STATEMENT OF

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BEFORE

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THE COMMITTEE ON THE JUDICIARY

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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. Although we predominantly represent major corporations as company counsel in insolvency matters, my practice also includes representing creditors, equity holders, investors, and other parties in a wide variety of highly complex distressed situations. I have served clients from a range of industries, including financial institutions, energy, telecommunications, gaming, hospitality and real estate, and manufacturing. My cases have included some of the largest and most challenging bankruptcies in history, including Energy Futures Holdings Corporation, Charter Communications, Inc., and Calpine Corporation. I presently am counsel for Patriot Coal Corporation in its Chapter 11 proceedings, which involve 48 debtors and approximately $790 million in funded debt.

Beyond my client representations, I recently 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. I teach a class each fall at the University of Pennsylvania to Law School and Wharton Business School students on distressed investing. And alongside an advisory board of approximately two dozen leading finance principals, professionals, public officials, and academics, I am currently involved in founding a think tank to explore restructuring related issues.

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, most relevantly, how to address most effectively the failure and resolution of systemically important financial institutions ("SIFIs").[1] To that end, I am pleased to appear before this Subcommittee again regarding H.R. ____, the "Financial Institution Bankruptcy Act of 2015," also known colloquially as "Subchapter V," insofar as the legislation proposes to add a new subsection to Chapter 11 to handle a SIFI bankruptcy filing. It was my privilege to testify in July 2014 in favor of the prior iteration of Subchapter V,[2] which was passed by the Judiciary Committee in September 2014 and the House in December 2014. My understanding is Subchapter V is being reintroduced in the House in essentially identical form.

In my previous testimony, I expressed my general support for Subchapter V, subject to limited reservations about certain of the bill's key provisions. Over the past year, Subchapter V has been beneficially amended, and I have devoted further study to

[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 DAILY DEAL (May 21, 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 http://www.federalreserve.gov/SECRS/2011/June/20110607/OP-1418/OP1418_053111_80002_310357154312_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.

I also was a member of a 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] My prior testimony is available at http://judiciary.house.gov/index.cfm/hearings?Id=2CBBB696-44EA-424F-85F7-555A2CDAA3B9%20&Statement_id=C7DF5B14-9571-4675-8EB6-E9F4D56313D7, and is incorporated by reference herein.

the legislation.[3] Accordingly, while I summarize briefly herein my overall views of Subchapter V, the focus of my presentation will be updating and expanding my thoughts on the specific issues about which I previously stated the need for additional analysis.

My testimony is organized as follows. *First*, I will review quickly both how Subchapter V amends Chapter 11 to provide SIFI debtors with certain key incremental reorganization tools designed to address the unique exigencies of a major bank failure—and how Subchapter V leaves undisturbed certain critical existing Chapter 11 protections. *Second*, I will supplement my prior testimony with further examination of three of the most notable features of Subchapter V:

- the "single point of entry" approach to the rapid transfer of a financial corporation's "good" assets to a nondebtor bridge company;
- the limited automatic stay of qualified financial contract counterparty termination rights; and
- the very fast case commencement deadlines and implications for meaningful creditor involvement and judicial review.

Lastly, I will touch upon the comparative benefits of the insolvency resolution regimes at issue, and explain how Subchapter V most effectively incentivizes financial corporation debtor and creditor expectations and actions.

I. Operational Summary

I will begin with a high level description of how Subchapter V works—specifically focusing upon what it adds to Chapter 11, and what it preserves.

[3] *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.

A. Subchapter V—Incremental Tools

1. Quick Transfer of Assets

Perhaps the central feature of Subchapter V is the so-called "single point of entry" ("SPOE") approach that would allow a financial corporation to effect a very fast separation of "good" from "bad" assets. This would occur via the near-immediate postpetition transfer of the debtor's good assets to a nondebtor bridge financial company whose equity is held by a trust that is managed by a special trustee for the benefit of the Chapter 11 estate's creditors. The bad assets subsequently would be liquidated by the debtor within the Chapter 11 cases. And, importantly, both the transfer and liquidation would be subject to Bankruptcy Court approval.[4] (Please note I address SPOE, including criticisms and defenses of the mechanism, in greater detail below.)

