) of FIBA provides:

> The members of the board of directors (or body performing similar functions) of a covered financial company shall have ***no liability*** to shareholders, creditors, or other parties in interest for a ***good faith filing*** of a petition to commence a case under this subchapter, or for ***any reasonable action taken in good faith*** in contemplation of or in connection with such a petition or transfer under section 1185 or section 1186, whether prior to or after commencement of the case.[16]

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13 11 U.S.C. § 1121.

14 11 U.S.C. §§ 1107, 1108.

15 *See infra* § II.A.

16 Section 1183(c) (emphases added).

This exculpation provision understandably may prompt some to question whether FIBA is unwarrantedly (and problematically) shielding directors and officers from potential liability for their actions (or inactions). It is my strong view, for the following reasons, that this provision is highly justifiable.

1. Debtor In Possession

First, as a threshold matter, and as I have testified before, in my experience as a practitioner representing very large Chapter 11 debtors, the knowledge, expertise, and commitment of the company's prepetition directors and officers are indispensable to effectuating a soft landing into, and orderly passage through, bankruptcy. As noted above, the Code authorizes the "debtor in possession" to continue to manage the businesses postpetition,[17] not to insulate executives from responsibility for their actions, but to ensure the decisionmakers of distressed corporations are not dissuaded from pursuing the difficult but necessary restructuring decisions that may result in a Chapter 11 filing. In other words, it is distinctly beneficial to motivate directors and officers to confront the corporation's problems as early as practicable and to pursue diligently all viable restructuring options. FIBA helpfully incentivizes such conduct by removing the specter of legal liability for actions taken as responsible fiduciaries.

2. Limited Scope & Language

Second, the scope and language of section 1183(c) are appropriately limited. Again, the only board decisions that FIBA protects from potential liability are for a "good faith filing of a petition to commence a case," and for "any reasonable action taken in

[17] 11 U.S.C. §§ 1107, 1108.

good faith" in contemplation of or connection with the filing or asset transfer decision.[18] As an initial matter, the Bankruptcy Code already provides that a Chapter 11 case may be dismissed "for cause," which has been interpreted to include a "bad faith" filing (such as commencing a case without a legitimate economically rehabilitative purpose).[19] In other words, FIBA merely reinforces the existing requirement that a Chapter 11 filing must be made in good faith—if it is not, and the case is dismissed, FIBA offers no added protection from liability.

Moreover, it is manifestly sound public policy that "any reasonable action taken in good faith" in contemplation of or connection with the filing or asset transfer decision *should* be protected. Here as well, if it can be shown that the challenged actions were taken in bad faith or were unreasonable, the board could be liable. And to further state the obvious, the language of section 1183(c) does not at all encompass any hypothetically improper conduct that may have led to the filing—it only covers the *good faith* filing and asset transfer determinations. Put simply, FIBA does not bestow extraordinary or unwise protections for bad faith or unreasonable board actions.

3. Other Remedies

Finally, FIBA properly does not supplant other existing remedies, both under the Bankruptcy Code or otherwise applicable law, for any board malfeasance. In stark contrast, for example, Title II requires that, upon placement of the financial company into receivership, all directors and officers shall be dismissed, potentially subject to clawback

[18] Section 1183(c).

[19] 11 U.S.C. § 1112(b)(1).

of compensation, and possibly banned from future industry employment.[20] Within Title II's punitive construct, directors and officers are perversely discouraged from pursuing formal restructuring options (that will trigger their dismissal), which is a distinctly negative dynamic.

FIBA, on the other hand, exercises admirable restraint in not vilifying, much less outright disqualifying, a covered financial company's existing leadership from continuing to serve the debtor in possession—subject to already applicable Bankruptcy Code grounds for penalty as merited. For instance, 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 and installing an examiner or trustee.[21] And, of course, FIBA does not preclude suits for breach of fiduciary duty, or other shareholder derivative claims against directors and officers for unlawful actions. To be clear, any director and officer misconduct should be prosecutable to the fullest extent of the law—and FIBA in no way impedes the ability of law enforcement or interested parties from holding directors and officers accountable for any legally cognizable misdeeds.

