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Written Testimony of

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in Business Bankruptcy Law

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Judiciaryôs Subcommittee on Regulatory Reform, Commercial and Antitrust Law

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Witness Background Statement

Bruce Grohsgal is the Helen S. Balick Visiting Professor in Business Bankruptcy Law at Widener University, Delaware Law School, where he teaches bankruptcy, secured transactions, contracts, and financial regulation, and is a member of the Institute of Delaware Corporate and Business Law.

Prior to joining the Delaware Law School faculty in 2014, Professor Grohsgal was a partner in the Wilmington, Delaware office of Pachulski Stang Ziehl & Jones, LLP. Until 2000, he was a partner at Wolf Block LLP. He has represented numerous debtors, committees, trustees and other parties in Chapter 11 business bankruptcy cases.

Professor Grohsgal served as Chair of the Bankruptcy Section of the Delaware State Bar Association from 2008-2009. He was a Senior Fellow at Americans for Financial Reform, Washington, D.C. from October 2012 to January 2013.

Professor Grohsgalôs recent publications include: *Case in Brief against Chapter 14*, American Bankruptcy Institute Journal, Vol. XXXIII, No. 5, May 2014, also available at Harvard Law School Business Bankruptcy Roundtable, June 17, 2014, http://blogs.law.harvard.edu/bankruptcyroundtable/page/3/; *Why Recent SPOE Bills for SIFIs Fail*, American Bankruptcy Institute Journal, Vol. XXXIII, No. 12, December 2014; *Colder Than a Landlord's Heart? Reconciling a Debtor's Authority to Sell Property Free and Clear of a Lease under Bankruptcy Code Section 363(f) with the Tenant's Right to Remain in Possession on a Lease Rejection under Section 365(h)*, 100 Marquette L. Rev. 295 (2016), available at SSRN-id2845369, forthcoming in print, March 2017; and *How Absolute is the Absolute Priority Rule in Bankruptcy? The Case for Structured Dismissals*, 8 Wm. & Mary Bus. L. Rev. (2017), available at SSRN-id2845430, forthcoming in print, April 2017.

Professor Grohsgal received his J.D. in 1980 from Columbia University School of Law in 1980, and his B.A. in 1977 from Brandeis University.

Professor Grohsgal has not received any federal grants or other compensation in connection with his testimony, and is not testifying on behalf of any organization. The views expressed in his testimony are solely his own.

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Chairman Goodlatte, Ranking Member Conyers, Members of the Subcommittee:

Good morning. Thank you for inviting me to testify today on the ñFinancial Institution Bankruptcy Act of 2017.ò I am a Professor of Law at Delaware Law School, where I teach courses on bankruptcy, secured transactions, contracts, and financial regulation. Prior to joining the faculty, I practiced law for more than thirty years, for most of that time as a business bankruptcy lawyer representing debtors, committees and trustees in Chapter 11 cases.

I am here today solely as an ordinary citizen and an academic. I am not testifying on behalf of any regulated entity or other organization, and have no financial interest connected with the proposed legislation.

I. Introduction – Single Point of Entry and the "Financial Institution Bankruptcy Act of 2017" ("FIBA")

The goal of the ñFinancial Institution Bankruptcy Act of 2017ò or FIBA is to facilitate the swift and transparent resolution of a distressed financial institution under the Bankruptcy Code.[1]

FIBA would accomplish this through a new Subchapter V of the Code that envisions a ñsingle point of entryò strategy to a financial institutionôs resolution. In a single point of entry bankruptcy, the bank holding company or other top-tier parent entity of the distressed financial institution would commence its bankruptcy case. The debtorôs U.S. and foreign operating subsidiaries, by contrast, would not commence bankruptcy

[1] I have been informed in connection with my invitation to testify before the Subcommittee that the sponsors of the ñFinancial Institution Bankruptcy Act of 2017,ò or FIBA, intend to introduce the bill shortly after the deadline for submission of this written testimony, and that the bill will be nearly identical to the ñFinancial Institution Bankruptcy Act of 2016,ò H.R. 2947, which was introduced on April 13, 2016. Based on this information and assumption, my comments set forth in this written testimony are based on what I am informed is the nearly identical text of H.R. 2947, and section references are to the section numbers of H.R. 2947.

cases under U.S. or other law, but would continue to operate outside of bankruptcy. The top-tier parent that filed for bankruptcy would then promptly transfer the equity in its solvent subsidiaries and certain other assets to a newly-formed bridge company, leaving many liabilities behind in the bankruptcy estate. The bridge company, as transferee of the financial institutionôs ñgoodò assets and a stronger balance sheet, would immediately commence operations.

An essential goal of FIBA is to create a framework within which a complex, distressed financial institution and its many subsidiaries can be resolved through the bankruptcy process without posing a systemic risk to the broader financial system and without the need for governmental intervention or funding. FIBA recognizes that the current Bankruptcy Code is not optimally designed for the orderly resolution of a large financial institution in a manner that mitigates such risk. First, as a result of ñsafe harborsò enacted with respect to many kinds of financial contracts over the past several decades, the Bankruptcy Code does not stay the counterparties to financial contracts, such as repurchase agreements and derivatives, from exercising their pre-bankruptcy contractual rights to liquidate their collateral and positions.[2] Thus, runs are encouraged, rather than stayed, on these financial contracts and on any property that the debtor posted as collateral to back its obligations under them. Second, the mitigation of systemic risk is not one of the purposes of bankruptcy law that a bankruptcy judge must consider in deciding a motion or other matter in a bankruptcy case.[3]

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[2] The automatic stay is set forth in Bankruptcy Code section 362(a). 11 U.S.C. § 362(a). The counterparties to repurchase agreements, derivatives, and other financial contracts are exempted from the automatic stay by the ñsafe harborsò set forth in the Bankruptcy Code, at 11 U.S.C. §§ 362(b)(6), (7), (17) and (27), and 362(o).