2. Experienced Jurists

Importantly, Subchapter V provides that Chapter 11 cases of financial corporations will be administered by an arbiter selected from a pool of at least 10 predetermined experienced Bankruptcy Court judges, within the established practice and precedent of the Bankruptcy Code[5]—instead of Title II's utilization of executive branch officials within a novel, non-judicial process.

As to appellate review, Subchapter V provides "the Chief Justice of the United States shall designate not fewer than 3 judges of the courts of appeals in not fewer than 4 circuits to serve on an appellate panel to be available to hear" financial corporation

[4] Sections 1185, 1186, 1187, 1188, 1189, 1191.

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

appeals.[6] This is a departure from the status quo, which involves Federal District Courts in the jurisdiction where the Chapter 11 case is being administered serving as the initial appellate bodies to review Bankruptcy Court decisions. But given that Chapter 11 debtors already have the right to seek direct appeal of Bankruptcy Court rulings to the relevant Court of Appeals,[7] and given the time-sensitive ruling requirements imposed by Subchapter V (also discussed below), this is, I believe, a relatively limited and justified alteration of current practice.

3. Federal Government Role

As to ability to commence a Chapter 11 case, Subchapter V supplements the Bankruptcy Code to allow the federal government (specifically, the Board of Governors of the Federal Reserve) to file an involuntary petition without the financial corporation's consent.[8] Because regulators already are essentially capable of compelling a financial corporation to commence a voluntary case under the Code, making this ability explicit—and subject to Bankruptcy Court approval—hypothetically could motivate financial corporations to pursue meaningful restructuring options sooner rather than later (though I am skeptical, as described below, that the prospect of an involuntary filing is realistic or helpful).

As to standing, the Bankruptcy Code does not currently provide an expansive grant to the Federal Government to participate in Chapter 11 cases.[9] The Code does give

[6] Section 298(a).

[7] 28 U.S.C. § 158(d)(2).

[8] Section 1183(a)(2).

[9] Section 1109(b) provides "[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

a limited right to be heard to the Securities and Exchange Commission (the "SEC"),[10] 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 advance their public interest mandates in SIFI cases under Chapter 11. Subchapter V appropriately addresses this limitation by providing that the Federal Reserve, the SEC, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation (the "FDIC") "may raise and may appear and be heard on any issue in any case or proceeding under" Subchapter V.[11]

4. Limitation on Automatic Stay Safe Harbors

The Bankruptcy Code presently exempts counterparties to qualified financial contracts (*e.g.*, derivatives, swaps, repos, *etc*.) from Section 362's automatic stay against termination.[12] Thus a Chapter 11 filing by a financial corporation could be plunged into chaos from the start if counterparties terminate and enforce immediately their rights in the debtor's assets. Subchapter V addresses this issue by subjecting qualified financial contracts to the automatic stay—for 48 hours.[13] (On this issue as well, please note I

trustee, may raise and may appear and be heard on any issue in a case under this chapter." 11 U.S.C. § 1109(b).

[10] 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).

[11] Section 1184. Further, section 1192 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." As I have previously noted, a historical analogue to Subchapter V, 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").

[12] 11 U.S.C. § 362.

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

address below at greater length criticisms and defenses of this limited imposition of the automatic stay.)

B. Chapter 11—Preserved Status Quo

Beyond Subchapter V's key amendments, equally important are the core protections of Chapter 11 that Subchapter V does *not* modify.

1. Absolute Priority Rule

The Bankruptcy Code requires debtors to comply with the absolute priority rule, which generally mandates 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.[14] Unlike Title II, which provides that similarly situated creditors may receive dissimilar treatment,[15] 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.

2. Exclusivity

Subchapter V likewise does not alter a debtor's exclusive right under section 1121 to file a plan of reorganization.[16] This means the Federal Reserve, the FDIC, and all other regulators to which Subchapter V confers standing,[17] like all parties in interest, would have the right to file a motion to terminate exclusivity for "cause,"[18] but the

[14] *See* 11 U.S.C. § 1129.