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[20] Specifically, Title II mandates 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 financial company. 12 U.S.C. § 5384(a). The FDIC may seek to recover from any current or former senior executive or director "any compensation" received within two years of the FDIC appointment date. 12 U.S.C. § 5390(s)(1). 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. 12 U.S.C. § 5393(c)(1).

[21] *See*, *e.g.*, 11 U.S.C. § 1104(a)(1) (providing the court shall order the appointment of a trustee or examiner to assume and perform the management duties of the debtor "for cause, including fraud, dishonesty, incompetence, or gross mismanagement of the affairs of the debtor by current management, either before or after the commencement of the case").

In sum, I believe FIBA strikes the right balance between encouraging covered financial corporation boards to make responsible restructuring decisions, without undue concern for potential legal liability (that could lead to delay or otherwise erode estate value, while exacerbating broader market instability), and not diminishing third-party rights to seek recourse for legitimately culpable conduct.

B. Federal Government Ability To File

Prior versions of FIBA expressly allowed the Federal Government (specifically, the Board of Governors of the Federal Reserve) to file an involuntary petition commencing a Chapter 11 case without the covered financial corporation's consent, and included a complex (and severely temporally truncated) scheme for the debtor to challenge the filing. I and others testified this grant of authority was an unnecessary and unhelpful distraction—and the version of FIBA that passed the House in April 2016 did not include the provision. For the following reasons, ideally the next version of FIBA likewise will decline to give the Federal Government the ability to initiate an involuntary Chapter 11 proceeding of a covered financial corporation.

As a gating item, it bears reminding that Title II already gives the Federal Government an involuntary filing right[22]—albeit for a regulator-administered liquidation, not a Chapter 11 reorganization. That said, and as discussed further below, I acknowledge that, while FIBA itself has no direct effect on Title II, the debate on the former also includes at least some discussion about whether to repeal the latter. But most importantly for present purposes is that the Federal Government, either through even only the threat of a Title II proceeding or its other general regulatory powers, already has

[22] 12 U.S.C. § 5382(a).

sufficient influence to compel a covered financial corporation to commence a Chapter 11 case, without having to resort to a formal involuntary filing trigger.

To further illustrate: regardless of whether Title II remains in place or whether FIBA ultimately provides the Federal Government with an involuntary filing right, it is exceedingly unlikely there would ever be an involuntary case of a covered financial corporation. This is because, although under existing Bankruptcy Code provisions, involuntary Chapter 11 cases can be initiated by under- or unsecured creditors in limited circumstances,[23] they are very rare in the context of major corporations. Debtors often are effectively (but still voluntarily) "forced" into commencing Chapter 11 because of funded debt maturity or interest payment deadlines that, if unmet, would give rise to creditors' rights to foreclose on collateral or otherwise prompt a cascading series of cross defaults. Accordingly, as this day of reckoning gets closer, an insolvent corporation already will be in active negotiations with its key creditor and third-party constituencies over the timing and necessity of a potential filing—and it will be highly motivated to file a voluntary case before a creditor is able to commence an involuntary proceeding.

Presumably the same dynamic will be present in the context of distressed covered financial corporations and the Federal Reserve (among other regulators and counterparties)—meaning, it is essentially unthinkable that a SIFI would be thrust suddenly and previously unaware into the circumstance of defending its viability or undergoing an involuntary restructuring. And FIBA reflects this commercial reality, by requiring:

> Counsel to the debtor shall provide, to the greatest extent practicable without disclosing the identity of the potential debtor, sufficient

[23] 11 U.S.C. § 303.

> confidential notice to the chief judge of the court of appeals for the circuit embracing the district in which such counsel intends to file a petition to commence a case under this subchapter regarding the potential commencement of such case.[24]

In my experience as debtors' counsel, these prefiling discussions about the path of a potential, voluntary Chapter 11 case—among the company, its largest creditors, regulators, and other key parties in interest—are already underway and highly active well in advance of the petition date.

Given this well-established practice of prepetition coordination, I expect the prelude to a FIBA case would occur similarly. And thus the prospect of an involuntary proceeding is not needed to generate what is otherwise optimal: a relatively planned voluntary filing by a covered financial corporation seeking to stay ahead of its regulators, and creditors, and ensure control of its Chapter 11 case.