[3] The purposes of Chapter 11 are maximize the value of the bankruptcy estate and the distributions to creditors, *Fla. Dep't of Revenue v. Piccadilly Cafeterias*, 554 U.S. 33, 51 (2008), to preserve businesses *Bank of Am. v. 203 N. LaSalle St. P'ship*, 526 U.S. 434, 453 (1999) (Section 1129(b)(2)(B)(ii) of the Bankruptcy Code is ñintended to reconcile the two recognized policies underlying Chapter 11, of preserving going concerns and maximizing property available to satisfy creditors.ò); *Commodity Futures Trading Com'n v. Weintraub*, 471 U.S. 343, 352ï 53 (the trustee ñhas the duty to maximize the value of the estate,ò ñan important goal of the bankruptcy lawsò); *Kothe v. R.C. Taylor Tr.*, 280 U.S. 224, 227 (1930) (ñThe broad purpose of the Bankruptcy Act is to bring about an equitable distribution of the

A key provision of FIBA aimed at containing the contagion of a financial panic is an amendment to the Bankruptcy Code that would provide for a 48-hour stay of counterpartiesô actions under ñqualified financial contracts,ò such as repurchase agreements and derivatives. The 48-hour stay under FIBA would remain in effect only so long as the debtor or its affiliate performed its payment and delivery obligations coming due post-bankruptcy under each financial contract. [4]

The theory behind this 48-hour stay, in conjunction with other FIBA provisions, is to enable the top-tier debtor financial institution to transfer the equity in its solvent subsidiaries and its other assets to a newly-formed bridge company. Under this approach, insolvent subsidiaries and unsecured debt, such as trade debt, will be left behind in the bankruptcy estate. The bridge company thus will be freed from many of the debtorôs liabilities, and presumably will have a stronger balance sheet against which it can obtain new financing, making governmental intervention and a taxpayer bailout less likely. The bridge company, upon completion of the transfers to it pursuant to FIBA, will immediately commence operations, without further bankruptcy court supervision.

FIBA would further attempt to mitigate risk to the financial system by expressly providing that the bankrupt financial institutionôs key regulators are parties in interest, with standing to be heard in the case. Accordingly, those regulators can advocate before the bankruptcy court for outcomes that might stem a financial panic and otherwise mitigate systemic risk.

Finally, FIBA addresses systemic risk by expressly authorizing the bankruptcy judge to take into account the extent to which her or his decision on a motion in

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bankruptôs estate among creditors holding just demands based upon adequate consideration. Any agreement which tends to defeat that beneficent design must be regarded with disfavor.ò).

[4] FIBA § 1188. The financial contracts covered by the 48-hour stay and the other special provisions of FIBA are defined in FIBA as ñqualified financial contracts,ò incorporating by reference the Bankruptcy Codeôs definitions of repurchase agreements, swaps, forward contracts, securities contracts, commodities contracts, and similar financial contracts and related agreements. FIBA § 1182(5).

Subchapter V, including the motion to make the transfers to the bridge company, would affect the financial stability of the United States. This requirement that the bankruptcy judge in a Subchapter V case must seek to mitigate systemic risk apparently is in addition to the other, established purposes of a Chapter 11 bankruptcy case must consider in deciding motions and other matters in the case.[5]

FIBA works in conjunction with, and does not repeal the ñliving willsò mandate of Title I of the Dodd-Frank Act. Title I requires each large financial company to file with the regulators a ñliving willò that provides for its ñrapid and orderly resolutionò under the Bankruptcy Code in the event of its material distress or failure.[6]

FIBA also works in conjunction with, and does not repeal the orderly resolution authority of Title II of the Dodd-Frank Act. Under Title II of Dodd-Frank, U.S. financial regulators have the power to put a large, failing financial institution into a Federal Deposit Insurance Corp. (FDIC) receivership,[7] for the purpose of selling the business or assets of the financial institution. [8] A Title II receivership may be commenced only if the financial institution is in default or in danger of default, its failure would have serious adverse effects on the financial stability of the U.S., neither a private sector alternative nor a bankruptcy case is appropriate, and the receivership would mitigate the adverse effects of the default.[9]

The purpose of the Dodd-Frank Title II resolution authority is ñto provide the necessary authority to liquidate failing financial companies that pose a significant risk to the financial stability of the United States in a manner that mitigates such risk and minimizes moral hazard.ò[10]

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[5] See note 3, *supra*.
[6] 12 U.S.C. § 5365(a)(1), (d)(1) and (d)(4).
[7] 12 U.S.C. § 5382(a).
[8] 12 U.S.C. § 5384(a).
[9] 12 U.S.C. § 5383(a).
[10] 12 U.S.C. § 5384(a).