[15] 12 U.S.C. § 5390(b)(4)(B).

[16] 11 U.S.C. § 1121. Subchapter V does 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)(1)(A).

[17] Section 1184.

[18] 11 U.S.C. § 1121.

Federal Government appropriately must first obtain Bankruptcy Court permission before abrogating a debtor's prerogatives on these fundamental restructuring decisions.

3. Management/Directors & Officers

In my experience as Chapter 11 company counsel, the knowledge, expertise, and commitment of management and directors and officers are indispensable to effectuating a debtor's soft landing into, and orderly passage through, bankruptcy. Chapter 11 embodies the concept of a "debtor in possession" retaining the ability to manage its businesses post-petition[19]—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 involve or lead to a Chapter 11 filing.

Subchapter V, unlike Title II,[20] exercises appropriate (and admirable) restraint in not vilifying, much less outright disqualifying, a financial corporation's existing

[19] 11 U.S.C. §§ 1107, 1108.

[20] 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). 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 date. 12 U.S.C. § 5390(s). 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).

leadership from continuing to serve the debtor in possession[21]—subject to already applicable Bankruptcy Code grounds for penalty as merited.[22]

II. Further Examination of Key Provisions

Again, in my July 2014 testimony, I stated that, while I was overall very supportive of Subchapter V, there were certain issues about which I had reservations and that deserved additional careful consideration. The following are my further revised views on these issues.

A. Single Point of Entry

At the heart of Subchapter V is SPOE, the most significant restructuring mechanism in the bill. Although I described briefly above the aims of SPOE, before addressing why the approach is justified given the special circumstances of a SIFI failure, it is helpful to set forth more fully the details of the asset transfer process.

- At the request of the debtor or the Federal Reserve, after notice and a hearing that shall occur not less than 24 hours after commencement of the case, the Bankruptcy Court may order the transfer of estate property and the assignment of executory contracts, unexpired leases, and qualified financial contracts to a bridge company. The transfer and assignment shall be subject to approval under sections 363 and 365 of the Bankruptcy Code and, upon transfer, these assets shall no longer be property of the estate.[23]

[21] The only incremental requirements that Subchapter V appears to establish on this front are: (a) 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 (b) 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).

[22] If the leadership of a Chapter 11 debtor (including a financial corporation) has acted in a manner that justifies its removal, the Bankruptcy Code already provides ample tools for doing so. *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").

[23] Section 1185(a).

  - Although the text of Subchapter V only specifies that the transfer determination hearing cannot be held within the first 24 hours of the case, the expectation is it will occur within the first 48 hours.[24]

- There shall be not less than 24 hours' notice of the transfer hearing provided to: the debtor; creditors holding the 20 largest secured claims; creditors holding the 20 largest unsecured claims; counterparties to any debt, executory contract, unexpired lease, and qualified financial contract to be transferred; and various regulatory and other governmental entities.[25]

- To authorize the transfer, the Bankruptcy Court must find, by a preponderance of the evidence:

  - the transfer is "necessary to prevent serious adverse effects on financial stability in the United States";

  - the transfer does not provide for assumption by the bridge company of any of the financial corporation's property that is subject to a lien—including secured debt, executory contracts, and unexpired leases—*unless* the bridge company assumes the relevant obligations subject to the applicable lien, *and* the Bankruptcy Court determines such assumption is in the best interests of the estate—*or* such property is transferred to the bridge company in accordance with section 363 (which allows chapter 11 debtors to sell estate property free and clear of prepetition liens);

  - the transfer does not provide for assumption by the bridge company of any of the financial corporation's unsecured debt;

  - the transfer does not provide for transfer to the bridge company of the equity interests in the debtor (*i.e.*, the parent holding company);

  - the party requesting the transfer has demonstrated the feasibility of the bridge company upon receipt of the transferred assets and obligations; and

  - the requested transfer of estate assets and obligations to the bridge company also provides for the appointment of, and transfer to, a special trustee of all of the equity interests in the bridge company—and that adequate provision has been made for payment

[24] *See* H.R. Rep. No. 113-630, at 4 & n.12 (2014) (stating SPOE "allows the debtor holding company that sits atop the financial firm's corporate structure to transfer its assets, including the equity in all of its operating subsidiaries, to a newly-formed bridge company over a single weekend" because "[g]iven the sensitivity of banking relationships and the financial marketplace, practicalities dictate that this transfer must be performed over the course of a period when the financial markets are not open.").