C. Legislative Placement—Subchapter V or Chapter 14

FIBA proposes to add a new Subchapter V to Chapter 11 of the Bankruptcy Code to handle the filing of a covered financial corporation.[25] Also previously introduced in the Senate were S. 1840 and S. 1841, both titled the "Taxpayer Protection and Responsible Resolution Act," and those bills proposed to add a new, standalone Chapter 14 within the Bankruptcy Code for essentially the same purpose.

The question has been raised: is one of these placement options substantively preferable—or is this a distinction that, with proper legislative drafting, has no material difference? Although I agree this is a very narrow issue, for the reasons briefly summarized below, I do believe FIBA's Subchapter V is, on balance, the better

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[24] Section 1183(d).

[25] Section 2(b).

approach—and does have some practical impact on the efficacy of the resolution procedures to be adopted.[26]

1. Chapter 14—Proffered Justifications

Neither the text nor legislative record of Chapter 14 appears to specify the reasons for creating a new chapter of the Bankruptcy Code. Certain justifications were proffered by the various scholars who generated the original proposal, but many of those reasons are no longer salient, given the evolution of the legislation and the specific provisions that were (and were not) included in the latest iterations of Chapter 14.[27]

One point that should still be addressed, though, is the notion that amending the applicable provisions of Chapter 11 (to add the requisite SIFI restructuring tools) would be too cumbersome, as opposed to simply adopting those tools in a new Chapter 14.[28] Put simply, the advanced status of Subchapter V, with FIBA having already passed the Judiciary Committee and full House twice, belies the notion it would be too unwieldy a drafting exercise to situate a financial institution resolution regime within Chapter 11.

2. Bankruptcy Code Historical & Structural Consistency

Looking to prior Bankruptcy Code reform amendments also supports situating Subchapter V within Chapter 11, instead of creating a standalone Chapter 14. To cite a few examples:

- When the modern Bankruptcy Code was enacted in 1978, it consolidated the two chapters for corporate reorganizations (Chapters X and XI) into a unified Chapter 11 on the ground that "[a] single chapter for all business

[26] Attached as Exhibit A is a letter I sent to the House Judiciary Committee on March 14, 2016, that addressed this issue at greater length, and was cited in the final report on H.R. 2947. H.R. REP. NO. 114-477, at 11 n.9 (2016).

[27] *See* Ex. A at 2-3.

[28] *Id*. at 2.

reorganizations will simplify the law by eliminating unnecessary differences in detail that are inevitable under separately administered statutes."[29] Insofar as there does already exist a "single chapter for all business reorganizations"—Chapter 11—creating a new Chapter 14 seemingly runs counter to Congress's efforts to "simplify the law"—by reintroducing "unnecessary differences in detail" that can arise if and when parties resort to litigating the applicability of the "separately administered" statutory scheme of Chapter 11.

- Similarly, the 1978 Act placed railroad reorganizations, previously administered under Section 77 of the Bankruptcy Act of 1933, within Subchapter IV of Chapter 11, so that "the often complex and time consuming dichotomy between railroad and other business reorganizations is eliminated by incorporating railroad reorganizations into the pattern of business reorganizations generally, and including in Subchapter IV only those additional provisions which are necessary to reflect the special characteristics of railroad reorganizations."[30] Financial institution reorganizations also present certain special characteristics, but the proceeding otherwise is fundamentally a business reorganization properly subject to the other preexisting provisions of Chapter 11.

- Lastly, in contrast, is Congress's adoption of standalone Chapters 9 and 15, which reflect a continued legislative preference for domestic corporate restructurings to be administered under Chapter 11—and non-corporate and non-domestic cases under other chapters.[31]

3. Applicability of Chapter 11 Precedent

Among the most critical underpinnings of FIBA and Subchapter V is the ready availability of the key protections of Chapter 11. The hallmark of an optimal resolution regime for failing financial institutions must be clear and established rules, administered by an impartial tribunal. Subchapter V is a covered financial corporation-specific supplement to the existing reorganization provisions of Chapter 11, and builds upon decades of precedent and practice that have refined the Code and otherwise provides a

[29] *Id*. at 3.