The ñsingle point of entryò approach advanced by FIBA follows the FDICôs preferred strategy for resolving a distressed financial institution under Title II of the Dodd-Frank Act.[11] The FDIC opted for the single point of entry strategy for a Title II orderly resolution proceeding on the theory that this approach would minimize the risk posed to the financial system by the failure of a systemically important financial institution, because the bankruptcy would be confined to the holding company and ñwould not trigger the need for resolution or bankruptcy across the operating subsidiaries, multiple business lines, or various sovereign jurisdictions.ò[12]

Dodd-Frank recognizes that an orderly resolution through a receivership under Title II is a last, if crucial, resort for a failing financial institution. An orderly resolution proceeding cannot be commenced unless a bankruptcy case will not resolve the failing financial institution in a manner that does not pose systemic risk.[13] The preferred approach under Dodd-Frank is a bankruptcy case that resolves the financial institution in a manner that does not imperil the financial system,[14] and does not require a taxpayer bailout.[15] The single point of entry approach proposed by the FDIC for a Title II receivership also became a blueprint for the resolution of a large financial institution in a Chapter 11 bankruptcy proceeding. It is not surprising therefore, that seven of the eight largest systemically important U.S. banking institutions have adopted a single point of entry strategy under their Title I living wills for their resolution in Chapter 11 of the Bankruptcy Code.[16]

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[11] Resolution of Systemically Important Financial Institutions: The Single Point of Entry Strategy, 78 Fed. Reg. 76,614 (Dec. 18, 2013).

[12] Resolution of Systemically Important Financial Institutions: The Single Point of Entry Strategy, 78 Fed. Reg. at 76,623.

[13] 12 U.S.C. § 5383(a).

[14] 12 U.S.C. § 5383 (a)(2)(F) and (b)(2).

[15] 12 U.S.C. § 5394(a) (ñAll financial companies put into receivership under this subchapter [Dodd-Frank Title II] shall be liquidated. No taxpayer funds shall be used to prevent the liquidation of any financial company under this subchapter.ò

[16] Paul L. Lee, ñA Paradigmôs Progress: The Single Point of Entry in Bank Resolution Planning,ò The CLS Blue Sky Blog (January 18, 2017), available at http://clsbluesky.law.columbia.edu/2017/01/18/a-paradigms-progress-the-single-point-of-entry-in-bank-resolution-planning/.

Dodd-Frank also contemplated amendments to the Bankruptcy Code that encourage the successful resolution of large financial institutions in Chapter 11, rather than Title II. Section 216 of Dodd-Frank required a study of whether amendments should be made to the Bankruptcy Code that would enhance the Codeôs ability to resolve financial companies in a manner that would minimize adverse effects on financial markets without creating moral hazard, and would address the manner in which qualified financial contracts, such as repurchase agreements and derivatives, are treated. Section 216 of Dodd-Frank also contemplated the creation of a new chapter or subchapter of the Bankruptcy Code to deal with financial institutions.[17]

In light of the foregoing, my testimony focuses on the extent to which FIBA reduces moral hazard, mitigates systemic risk, and decreases the likelihood of a taxpayer or other governmental bailout. I conclude that FIBA does not further these goals in several material respects. Rather, certain of key provisions of FIBA encourage moral hazard, increase systemic risk, and make more likely a taxpayer bailout with respect to the failure of a systemically important financial institution. Accordingly, I urge at the very least certain revisions to the proposed legislation without which, I argue, FIBA should not be passed.

II. Analysis of FIBA

A. Analysis

1. FIBA Increases Moral Hazard in the Financial Sector by Absolving Directors from Liability

FIBA expressly provides that directors of a failing financial institution shall have ñno liability to shareholders, creditors, or other parties in interest,ò such as the financial

[17] Dodd-Frank Act § 216(a)(2)(C), (D), and (E).

institutionôs regulators, for any ñreasonable actionò taken by those directors in ñgood faith in contemplation of or in connection withò a Subchapter V filing under the Bankruptcy Code or the transfers to the bridge company. This ñno liabilityò safe harbor for the directors of a failing financial institution, which exists nowhere in the Bankruptcy Code for the directors of other kinds of companies, increases rather than reduces moral hazard.

Moral hazard was a causal factor in the failure of many large financial institutions that resulted in the financial crisis of 2009. Moral hazard is, simply, a lack of incentive to guard against risk where one will not be held accountable for the resulting harm. Dodd-Frank recognized the need for some accountability for directors and officers of financial institutions, whose improvidence can result in a failure that is so cataclysmic that the financial system and the greater economy are damaged. Reducing moral hazard is a fundamental purpose of the resolution authority of Dodd-Frank.[18]

Several provisions of Dodd-Frank are specifically aimed at holding responsible the directors and executive officers whose actions may have led to a financial institutionôs failure. Section 210(s)(1) expressly provides that the FDIC as receiver in a Title II orderly resolution proceeding ñmay recover from any current or former senior executive or director substantially responsible for the failed condition of the covered financial company any compensation received during the 2-year period preceding the date on which the Corporation was appointed as the receiver of the covered financial company, except that, in the case of fraud, no time limit shall apply.ò[19] Section 210(s)(3) requires the FDIC to promulgate regulations to implement the requirements of section 210(s), ñincluding defining the term ócompensationô to mean any financial remuneration, including salary, bonuses, incentives, benefits, severance, deferred compensation, or

[18] 12 U.S.C. § 5384(a).
[19] 12 U.S.C. § 5390(s)(1).

golden parachute benefits, and any profits realized from the sale of the securities of the covered financial company.ò[20]

Congress in Dodd-Frank Title II departed from the great deference given in corporate law to the business judgment of directors and officers who act in ñgood faith.ò The term ñgood faithò has a special meaning in corporate governance law. Under the business judgment rule, directors cannot be held liable, even if they acted negligently and caused harm, unless they acted or failed to act in ñgood faith.ò A directorôs obligation to act in good faith and thus be insulated from liability is satisfied by the directorôs having a loyal state of mind and the absence of a selfish interest to injure the corporation. The purpose of this deference is to encourage directors to take risks for the purpose of seeking profits for the benefit of the corporation and its shareholders.[21]