[25] Section 1185(b).

> of the expenses of the special trustee and requisite corporate governance of the bridge company.[26]

The most salient criticisms of SPOE are, in my view, fairly characterized as: a hearing to authorize the transfer, and the actual transfer, of the most valuable estate assets within hours 24 to 48 of a SIFI chapter 11 filing, after notice to a relatively limited number of secured and unsecured creditors (and regulators), is contrary to prevailing Bankruptcy Code norms of due process, transparency, and inclusiveness. While these points are not without some merit, they must be considered, and thus mitigated, within proper context.

First, as a threshold matter, to the extent SPOE may be an atypical Chapter 11 mechanism, SIFIs have corporate structures that do not comport with the conventional bankruptcy practice of filing the parent holding company and all operating subsidiaries (most often because all members of the corporate family are obligors or guarantors on funded debt issuances). Importantly, many SIFI operating subsidiaries, such as insurance companies and banks, are not eligible to file for Chapter 11 protection—and for the other operating subsidiaries that may file, some are permitted only to liquidate in a proceeding administered by a trustee.[27] In other words, SPOE actually accommodates the unusual structural issues that otherwise could preclude SIFIs from obtaining effective access to Chapter 11 at all.

[26] Section 1185(c).

[27] *Exploring Chapter 11 Reform: Corporate and Financial Institution Insolvencies; Treatment of Derivatives Hearing Before the Subcomm. on Regulatory Reform, Commercial & Antitrust Law of the H. Comm. on Judiciary*, 113th Cong. 51, at 51 (2014) (Testimony of Jane Vris); *see also* Skeel, David A., *Single Point of Entry and the Bankruptcy Alternative*, at 2 (2014), available at http://scholarship.law.upenn.edu/faculty_scholarship/949.

Second, while the discrete steps of SPOE itself would be a novel addition to Chapter 11, the transfer determination, and its most significant consequences, are themselves subject to the safeguards of Bankruptcy Court authorization, applying well-established Chapter 11 legal principles. More specifically:

- the provisions of section 363 and 365 shall apply to a transfer of estate property and the assignment of executory contracts, unexpired leases, and qualified financial contracts;[28]
- the bridge company must obtain Bankruptcy Court approval of its governing documents,[29] including the agreement governing the trust;[30] and
- perhaps most critically, the ultimate distribution of the trust assets (including the equity in the bridge company) shall be done in accordance with otherwise governing Chapter 11 plan of reorganization confirmation requirements and protections.[31]

Third, as a practical matter, while the adoption of Subchapter V would formalize SPOE within the Bankruptcy Code, arguably substantively similar versions of the approach are already being employed by debtors (and approved by Bankruptcy Courts) in the very fast "melting ice cube" asset sales occurring under section 363 of the Bankruptcy Code—including, most notably for present purposes, in the sale of most of Lehman's operations within less than a week after its petition date.[32] To acknowledge the obvious, transferring substantially all of a debtor's valuable operations within 48 hours is a

[28] Section 1185(a).

[29] Section 1185(c)(9).

[30] Section 1186(a)(1).

[31] Section 1186(c)(1).

[32] *See also* Skeel, *supra,* at 15 (noting SPOE "bears a striking resemblance to the transactions that were used to bail out and restructure Chrysler and General Motors in 2009. In each case, the company filed for bankruptcy at the behest of the US government and promptly transferred nearly all of its assets and many (but not all) of its liabilities to a newly created entity. The claims that were transferred, such as employee health care obligations and the companies' trade debt, were paid in full, while many of the creditors left behind received only a fraction of what they were owed.").

significantly more accelerated timeframe than the standard (yet also fast) 45-90 days. But the need to do so is warranted by the unusually fragile nature of the operating assets, and the dire potential that counterparties will not continue to transact with the operating subsidiaries unless they are immediately and safely situated within the non-debtor bridge company.