[30] *Id*. at 4.

[31] *Id*. at 4-5.

well-tested and proven successful reorganization framework for financial institutions and their creditor constituencies.

Chapter 14 does attempt to incorporate Chapter 11 by providing a catch-all provision that "[e]xcept as provided in chapter 14 of this title, chapter 11 of this title applies in a case under chapter 14 of this title."[32] And perhaps this incorporation clause would be sufficient to ensure that all of the Chapter 11 mainstays are available in a Chapter 14 proceeding. But it is unnecessary to take even minimal risk of litigation and uncertainty (and the attendant costs to the estate and therefore creditors), when a more straightforward and unambiguously protective approach is available directly through Subchapter V.

III. Insolvency Resolution Regimes & Comparative Benefits

While I have been and remain critical of Title II, I also hope the debate over whether it should be repealed does not impede the prospects for FIBA's ultimate enactment. Notably, if Title II does remain law, the availability of FIBA's provisions would make it far less likely that Title II ever will be invoked, which is consistent with Congress's intent to utilize the Bankruptcy Code first and a regulatory process only as a last resort.[33] And although FIBA is a needed and beneficial bankruptcy reform regardless of whether Title II is repealed, the uncertainty on that front makes FIBA's adoption even more essential.

The touchstone analytical framework for evaluating FIBA should not be as a standalone proposal, but rather FIBA as compared to the other SIFI insolvency resolution

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[32] S. 1840, 114th Cong. § 2(b) (2015); S. 1841, 114th Cong. § 2(b) (2015).

[33] *See* 12 U.S.C. § 5383(a)(2)(F).

regimes at issue—namely, Chapter 11 in its current form, Chapter 11 as amended by FIBA, and Title II. As I have testified previously, among those alternatives, FIBA is the best-designed option, both structurally and philosophically, to advance the private and public policies that animate the reorganization of a covered financial corporation. In other words, FIBA 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 SIFI. To explain further, I will assess briefly the varying incentives the available restructuring options present for debtors, creditors, and regulators.[34]

A. Debtor Incentives

As described above, in my experience representing very large Chapter 11 debtors, perhaps the most important component of a successful corporate restructuring is for directors and officers not to wait to address the company's increasing insolvency. Contrary to this goal are Title II's series of punitive measures—dismissal upon commencement of a case, accompanied by the potential clawback of compensation and ban from future employment, *etc*.[35]—that paradoxically will dissuade leadership from making the hard decisions to safeguard and enhance estate value. FIBA's express

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[34] *Cf.* Jeffrey M. Lacker, President, Fed. Reserve Bank of Richmond, Address at Louisiana State Univ. Graduate Sch. of Banking, *From Country Banks to SIFIs: The 100-Year Quest for Financial Stability* (May 26, 2015), at 5.

> The long-term solution [to the "too big too fail" problem] is not more regulation. Instead, it's to restore market discipline so that financial firms and their creditors have an incentive to avoid fragile funding arrangements. Two conditions are necessary to achieve this. First, creditors must not expect government support in the event of financial distress. Second, policymakers must actually allow financial firms to fail without government support. If we can make unassisted failures manageable, policymakers could credibly commit to foregoing rescues, thereby improving private sector incentives.

[35] *See supra* § II.A.3.

allowance for management to continue to operate the debtor in possession—and/or manage the bridge company—to maximize stakeholder recoveries is the proper approach to incentivize management and align their interests with creditor constituencies.[36]

B. Creditor Incentives

As to creditor incentives, the key challenge is to craft a scheme of enforceable recovery rights and value distribution priority that favorably influences lender behavior. As I have previously testified, the "moral hazard" targeted by Title II results when creditors are incentivized to make risky loans because governing legal and regulatory regimes 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.

To the extent that Title II requires "[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],"[37] it does (arguably) follow that public dollars will not be used to "bail out" a failing covered financial corporation. But lenders care about being repaid in full; they are not concerned with whether the borrower survives or which entity, private or public, funds the repayment.