Dodd-Frank does not give this capacious deference to the managers of a failed financial institution. Some of its key provisions take aim at moral hazard by holding directors and executive officers more accountable for their actions. Dodd-Frank § 210(s) says nothing of ñgood faith,ò and reflects Congressô decision to minimize moral hazard in the financial sector by authorizing the FDIC as a receiver in Title II to claw back the compensation of directors who were substantially responsible for the failure of a financial institution. The Bankruptcy Code currently uses the term ñgood faithò in several very different contexts, none of which limit directorsô liability for their actions, e.g., a debtor in possessionôs reorganization plan must be proposed in ñgood faith and not by any means forbidden by law,ò or the bankruptcy court cannot confirm it.[22] Significantly, the Bankruptcy Code currently contains no special protections that insulate directors and officers from responsibility for their actions taken either prior to or after the filing of the bankruptcy petition, whether or not those actions were taken in ñgood faith.ò

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[20] 12 U.S.C. § 5390(s)(3).
[21] *See e.g.*, Leo E. Strine, Jr., Lawrence A. Hamermesh, R. Franklin Balotti and Jeffrey M. Gorris, *Loyalty's Core Demand: The Defining Role of Good Faith in Corporation Law*, 98 Geo. L.J. 629 (March. 2010).
[22] 11 U.S.C. § 1129(a)(3).

The proposed Subchapter V creates this special protection for directors of a failed financial institution by providing that:

> (c) 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 a transfer under section 1185 or section 1186, whether prior to or after commencement of the case*. (emphasis supplied).[23]

The scope of this provision clearly includes pre-bankruptcy transfers of assets (including those made without the entityôs receiving reasonably equivalent value in return), and the payment of bonuses, retention or ñstayò payments, and other extraordinary compensation to executives and other employees, made in contemplation of or in connection with the filing of the case or the transfers to the bridge company.

The persons adversely affected by this ñno liabilityò safe harbor clause include non-financial creditors. Pre-bankruptcy transfers made by an insolvent entity that does not receive reasonably equivalent value in return normally are avoidable as ñfraudulent transfersò under both the Bankruptcy Code[24] and state law.[25] On avoidance, the funds or other property previously transferred are returned to the estate for distribution to creditors. The ñno liabilityò safe harbor frees the directors to make such transfers and payments in contemplation of filing the Subchapter V petition or the transfers to bridge company, to its executives, affiliates or third parties, without consequence to themselves and at the cost of creditors.[26]

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[23] FIBA § 1183(c).
[24] 11 U.S.C. § 548(a)(1)(B).
[25] 11 U.S.C. § 544(b).
[26] FIBA also permits the directors to disregard the pre-bankruptcy bargained for rights of the creditors of the financial institution and its affiliates, by providing that fraudulent transfers made among the financial

This ñno liabilityò safe harbor for directors also increases moral hazard by undermining the provisions of Dodd-Frank that are aimed at reducing it. Parties in interest in Subchapter V include the Federal Reserve, the FDIC and other key federal regulators by virtue of their right to be heard, and the ñno liabilityò safe harbor thus protects directors from the regulators.[27]

An orderly resolution proceeding may be commenced under Dodd-Frank Title II, if the debtor is causing systemic risk notwithstanding its having commenced a bankruptcy case. The Title II proceeding in such a case trumps and requires the dismissal of the previously filed bankruptcy case.[28] The FDIC in a Title II proceeding may determine that the directors were substantially responsible for the failure of the financial institution, and the FDIC is authorized to claw back the directorsô compensation in whole or in part under section 210(s).[29] If FIBA is enacted with the ñno liabilityò safe harbor, the directors in a Title II proceeding can be expected to argue in response that all of their actions in the months and even years leading up to the bankruptcy were taken in good faith and in contemplation of or in connection with the Subchapter V filing, and thus that they cannot be held liable to the FDIC (or to creditors or shareholders) for those actions. The broad language of the proposed ñno liabilityò safe harbor easily can be construed to capaciously excuse directors duty to act prudently, and to absolve them from liability including under section 210(s) of Dodd-Frank if they fail to do so. The time span during which directors may take actions for which they may assert that they have ñno liabilityò is especially lengthy, because large financial institutions are engaged in continuous resolution planning under section 165(d) of Dodd-Frank,[30] and the directorsô safe harbor

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institution and its affiliates are *not* avoidable in Subchapter V or under state law, whether made or prior to or after commencement of the Subchapter V case, so long as they were made ñin contemplation of or in connection with a transferò to the bridge company. FIBA § 1191.

[27] FIBA § 1184(c).

[28] 12 U.S.C. § 5388(a).

[29] 12 U.S.C. § 5390(s)(1).

[30] 12 U.S.C. § 5365(d).

applies to any actions taken ñin contemplationò of a Subchapter V filing, presumably at any time.

The proponents of FIBA may claim that the rationale behind a ñno liabilityò safe harbor is to encourage directors to file a Subchapter V bankruptcy case rather than let the regulators commence a Dodd-Frank Title II orderly regulation proceeding. This rationale is unfounded.

First, the Bankruptcy Code, which contains no similar provision, already encourages directors to file a Chapter 11 bankruptcy case when appropriate, because the directors and officers remain in control and continue to manage the company as debtor in possession.[31] By contrast, directors and officers are removed in a Dodd-Frank Title II proceeding.[32] Second, Dodd-Frank through the Title I ñliving willò process already requires the directors of a financial institution to plan and strive for a ñrapid and orderly resolution in the event of material financial distress or failureò under the Bankruptcy Code.[33] Third, as noted, the FDIC can claw back a directorôs compensation in a Title II proceeding.[34] For this reason, if no other, the last place that the directors would like to find their financial institution is in a Title II proceeding. If the directors are succeeding in guiding their troubled financial institution through a Subchapter V proceeding, the last resort of a Title II orderly resolution proceeding will not be triggered, and the directors will never face the prospect of disgorging their compensation under section 210(s) of Dodd-Frank.