Lastly, from the perspective of stakeholder expectations, the treatments resulting from SPOE are essentially consistent with existing Chapter 11 practices.

- For secured creditors, the bridge company shall assume their debt subject to existing liens, unless the Bankruptcy Court authorizes the transfer of their collateral free and clear of these encumbrances under section 363—with secured creditors receiving senior claims to be satisfied by the Chapter 11 estate (again, which is the beneficiary of the economic value of the equity interests in the bridge company held by the trust).

- For unsecured debt holders, their claims shall remain against the Chapter 11 estate, insofar as the bridge company cannot assume unsecured debt—but these creditors never had a security interest in the collateral being transferred, and thus always bore the risk of a subordinated recovery against the proceeds of sold assets.

- And while equity interests in the financial corporation holding company also cannot be transferred to the bridge company, and are very likely to be discharged with no recovery against the estate, this is very much a typical Chapter 11 outcome, and in line with conventional corporate finance principles of equity interests being the first layer of loss-bearing capacity in the event of a bankruptcy.

In sum, SPOE is an insolvency mechanism carefully designed as a targeted response to the unique corporate structures of financial corporations, yet still governed by well-established Chapter 11 principles, and codifying existing section 363 practices (while providing helpful definition around the same), in accordance with typical treatments of senior and junior stakeholders.

B. Qualified Financial Contracts

As a general rule, upon a debtor commencing a Chapter 11 case, contract counterparties are automatically stayed from terminating their agreements and engaging in self-help remedies against estate assets.[33] The Bankruptcy Code, however, currently provides that counterparties to qualified financial contracts (such as derivatives, repos, swaps, *etc*.) enjoy a "safe harbor" from the automatic stay.[34] Consequently, a Chapter 11 filing by a financial corporation with significant qualified financial contracts could be problematically tumultuous at the outset as counterparties, not subject to the automatic stay, proceed to terminate and enforce their rights in the debtor's assets.

Subchapter V addresses this potential problem by precluding access to the qualified financial contract safe harbors from the automatic stay for 48 hours after commencement of the case[35]—consistent with the time period under section 1185 for effecting the transfer of subsidiary operating assets (including qualified financial contracts) to the bridge company.[36]

I have previously criticized Title II for imposing too brief a stay, until only 5:00 p.m. ET 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.[37] The first of my two primary concerns is that Title II provides too much discretion to the FDIC to pick winners and losers, by determining

[33] 11 U.S.C. § 365(e)(1).

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

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

[36] Section 1185.

[37] 12 U.S.C. § 5390(c)(10)(B)(i)(I).

which counterparties will have their qualified financial contracts transferred to the solvent bridge company (thus maintaining the full economic benefits of the agreement), and which will remain with the insolvent debtor estate (thus ensuring only the liquidation value of their claims).

Subchapter V, by contrast, provides that the debtor or the Federal Reserve may request the transfer of estate property, including qualified financial contracts to be assumed, to a bridge company, and this request is subject to Bankruptcy Court approval.[38] Because the debtor is at least co-equally involved in those decisions, and because those decisions must be authorized by the Bankruptcy Court, the unchecked regulatory discretion in Title II is not present in Subchapter V.

My second key concern is whether it is commercially viable to require a debtor (and/or the Federal Reserve) to make transfer and assignment decisions about a financial corporation's entire book of qualified financial contracts essentially immediately upon a filing. For the following reasons, however, I am persuaded that Subchapter V proposes a workable construct on this front.

- Since passage of the Dodd-Frank Act in 2010, financial corporations have had five years to draft and refine their "living wills." Ideally the enactment of Subchapter V would reinforce the need to be prepared to make expedited qualified financial contract transfer and assignment decisions.[39]

- Subchapter V requires that decisions on whether to transfer and assign all of the debtor financial corporation's assets—expressly including qualified financial contracts[40]—must be made within 48 hours. It logically follows that 48 hours is a sufficient period to stay qualified financial contract

[38] Section 1185(a).