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[36] Again, this is not to say that management should be shielded from consequence for any misdeeds, but the Bankruptcy Code already provides various powers to remove a Chapter 11 debtor's leadership as justified, and the limited protection from liability provided by FIBA does not unduly circumscribe third-party remedies. *See supra* § II.A.3.

[37] 12 U.S.C. § 5394(a).

Further, Title II expressly authorizes the dissimilar treatment of similarly situated creditors.[38] And because any excess costs of liquidation will be funded by assessments on third-party financial companies,[39] the Dodd-Frank Act essentially allows regulators to pay creditors whatever amounts are deemed necessary to stabilize the economy, according to the economic and political priorities of the current Administration.

FIBA, on the other hand, provides to creditors clear rules, that build upon the established provisions of Chapter 11, applied by experienced and neutral Bankruptcy Court judges. Accordingly, creditors will make their investment decisions with at least an informed understanding of (and confidence in) the enforceability and priority of repayment rights, based on the transparency and predictability of Chapter 11, if the borrower needs to restructure. So understood, FIBA augments Chapter 11's promotion of knowledgeable—and hopefully rational—creditor behavior.

C. Regulator Incentives

Divining regulator incentives may be more difficult, as these actors are primarily charged with advancing the public good, not safeguarding economic self interest. That said, it seems fairly logical to assume that, in the absence of FIBA, if a SIFI is failing, the Federal Government almost certainly will initiate a Title II proceeding, given the Bankruptcy Code does not currently provide an expansive grant of standing to the Federal Government to participate in Chapter 11 cases.[40] The Code does give a limited

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[38] 12 U.S.C. § 5390(b)(4).

[39] 12 U.S.C. § 5390(o)(1)(B).

[40] 11 U.S.C. § 1109(b) ("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.").

right to be heard to the Securities and Exchange Commission (the "SEC"),[41] but unless the Federal Government has a financial stake in the debtor, regulatory bodies do not have standing to appear, in their capacity as regulators, and pursue their public interest mandates in SIFI cases under Chapter 11. As between Chapter 11 in its present form and Title II, it would be rational for regulators to prefer the resolution regime that facilitates their robust involvement.

FIBA, however, appropriately addresses this present limitation by providing the Federal Reserve, the SEC, the Office of the Comptroller of the Currency, and the FDIC "may raise and may appear and be heard on any issue in any case or proceeding under" Subchapter V.[42] Moreover, FIBA further provides "[t]he [bankruptcy] court may consider the effect that any decision in connection with this subchapter [V] may have on financial stability in the United States."[43]

In sum, even if Title II remains an available option indefinitely, FIBA's express grant of standing to the Federal Government, and consideration of the public interest pursuant to a SIFI restructuring, makes it plausible (if not likely) the applicable regulators would allow a FIBA proceeding by declining to exercise their Title II commencement rights.

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[41] 11 U.S.C. § 1109(a) ("The 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.").

[42] Section 1184.

[43] Section 1192. As I have previously noted, a historical analogue to FIBA, and its stated goal of protecting the public interest, are the Bankruptcy Code provisions that include the "public interest" as an applicable factor in a debtor's decisions in railroad cases. *See* 11 U.S.C. § 1165 (requiring that "[i]n applying sections 1166, 1167, 1169, 1170, 1171, 1172, 1173, and 1174 of this title, the court and the trustee shall consider the public interest in addition to the interests of the debtor, creditors, and equity security holders").

Conclusion

Thank you again for inviting me to appear before you today. I appreciate the Subcommittee allowing me to share my views. And I welcome the opportunity to answer any questions about my testimony.