The proponents of FIBA also may note that section 207 of Dodd-Frank already provides some shelter for directors from liability to the financial institutionôs creditors and shareholders in a Title II proceeding. That provision, though, protects directors only from liability for ñacquiescing in or consenting in good faith to the *appointment*ò of the

[31] 11 U.S.C. §§ 1101(1), 1107(a), and 1108.
[32] 12 U.S.C. § 5386(4) and (5).
[33] 12 U.S.C. § 5365(d)(1) and (4).
[34] 12 U.S.C. § 5390(s)(1).

FDIC as the receiver in a Title II proceeding.[35] Section 207 does not protect directors from liability for actions that they might assert were taken *in contemplation of or in connection with* the commencement of a bankruptcy case or the transfers to a bridge company. Section 207 also does not deprive the FDIC of its authority to reduce moral hazard by requiring disgorgement of bonuses and other compensation for improvident actions taken by the directors that resulted in the failure of the financial institution if, ultimately, a Title II orderly resolution proceeding is commenced.

FIBA insulates directors from responsibility for a broad range of actions taken over a lengthy period of time prior to and after the commencement of the Subchapter V bankruptcy case. The ñno liabilityò safe harbor for directors under FIBA has no parallel under the current Bankruptcy Code and is unnecessary, because the directors of a financial institution have ample incentives to resolve the enterprise in Subchapter V rather than in Title II of Dodd-Frank. The ñno liabilityò safe harbor for directors in FIBA increases rather than reduces moral hazard, and in my view should be removed.

2. FIBA Decreases the Likelihood of Non-Governmental Financing for a Failed Financial Institution and Increases the Likelihood of a Taxpayer Bailout

FIBA does not solve the problem of postpetition financing for the financial institution (i.e., financing for the bankruptcy case and the failed firmôs operations during the bankruptcy case). It actually makes the problem worse.

A major threat to the successful resolution of a large and failing financial institution is its obtaining sufficient financing for its bankruptcy case and its postpetition operations. The size and cash needs of the firm and the likelihood that other financial institutions will be under stress and short on cash at the same time can be expected to make the necessary financing difficult to obtain in the credit markets. This difficulty makes direct or indirect government bailouts all the more likely.

[35] 12 U.S.C. § 5387.

The Federal Reserve and the FDIC, in an effort to address this problem, have focused on the single point of entry approach for systemically important financial institutions. Under this structure, the assets of the financial institution (typically the assets of the holding company) will be transferred to a bridge company free of unsecured and deeply subordinated liabilities. The hope under this approach is that once the ñgood assetsò are transferred to the bridge company, the bridge companyôs balance sheet will be sufficiently strong and ñcleanò that the bridge company will be able to obtain the necessary financing in the credit markets by using its assets as collateral.

FIBA embraces this strategy, but ineffectively. FIBA contemplates and authorizes the prompt transfer (on not less than 24 hoursô notice) of ñproperty of the estate, and the assignment of executory contracts, unexpired leases, and qualified financial contracts of the debtor, to a bridge company.ò[36] But the provisions of FIBA undermine the possibility of the bridge companyôs having a balance sheet that will enable it to obtain financing in the market, for at least two significant reasons.

First, the debtor or trustee cannot transfer assets that are subject to a mortgage or other lien securing a debt, executory contract, unexpired lease or agreement (including a qualified financial contract), unless the bridge company assumes the entire debt, executory contract, unexpired lease or agreement.[37] FIBA imposes this requirement even if the collateral is worth far less than the debt, i.e., the loan is undersecured.

Consider the following example: the debtorôs assets are worth $700 million due to the downturn in the economy, but are subject to a lenderôs $1 billion lien. The debtor in the Subchapter V case cannot transfer these assets to the bridge company unless the bridge company assumes the entire $1 billion debt and thus undertakes to repay that debt to the lender from the assets of the bridge company.

[36] FIBA § 1185(a).
[37] FIBA § 1185(c)(3)(A)(i).

This is opposite to the treatment that the holder of the lien would receive in a bankruptcy case outside of the proposed Subchapter V. Under section 506 of the Bankruptcy Code the claim of a creditor secured by a lien on the debtorôs property is a secured claim only to the extent of the value of the collateral, and is an unsecured claim to the extent that the value of the collateral is less than the amount of the claim.[38] The $1 billion claim in the prior example would be bifurcated under section 506 into a $700 million secured claim and a $300 million unsecured claim. The debtor could pay the lender the cents on the dollar that it ultimately pays to all general unsecured creditors in the bankruptcy case. In Subchapter V, the $1 billion lien remains against the collateral and the bridge company becomes obligated to pay the $1 billion in full, regardless of the value of the lenderôs collateral.[39]

Second, a financial institution in a Subchapter V proceeding will have an unrealistic period of time within which to determine whether to assume or reject qualified financial contracts, such as its books of repurchase agreements, derivatives and other financial contracts. Bankruptcy Code section 365 authorizes a debtor, with court approval, to assume advantageous contracts and preserve the value and benefit of those contracts for the estate, and to reject disadvantageous contracts and walk away from the debtorôs obligations under those contracts.[40] Section 365 is a key to a Chapter 11 debtorôs ability to restructure and reorganize. But various provisions of FIBA, when applied in conjunction with the provisions of the Bankruptcy Code, will force the debtor to assume or reject qualified financial contracts within the first 48 hours after the case is filed.