[39] *Cf.* Arantxa Jarque & David A. Price, *Living Wills: A Tool for Curbing "Too Big to Fail,"* at 9-11, in 2014 Annual Report, Fed. Reserve Bank of Richmond (2014).

[40] Section 1185(a).

counterparties from taking remedial actions that would interfere with these determinations.

- The implicit expectation of Subchapter V is that essentially all qualified financial contracts will be transferred to the bridge company, insofar as the bill requires that "all qualified contracts between [a counterparty] and the debtor are assigned to and assumed by the bridge company."[41] In other words, Subchapter V precludes "against 'cherry picking' transfers of only a select number of" qualified financial contracts, thus reducing the burden of having to make transfer determinations for every individual agreement.[42]

- Again, the most likely alternative to a Subchapter V case, Title II, proposes a shorter stay than 48 hours—and Chapter 11, without Subchapter V, provides for no stay at all on qualified financial contract counterparty termination. Accordingly, Subchapter V's 48-hour stay is actually the most robust option under the current and potential SIFI insolvency regimes at issue.

C. Commencement Deadlines & Judicial Review

If a financial corporation files a voluntary Subchapter V petition, or consents to an involuntary filing by the Federal Reserve, the case commences immediately.[43] If, on the other hand, the financial corporation does not consent to an involuntary filing by the Federal Reserve:

- The Bankruptcy Court shall hold a hearing within 16 hours of the petition filing, with notice only to the debtor and the FDIC, the Office of the Comptroller of the Currency, and the Secretary of the Treasury—and records of the proceedings may, upon request, be sealed.[44]

- The Bankruptcy Court must rule on the Federal Reserve's involuntary petition within 18 hours after filing—or within two hours after the hearing must start.[45]

[41] Section 1188(c).

[42] H.R. Rep. No. 113-630, at 15.

[43] Section 1183(a)(1)-(2).

[44] Section 1183(b).

[45] Section 1183(c).

- The debtor or Federal Reserve may appeal the Bankruptcy Court's ruling, within one hour after entry.[46]
- The appellate panel must hear the appeal within 12 hours of the notice being filed, and rule on the appeal within 14 hours of the notice being filed—or within two hours after the appellate hearing must start—and the standard of review shall be abuse of discretion.[47]

In sum, in a contested involuntary Subchapter V filing, the duration from notice of commencement to final ruling on appeal appears to be no more than 33 hours.

As I stated in my prior testimony, these are highly compressed time periods, with atypical sealing provisions and limited judicial review, and the provisions depart meaningfully from standard Bankruptcy Code principles of due process and transparency. These proposed measures arguably are justified by the fragile nature of the financial corporation's assets, their inability to withstand the prolonged public scrutiny inherent in most Chapter 11 cases, and the need to situate the operating subsidiaries outside of the Bankruptcy Court's jurisdiction quickly enough to convince counterparties to continue to transact with the financial corporation.

But for the following reasons, the involuntary filing provisions of Subchapter V—and the potential 33-hour commencement/litigation/appeal time period—are, on balance, an unhelpful distraction, and I support removing them entirely. Most significantly, regulators already have myriad methods of effectively requiring that a financial company commence a voluntary case under the Bankruptcy Code. And even if Subchapter V obtains final passage in its current form, it is exceedingly unlikely there would ever be an involuntary case.

[46] Section 1183(d)(1).

[47] Section 1183(d)(2). The Bankruptcy Court hearing on the debtor or Federal Reserve section 1185 transfer motion shall not be delayed pending determination of the appeal. Section 1183(d)(3).

Although, under existing law, involuntary Chapter 11 cases can be initiated by under- or unsecured creditors in limited circumstances,[48] they are rare in the context of major corporations. Debtors are often effectively forced into commencing Chapter 11, albeit voluntarily, because of funded debt maturity or interest payment deadlines that, if unsatisfied, shall give rise to creditors' rights to foreclose on collateral or trigger a cascading series of cross-defaults. Accordingly, as this day of reckoning approaches, an insolvent corporation will already be in negotiations with its key creditor constituencies over the timing and necessity of a potential filing—and it will be highly motivated to file a voluntary case before a third party is able to commence an involuntary proceeding.