EXHIBIT A

March 14, 2016

Hon. Bob Goodlatte
Chairman, U.S. House Committee on the Judiciary
Hon. John Conyers, Jr.
Ranking Member, U.S. House Committee on the Judiciary
Hon. Tom Marino
Chairman, Subcommittee on Regulatory Reform, Commercial and Antitrust Law
Hon. Dave Trott
Lead Sponsor, H.R. 2947
2138 Rayburn House Office Bldg.
Washington, D.C. 20515

Re: Financial Institution Bankruptcy Act of 2016

Dear Sirs:

By way of reintroduction,[1] it was my privilege to appear before the Subcommittee in July 2014 and July 2015 to testify in favor of the legislation presently introduced as H.R. 2947, the "Financial Institution Bankruptcy Act of 2016," also known as "Subchapter V," insofar as the legislation proposes to add a new subsection to Chapter 11 of the Bankruptcy Code to handle the filing of bank holding companies.[2] Also presently introduced in the Senate are S. 1840 and S. 1841, both titled the "Taxpayer Protection and Responsible Resolution Act," and also known as "Chapter 14," as those bills propose to add a new, standalone Chapter 14 within the Bankruptcy Code for the same purpose.

Among the questions raised at the hearings on Subchapter V (and elsewhere) is whether one of these placement options is substantively preferable—or is this a distinction that, with proper legislative drafting, has no material difference. Although I would agree this is a narrow and discrete issue, for the reasons set forth below, I believe the Subchapter V approach does have comparative advantages consistent with the historical development, and in furtherance of the structural design, of the Bankruptcy Code—and does have practical relevance for the efficacy of the financial institution resolution procedures to be adopted.

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[1] I am a partner in the Restructuring Group of Kirkland & Ellis LLP, I teach a class annually at the University of Pennsylvania to Law School and Wharton Business School students on distressed investing, and I am the co-founder of the University of Pennsylvania Institute for Restructuring Studies. Although the topic explored in this letter was developed in conjunction with the latter two initiatives, the views expressed herein are solely my own, and are not offered on behalf of my firm, any client, or any other organization. I thank David Skeel for his commentary and Cole DuMond and Francis Petrie for their research assistance.

[2] My prior testimonies are available at http://judiciary.house.gov/index.cfm/hearings?Id=2CBBB696-44EA-424F-85F7-555A2CDAA3B9%20&Statement_id=C7DF5B14-9571-4675-8EB6-E9F4D56313D7, and at https://judiciary.house.gov/hearing/hearing-h-r-the-financial-institution-bankruptcy-act-of-2015/, and are incorporated by reference herein.

I. Chapter 14: Proffered Justification

Neither the text nor legislative record of Chapter 14 appears to specify the reason(s) for creating a new chapter of the Bankruptcy Code. It is generally understood, however, that Chapter 14 is derived from The Resolution Project, an initiative undertaken by scholars at the Hoover Institution in the wake of the financial crisis. And one of the primary authors of the Hoover effort, in a 2012 paper outlining their Chapter 14 idea, explained:

> In essence, our proposal provides a new bankruptcy process (including certain new substantive rules) for financial institutions for the liquidation or reorganization of these defined financial institutions. At the same time, the Bankruptcy Code's structure and rules for a liquidation proceeding, in Chapter 7, and for a reorganization proceeding, in Chapter 11, provide a solid starting place, with a wealth of important judicial gloss on statutory terminology, that would be usefully applied in many situations involving a covered financial institution. To accomplish both goals simultaneously, we propose that the proceeding (or "case") when a covered financial institution invokes (or is placed in) bankruptcy follow the rules of the existing Bankruptcy Code except where we propose to change those rules. Particularly because our proposal envisions a different judicial "path," as we describe below (involving district judges in lieu of bankruptcy judges), to use the existing Bankruptcy Code structure, and attempt to amend various provisions in Chapter 7 and 11 to accommodate our proposal, would be cumbersome. Thus, our proposal is to create a new Chapter 14 in the Bankruptcy Code and require covered financial institutions to concurrently file for Chapter 14 and Chapter 7 or Chapter 11 (that is, covered financial institutions cannot file for Chapter 7 or Chapter 11 without also filing for Chapter 14), and requiring the resulting liquidation (Chapter 7) or reorganization (Chapter 11) proceeding to be conducted according to the rules, and under the special court supervision, of Chapter 14.[3]

Without delving into the non-placement-related distinctions between Chapter 14 and Subchapter V, which analysis is beyond the scope of this limited submission, it is notable that many of the above-proffered justifications for creating a new Chapter 14 are no longer salient, to the extent the latest iteration of Chapter 14 does not contain many of those cited features. Specifically:

- The "single point of entry" approach that is now the central feature of Chapter 14 (and Subchapter V) can fairly be characterized as primarily reorganization in nature (and thus properly the subject of Chapter 11) instead of a liquidation (under Chapter 7);

[3] *Bankruptcy Code Chapter 14: A Proposal* (February 28, 2012), *available at* http://www.hoover.org/sites/default/files/bankruptcy-code-chapter-14-proposal-20120228.pdf.