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[38] 11 U.S.C. § 506(a)(1).

[39] FIBA § 1185(c)(3)(A)(i).

[40] 11 U.S.C. § 365(a). On rejection, the counterparty under the rejected lease or executory contract has a damage claim, but it is a general unsecured claim. General unsecured claims have no payment priority under the Bankruptcy Code, are paid after other claims are paid in full, and typically are paid cents on the dollar.

Those FIBA provisions include: (1) an automatic stay that is limited to 48-hours with respect to repurchase agreements, derivatives contracts and other qualified financial contracts (and all other debt and executory contracts), for both the debtor and its affiliates;[41] (2) the requirement that the debtor and its affiliates continue during such 48-hour period to perform their payment and delivery obligations under all qualified financial contracts;[42] and (3) a prohibition against the debtorôs transferring any qualified financial contract to the bridge company unless all of the qualified financial contracts with the same counterparty also are assigned to and assumed by the bridge company.[43] Further, (4) the filing of the Subchapter V case will constitute a default under all of the debtorôs qualified financial contracts,[44] and the Bankruptcy Code at present does not stay counterparties under qualified financial contracts. Thus unless the debtor and the bridge company make a decision with respect to the debtorôs qualified financial contracts within the first 48 hours of the case, the counterparties can be expected to exercise their rights on default against the debtor and any collateral supporting the debtorôs obligations.

These provisions put immense pressure on the Subchapter V debtor to seek to transfer its qualified financial contracts to the bridge company, and on the newly-formed bridge company to assume all of those obligations by FIBA, within the first 48 hours of the case. The magnitude of the decisions that the debtor, the bridge company and the bankruptcy judge will need to make within the first 48 hours of the case is staggering. JP Morgan Chase, for example, currently is counterparty to more than $50 *trillion* notional value in derivatives contracts,[45] that it assumes would require 18 months to wind down on an orderly basis in a resolution proceeding.[46] Lehman and its affiliates were party to

[41] FIBA §§ 1187 and 1188.
[42] FIBA § 1188(b)(1).
[43] FIBA § 1188(c).
[44] 11 U.S.C. §§ 555, 556, 559 through 561.
[45] JP Morgan Chase & Co., Annual Report 2015(released April 2016), Consolidated Financial Statements and Notes and Supplementary Information, at 211, available at https://www.jpmorganchase.com/corporate/investor-relations/document/Consol-financial-statements-2015.pdf.
[46] JP Morgan Chase & Co., Resolution Plan Public Filing 2016 at 8, available at https://www.federalreserve.gov/bankinforeg/resolution-plans/jpmorgan-chase-1g-20161001.pdf.

approximately 1.2 *million* derivatives *contracts*, with approximately 65,000 counterparties, on its bankruptcy petition date.[47]

It is thus likely that the debtor will transfer and the bridge company will assume many disadvantageous contracts thus weakening the bridge company's balance sheet, and that the debtor will reject many advantageous contracts that would have strengthened the bridge company's balance sheet, all in the 48-hour rush to make a decision.

Third, once these assets and obligations have been transferred to the bridge company, the bankruptcy court loses its jurisdiction and authority over the bridge company and the property transferred to it, and the bridge company loses any ability to restructure its debt or assume or reject qualified financial contracts in the Subchapter V case. This occurs because the bankruptcy court's jurisdiction and authority is based on the property that comprises the debtor's bankruptcy estate. The bankruptcy court loses its jurisdiction and authority over such property and the obligations associated with it when the property ceases to be property of the estate. FIBA expressly provides that upon entry of the bankruptcy court's order approving the transfer to the bridge company, the property transferred and the qualified financial contracts, leases and other executory contracts assigned "shall no longer be property of the estate."[48] The transfer to the bridge company, made within 48 hours of the Subchapter V filing, effectively ends the restructuring of the financial institution's assets and liabilities transferred.

In sum, FIBA decreases the likelihood that the bridge company will have the "clean" balance sheet that will enable it to obtain financing in the credit markets as hoped by the proponents of the single point of entry approach. FIBA may cause the bridge company's balance sheet to look very much like the balance sheet of the failed company, with its assets under water and with too little cash to pay its liabilities. These provisions

[47] Debtors' Disclosure Statement for Third Amended Joint Chapter 11 Plan of Lehman Brothers Holdings Inc. and its Affiliated Debtors Pursuant to § 1125 of the Bankruptcy Code, *Lehman Brothers Holdings Inc., et al.* (Bankr. S.D.N.Y. Case No. 08-13555 (JMP)), Docket No. 19629, at 33.
[48] FIBA § 1185(a).

will hinder the bridge company's ability to find the financing that it will need to operate and/or successfully complete an orderly resolution of its business, and will make a bailout and other emergency governmental support more likely.

At the very least, I urge the following:

First, secured debt in Subchapter V should be subject to the same rules that apply in Chapter 11 under section 506 of the Bankruptcy Code. The bankruptcy court should have the jurisdiction and authority to determine the value of the collateral – even if that valuation is made after a transfer to the bridge company – and the bridge company should be required to assume only that amount of the claim that equals the value of its collateral.