I assume the same dynamic will be present in the context of distressed financial corporations and the Federal Reserve (among other regulators and counterparties)—meaning, it seems incredibly unlikely a SIFI would be thrust suddenly and previously unaware into a 33-hour window to defend its viability or undergo a Chapter 11 case. And Subchapter V acknowledges this commercial reality, by requiring:

> Counsel to the debtor or the [Federal Reserve] shall provide, to the greatest extent practicable, sufficient confidential notice to the Office of Court Services of the Administrative Office of the United States Courts regarding the potential commencement of a subchapter V case without disclosing the identity of the potential debtor in order to allow such office to randomly designate and ensure the ready availability of one of the bankruptcy judges designated under section 298(b)(1) of title 28 to be available to preside over such subchapter V case.[49]

In my experience as debtors' counsel, these discussions about the path of a potential, voluntary Chapter 11 case—among the company, its largest creditors, regulators, and

[48] 11 U.S.C. § 303.

[49] Section 1183(f).

other key parties in interest—almost always are already actively underway well in advance of the petition date.

Given this well-established practice of prepetition coordination, I expect the prelude to a Subchapter V case would occur similarly. And thus the prospect of an involuntary case (and a 33-hour multi-stage litigation) is less likely than a relatively planned voluntary filing by a financial corporation seeking to stay ahead of its regulators and ensure control of its insolvency resolution proceeding.

III. Insolvency Resolution Regimes & Comparative Benefits

In closing, I offer a few quick parting thoughts. The touchstone analytical framework for evaluating Subchapter V should not be as a standalone proposal, but rather Subchapter V as compared to the other SIFI insolvency resolution regimes at issue—namely, Chapter 11 in its current form, Chapter 11 as amended by Subchapter V, and Title II. As I have testified previously, among the prevailing alternatives, Subchapter V is the best-designed option, both structurally and philosophically, to advance the private and public policies that animate the reorganization of a financial corporation. In other words, 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 SIFI. To further explain, I will assess briefly and at a high level the incentives that Subchapter V provides for debtors and creditors.[50]

[50] *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

A. Debtor Incentives

From my debtors' counsel perspective, one of the most critical components of a successful major corporation restructuring is to motivate directors and officers to confront their problems as early as practicable and to pursue diligently all viable restructuring options. Contrary to this goal is Title II's requirement that, upon placement of the financial company into receivership, all directors and officers shall be dismissed, potentially subject to clawback of compensation, and possibly banned from future industry employment.[51] 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.

Subchapter V's express 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.[52]

B. Creditor Incentives

Pivoting to the creditor perspective, 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 the Dodd-Frank Act results when creditors are incentivized to make risky loans because governing

government support. If we can make unassisted failures manageable, policymakers could credibly commit to foregoing rescues, thereby improving private sector incentives.

[51] *See supra* note 20.

[52] Again, this is not to say that management should be shielded from liability for misdeeds—but the Bankruptcy Code already provides various powers to remove a Chapter 11 debtor's leadership as justified. *See supra* note 22.

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 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],"[53] it does (arguably) follow that public dollars will not be used to "bail out" a failing financial company. 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.

Title II expressly authorizes the dissimilar treatment of similarly situated creditors.[54] And because any excess costs of liquidation will be funded by assessments on third-party financial companies,[55] 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.

The hallmark of an optimal resolution regime for failing SIFIs must be clear and established rules, administered by an impartial tribunal. To that end, Subchapter V is a financial corporation-specific supplement to the existing reorganization provisions of Chapter 11 of the Bankruptcy Code. Subchapter V builds upon the decades of practice and precedent that have refined the Code and that otherwise provide a well-tested, and

[53] 12 U.S.C. § 5394(a).

[54] 12 U.S.C. § 5390(b)(4).

[55] 12 U.S.C. § 5390(o)(1)(B).

proven successful, reorganization framework for major corporations, including SIFIs, and their creditor constituencies.

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In sum, Subchapter V does not directly preclude or supplant the potential applicability of Title II. Critically, however, by design and operation, the availability of Subchapter V will make it far less likely that Title II ever will be invoked.

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.