- It is expected that the final versions of both Chapter 14 and Subchapter V will not include the ability of the Federal Government to place involuntarily a financial institution into a bankruptcy proceeding;

- Both Chapter 14 and Subchapter V now propose that Bankruptcy Court judges (and not District Court judges) will administer a financial institution bankruptcy proceeding; and

- The advanced status of Subchapter V, having already been passed by the House Judiciary Committee in September 2014 and the full House in December 2014, belies the notion that it would be too cumbersome a drafting exercise to situate a financial institution resolution regime within Chapter 11.

These observations are not intended as criticism. Rather, they are meant to reflect that, as the fundamental precepts of Chapter 14 have evolved, it likewise follows that the placement rationales may be outdated as well. Accordingly, absent a current statement of the reasons for creating a standalone Chapter 14, it is helpful to turn to an examination of the reasons for instead situating Subchapter V within Chapter 11.

II. Subchapter V: Placement Comparative Advantages

A. Historical & Structural Consistency

1. 1978 Act—Merger of Chapters X and XI into Chapter 11

Prior to the enactment of the modern Bankruptcy Code in 1978, there were two chapters for corporate reorganizations: Chapter X for public companies and Chapter XI for private corporations. The 1978 Act consolidated the two chapters on the grounds that "[a] single chapter for all business reorganizations will simplify the law by eliminating unnecessary differences in detail that are inevitable under separately administered statutes."[4] Accordingly, "[t]he single chapter for business reorganization, which the bill provides, will eliminate the unprofitable litigation over the preliminary issue as to which of the two chapters apply."[5]

Of course, the pre-1978 litigation over whether Chapters X or XI applied is not identical here; if Chapter 14 is enacted, it seems unlikely there would be credible disputes over whether Chapter 11 or 14 applies to a financial institution proceeding (given the statutory clarification in Chapter 14 as to who may be a debtor in a case under the latter). And Chapter 14 does propose largely to incorporate Chapter 11 by providing a catch-all provision that "[e]xcept as provided in chapter 14 of this title, chapter 11 of this title applies in a case under chapter 14 of this title."[6]

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4 S. REP. NO. 95-989, at 9 (1978).

5 *Id*.

6 S. 1840, 114th Cong. § 2(b) (2016); S. 1841, 114th Cong. § 2(b) (2016).

But even a low likelihood of confusion is more than is needed, given the certainty about the applicability of Chapter 11 to a Subchapter V case—which, of course, is commenced directly under Chapter 11. And more importantly, to the extent there does already exist a "single chapter for all business reorganizations"—Chapter 11—creating a new Chapter 14 seemingly runs counter to Congress's efforts to "simplify the law"—by reintroducing "unnecessary differences in detail" that can arise if and when parties resort to litigating the applicability of the "separately administered" statutory scheme of Chapter 11.

2. 1978 Act—Inclusion of Subchapter IV (Railroad Reorganizations) Within Chapter 11

Even more on point is the 1978 Act's placement of railroad reorganizations, previously administered under Section 77 of the Bankruptcy Act of 1933, within Subchapter IV of Chapter 11. This was done so that "the often complex and time consuming dichotomy between railroad and other business reorganizations is eliminated by incorporating railroad reorganizations into the pattern of business reorganizations generally, and including in Subchapter IV only those additional provisions which are necessary to reflect the special characteristics of railroad reorganizations."[7]

Replacing "railroad" with "financial institution" in that statement would be appropriate. Like railroad reorganizations, financial institution reorganizations do present certain distinct exigencies—including express consideration of the "public interest"—which Subchapter V aptly addresses[8]—but the proceeding otherwise is fundamentally a business reorganization properly subject to the other preexisting provisions of Chapter 11. The logic in 1978 for placing Subchapter IV within Chapter 11 is equally compelling in 2016 for placing Subchapter V within Chapter 11.