Second, a far longer stay of actions by counterparties under qualified financial contracts is appropriate and necessary, so that the debtor, its creditors and financial regulators, and the bankruptcy judge, can make an informed decision regarding which secured debt and which qualified financial contracts the debtor will assume or reject. The counterparties will be adequately protected by the requirement, already in FIBA, that the debtor and its affiliates continue during the period of the stay to perform their payment and delivery obligations under qualified financial contracts.[49] If not, then the bankruptcy court can order, on the counterparty's motion, adequate protection against any diminution in value pursuant to Bankruptcy Code sections 361 and 363(e), which applies and protects creditors in a Chapter 11 case.[50]

Third, any requirement that the debtor assign and the bridge company assume all qualified financial contracts with the same counterparty should be limited to qualified financial contracts of the same type, e.g., all interest rate derivatives with the same counterparty. A Chapter 11 debtor normally can assume some and reject other unexpired leases and executory contracts with the same counterparty. For example, a retailer that

[49] FIBA § 1188(b)(1).
[50] 11 U.S.C. §§ 361 and 363(e).

leases space in numerous shopping centers owned by the same real estate developer can assume its advantageous leases for its profitable stores, and reject its disadvantageous leases for its unprofitable stores. This ability fosters the debtorôs successful reorganization. Derivatives arguably are different, because a party can hedge and speculate and counter-hedge and counter-speculate on a future value, such as a market interest rate, and the sum total of the contracts between the parties with respect to that future value represents their respective positions with respect to that future value. But there is no reason why the position of a debtor in its derivatives contracts with its counterparty with respect to the future rate of interest, should be tied to the debtorôs position in its derivatives contracts with the same counterparty on the future value of pork bellies.

These revisions, I assert, will make it more likely that that the bridge company will have the strong balance sheet - envisioned by those who formulated the single point of entry strategy - that will enable the bridge company to obtain the financing in the credit markets that it will need to survive.

3. FIBA Does Not Decrease Likelihood of a Run on the Debtor and the Bridge Company – The Efficacy of the Safe Harbors for Qualified Financial Contracts Should be Reconsidered

The run on the banks in the 1930s that resulted, among other things, in the enactment of the Federal Deposit Insurance Act, had its counterpart in the financial crisis of 2009. The run on repo and the damage caused to huge financial institutions by the actions of their credit default swap and other derivatives counterparties precipitated a widespread and harsh economic downturn, and resulted in the enactment of Dodd-Frank. Dodd-Frank, though, did not block the safe harbors for repo and derivatives (it instead incorporated those safe harbors into its provisions), nor was the Bankruptcy Code amended to address this problem.

Much of the effort to establish a legal regime under which large financial institutions can restructure at a time of financial distress, without creating further risk to the financial system, accepts as a given the safe harbors for qualified financial contracts that may have precipitated and deepened the crisis. Yet numerous commentators since the crisis ï both those directly involved in financial institution bankruptcies and those in the academy ï have called for the end or severe limitation of those safe harbors.[51]

Subchapter V as proposed by FIBA does little to decrease the likelihood of a run on the qualified financial contracts that the debtor has retained or that it has transferred to the bridge company. The automatic stay with respect to qualified financial contracts ends after 48 hours, and there is no automatic stay for the bridge company, all of the assets of which are beyond the jurisdiction and authority of the bankruptcy court.[52] The counterparty to a repurchase agreement, derivative, or other qualified financial contract can be expected to exercise whatever rights it has on default to liquidate its collateral and recover from the debtor after 48 hours, or from the bridge company after any transfer to it. In a systemic financial crisis, it can be expected that great pressure will exerted against the Subchapter V debtor and bridge company and on other distressed Subchapter V debtors and bridge companies that are facing the same financial crisis, to liquidate assets to satisfy these obligations, driving values ever lower, decreasing liquidity, and deepening the crisis.

The safe harbors for qualified financial contracts should be reconsidered. Numerous researchers and commentators have examined the issue since the financial crisis and the enactment of Dodd-Frank. I urge the revision of FIBA to include at the very least a provision for the study, based on relevant analytical works, on the benefits

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[51] See e.g., Edward R. Morrison, Mark J. Roe and Hon. Christopher S. Sontchi, ñRolling Back Repo Safe Harbors,ò *Business Lawyer*, Vol. 69, 1015-47, August 2014; and David Skeel, *The New Financial Deal: Understanding the Dodd-Frank Act and Its (Unintended) Consequences*, 163 (John Wiley & Sons, 2011) (ñif the special treatment of derivatives were reversed, the Dodd-Frank resolution regime would rarely, if ever, be necessary.ò).

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[52] FIBA §§ 1185(a), 1187(a)(3)(A), and 1188(a) and (b)(1).

and harms of continuing the safe harbors for qualified financial contracts.[53]

4. FIBA Deprives the Bankruptcy Court of its Oversight over the Subchapter V Debtor in Contradiction of Current Bankruptcy Law and to the Detriment of the Debtor's Creditors

In Chapter 11, once a bankruptcy case has been commenced, a debtor is under the supervision of the bankruptcy court and must obtain the bankruptcy courtôs approval for any transfer or transaction that is out of the ordinary course of the debtorôs business.[54] Thus Bankruptcy Code section 549 provides that a postpetition transfer made by the debtor is avoidable unless it was authorized by the Bankruptcy Code or by an order of the bankruptcy court.[55]

FIBA deprives the bankruptcy court of its supervisory role over postpetition transfers made by the debtor to its affiliates. FIBA provides that any such transfer that is made in contemplation of or in connection with a transfer to the bridge company is not avoidable under Bankruptcy Code section 549, other provisions of the Bankruptcy Code, or any similar nonbankruptcy law.[56]

Thus, for example, the debtor after filing its Subchapter V petition could transfer $10 million to its subsidiary for payment of a bonus to the subsidiaryôs CEO in contemplation of the transfer of the debtorôs shares of the subsidiary to a bridge company. Under the Bankruptcy Code at present, that transfer would require court approval, and if the debtor made the transfer without obtaining court approval, the transfer could be avoided. Under FIBA, if enacted, the debtor would be free to make such transfer without any approval or oversight by the bankruptcy court and without any

[53] S.3505, ñThe Bankruptcy Fairness Act of 2016ò (introduced on December 6, 2016), at§ 3, would require the preparation and submission to Congress of such a report by the Office of Financial Research, in consultation with Financial Stability Oversight Council.
[54] 11 U.S.C. § 363(b) and (c)).
[55] 11 U.S.C. § 549.
[56] FIBA § 1191.

consideration of the legitimate interests of the debtorôs creditors in preventing improvident transfers that dilute the debtorôs estate to their detriment and without affording those creditors their due process rights to object and be heard.

I urge the revision of FIBA to eliminate section 1191. Any proposed postpetition transfer should be subject to the approval of the bankruptcy court, which can decide whether to authorize the transfer based on the purposes of the Bankruptcy Code, as amended by FIBA.

5. FIBA Gives a Financial Institution the Authority to Transfer Assets Prepetition without Receiving Reasonably Equivalent Value to the Detriment of the Debtor's Creditors and in Violation of Fraudulent Transfer Laws

Creditors do business with and extend credit to a company on consideration of the companyôs current and historic financial condition. Fraudulent conveyance law reinforces this practice by providing that a transfer made by an insolvent company for less than ñreasonably equivalent valueò prior to the filing of a bankruptcy case is avoidable.[57]

Consider the following example regarding the policy behind the law permitting the avoidance of a pre-bankruptcy fraudulent transfer. A supplier who extends $1 million in credit to a company whose assets exceed its liabilities by $10 million does so with the expectation that the company will not give its $10 million in assets away for less than the rough equivalent of $10 million, and with the knowledge that the law will avoid any transfer for less than equivalent value if the transfer was made when the company was insolvent or by the transfer would become insolvent. Both the Bankruptcy Code and state fraudulent conveyance law protect a creditor against the effects of such a pre-bankruptcy transfer by making the transfer avoidable by the creditor or the trustee in bankruptcy.

[57] 11 U.S.C. § 548(a)(1)(B); Unif. Fraudulent Transfer Act § 5.

FIBA undoes these protections with respect to a Subchapter V debtor and pre-bankruptcy transactions between the debtor and its affiliates, all of which are separate legal entities with different creditors. FIBA provides that a transfer made or an obligation incurred by the debtor to or for the benefit of an affiliate in contemplation of the commencement of a Subchapter V case, or to an affiliate and or the bridge company in the Subchapter V bankruptcy case, is *not* avoidable under Bankruptcy Code sections 548(a)(1)(B) and 549 or under state fraudulent transfer law. Thus under FIBA, neither a creditor nor the trustee of a Subchapter V debtor can avoid a prepetition or postpetition fraudulent transfer made by the debtor of its assets without receiving a reasonably equivalent value, nor does the creditor or trustee have any recourse whatsoever with respect to such transfers even though they hollowed out the debtor for the benefit of certain of the debtorôs subsidiaries and those creditors there were preferred by the managers of the debtor in their discretion.

6. FIBA Prefers Wall Street Creditors over Ordinary Creditors

Finally, as set forth above, FIBA enhances the protection given to financial creditors and counterparties by requiring the bridge company to assume certain obligations with respect to undersecured debt and qualified financial contracts. These protections are given at the expense of the Subchapter V debtorôs ordinary creditors, including its suppliers, rank-and-file employees and retirees, non-financial counterparties and judgment creditors.

The recipients of these special protections generally will be financial counterparties and large companies who, because of their financial resources and sophistication, are most able to do their own due diligence and protect themselves. Yet FIBA gives these financial creditors and counterparties special protections beyond their bargained-for prepetition rights, at the expense of ordinary creditors with less leverage. The value of the shares of those ordinary creditors in the bridge company, and the

ultimate distributions to those ordinary creditors in the bankruptcy case, will be substantially decreased by this special treatment given to financial creditors.

7. The Upside: FIBA Does Not Repeal the Orderly Resolution Authority of Dodd-Frank Title II

Though, as set forth above, FIBA undermines certain key provisions of both Dodd-Frank and the Bankruptcy Code in a manner that, in my view, is both unnecessary and inadvisable, the upside of FIBA is that it does not repeal the financial regulatorsô authority to place a large, failing financial institution into a Dodd-Frank Title II receivership proceeding. It is essential, in my view, that Title II remain a last, if crucial, resort for the resolution of a distress financial institution in an orderly manner for the purpose of mitigating systemic risk to the financial system.

B. Conclusion

FIBA proposes amendments to the Bankruptcy Code in furtherance of the single point of entry strategy. Yet FIBA increases moral hazard by unnecessarily providing directors with a ñno liabilityò safe harbor for certain actions taken by them, ostensibly in contemplation of or in connection with the filing of a Subchapter V petition and transfers to a bridge company, but that may have resulted in the financial institutionôs failure and harmed its creditors. FIBA further undermines one of the foundational goals of single point of entry ï a financeable bridge company ï by the conditions that it imposes on the transfers to the bridge company of secured property and qualified financial contracts, by the inadequate 48-hour period within which qualified financial contracts must be transferred prior to the expiration of the 48-hour stay, and by perpetuating the safe harbors for qualified financial contracts. FIBA also deprives the bankruptcy court of its jurisdiction and authority with respect to significant transactions, made both before and after the bankruptcy filing. These provisions generally favor Wall Street creditors over

Main Street creditors and unnecessarily restrict the ability of the financial institution to restructure and reorganize in a manner that will mitigate systemic risk.