3. Separation of Chapters 9 and 15 (Non-Corporate & Non-Domestic Debtors)

Beyond Congress's reasons for merging pre-1978 Chapters X and XI into Chapter 11, and for drafting Subchapter IV as part of Chapter 11, additional support for placing Subchapter IV within Chapter 11 may be found in Congress's adoption of Chapters 9 and 15, which further reflects a continued legislative preference for domestic corporate restructurings to be administered under Chapter 11—and non-corporate and non-domestic cases under other chapters.

As to Chapter 9, which provides for adjustment of the debts of a municipality, its enactment actually predates adoption of the Bankruptcy Code in 1978. Accordingly, the 95th Congress could have moved Chapter 9's provisions into a subchapter of Chapter 11, but did not do so, presumably given the many key dissimilarities between a municipal

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[7] S. REP. NO. 95-989, at 11 (1978).

[8] *Id*. at 12; H. 2947, 114th Cong. § 1192 (2016).

and corporate restructuring—and instead opted to maintain the underlying doctrinal separation of Chapters 9 and 11 (while otherwise providing for incorporation into Chapter 9 those provisions of Chapter 11 that do justifiably apply to the debt adjustment of a municipality).[9]

As to Chapter 15, which does address the reorganization of corporate debtors, the decision to adopt these provisions as a standalone chapter apparently was due largely to the fact that the bill essentially followed the Model Law on Cross-Border Insolvency that had been drafted by the United Nations Commission on International Trade Law, with certain exceptions to ensure conformity with United States law, alongside repeal of preexisting Section 304 of Chapter 11.[10] It further stands to reason that, because other countries similarly were adopting the Model Law, to provide assurances of consistency within that collective effort, creating a discrete and standalone Chapter 15 was most appropriate.

Put differently, because Chapter 15 effectively implemented the Model Law as closely as practicable, it presumably was more efficient to enact a new chapter than to attempt to shoehorn the Model Law provisions into Chapter 11 (and expect other countries to be able to follow suit). Again, the very refined status of Subchapter V's relatively discrete provisions demonstrates that any such drafting challenge has already been proven surmountable in the financial institution insolvency context.

B. Applicability of Chapter 11 Precedent & Practice Norms

I have previously testified that, among the available alternatives, Subchapter V is the best-designed option, both structurally and philosophically, to advance the private and public policies that animate a financial institution reorganization—meaning, 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 an unmitigated financial institution failure.

Among the most critical underpinnings, in my view, are the ready availability of the key protections of Chapter 11. Again, the hallmark of an optimal resolution regime for failing financial institutions must be clear and established rules, administered by an impartial tribunal. Subchapter V is a financial corporation-specific supplement to the existing reorganization provisions of Chapter 11, and builds upon decades of precedent and practice that have refined the Code and otherwise provide a well-tested and proven successful reorganization framework for financial institutions and their creditor constituencies.

Specifically, Subchapter V preserves the status quo applicability of many of the core Chapter 11 protections to financial institution proceedings—including, for instance, the absolute priority rule, plan exclusivity, and debtor-in-possession utilization of

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[9] 11 U.S.C. § 901.

[10] H. REP. NO. 109-31, at 106-07 (2005).

prepetition management and directors and officers. Subchapter V also ensures the applicability of vital Chapter 11 provisions to the more novel provisions of the bill—including, most significantly, the "single point of entry" quick transfer of assets, and limitations on the automatic stay safe harbors for termination of qualified financial contracts.

Perhaps the "catch-all" provisions of S. 1840 and 1841 would be sufficient to ensure that all of these Chapter 11 mainstays are available in a Chapter 14 proceeding. But it seems ill-advised to take even minimal risk of litigation and uncertainty (and the attendant costs to the estate and therefore creditors), when a more straightforward and unambiguously protective approach is directly available through Subchapter V.

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Thank you for allowing me to share my further views. I welcome the opportunity to answer any additional inquiries on these issues.

Sincerely,

Stephen E. Hessler