FINANCIAL INSTITUTION BANKRUPTCY ACT OF 2015

HEARING

BEFORE THE

SUBCOMMITTEE ON
REGULATORY REFORM,
COMMERCIAL AND ANTITRUST LAW

OF THE

COMMITTEE ON THE JUDICIARY
HOUSE OF REPRESENTATIVES

ONE HUNDRED FOURTEENTH CONGRESS

FIRST SESSION

ON

H.R. 2947

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FINANCIAL INSTITUTION BANKRUPTCY ACT OF 2015

THURSDAY, JULY 9, 2015

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

The Subcommittee met, pursuant to call, at 10:10 a.m., in room 2141, Rayburn House Office Building, the Honorable Tom Marino (Chairman of the Subcommittee) presiding.

Present: Representatives Marino, Goodlatte, Farenthold, Collins, Walters, Ratcliffe, Trott, Bishop, Johnson, Conyers, and DelBene.

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

Mr. MARINO. The Subcommittee on Regulatory Reform, Commercial and Antitrust Law will come to order.

Good morning everyone. I apologize for the delay. We all have three or four things going on at once, starting at 7 in the morning. So without objection, the Chair is authorized to declare recesses of the Committee at any time. We welcome everyone to today's hearing on H.R. 2947, the "Financial Institution Bankruptcy Act of 2015." I will now recognize myself for an opening statement.

Last Congress, the Financial Institution Bankruptcy Act was reported favorably by this Committee and passed the House under suspension of the rules. This week, the legislation was reintroduced, and today, we build on last year's record by further examining the bill. In the wake of the financial crisis of 2008, Congress enacted the Dodd-Frank Wall Street Reform and Consumer Protection Act. That legislation was intended to address, among other things, the potential failure of large financial institutions.

While the Dodd-Frank Act created a regulatory process for such an event, the Act states that the preferred method of resolution for a financial institution is through the bankruptcy process. However, the Dodd-Frank Act did not make any amendments to the bankruptcy code to account for the unique characteristics of a financial institution. The legislation before us today fills that void.

The Financial Institution Bankruptcy Act is the product of years of study by industry, legal, and financial regulatory experts, as well as bipartisan review over the course of three separate Subcommittee hearings last Congress. The legislation includes several provisions that improve the ability of a financial institution to be resolved through the bankruptcy process. It allows for a speedy transfer of a financial firm's assets to a newly formed company. That company would continue the firm's operations for the benefit of its customers, employees, and creditors, and ensure the financial stability of the marketplace.

This quick transfer is overseen by, and subject to the approval of an experienced bankruptcy judge, and includes due process protections for parties-in-interest. The bill also creates an explicit rule in the bankruptcy process for the key financial regulators. In addition, there are provisions that facilitate the transfer of derivative and similarly structured contracts to the newly formed company. This will improve the ability of the company to continue the financial institution's operations.

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

The bankruptcy process has long been favored as the primary mechanism for dealing with distressed and failing companies. This is due to its impartial nature, adherence to established precedent, judiciary oversight, and grounding in the principles of due process and the rule of law. We are here today as part of an effort to structure a bankruptcy process that is better equipped to deal with the specific issues raised by failing financial firms.

As an original cosponsor of the bill, I look forward to hearing from today's expert panel of witnesses on the merits of the Financial Institution Bankruptcy Act and whether any further refinements to the bill are necessary. I now recognize the Ranking Member of the Subcommittee on Regulatory Reform, Commercial, and Antitrust Law, Mr. Hank Johnson, for his opening statement. Mr. Johnson.

[The bill, H.R. 2947, follows:]

I

114TH CONGRESS
1ST SESSION

H. R. 2947

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

IN THE HOUSE OF REPRESENTATIVES

JULY 7, 2015

Mr. TROTT (for himself, Mr. GOODLATTE, Mr. CONYERS, and Mr. MARINO) introduced the following bill; which was referred to the Committee on the Judiciary

A BILL

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

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

SECTION 1. SHORT TITLE.

This Act may be cited as the "Financial Institution Bankruptcy Act of 2015".

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

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

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

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

"(B) a corporation that exists for the primary purpose of owning, controlling and financing its subsidiaries, that has total consolidated assets of $50,000,000,000 or greater, and for which, in its most recently completed fiscal year—

"(i) annual gross revenues derived by the corporation and all of its subsidiaries from activities that are financial in nature (as defined in section 4(k) of the Bank Holding Company Act of 1956) and, if applicable, from the ownership or control of one or more insured depository institutions, represents 85 percent or more of the consolidated annual gross revenues of the corporation; or

"(ii) the consolidated assets of the corporation and all of its subsidiaries related to activities that are financial in nature (as defined in section 4(k) of the Bank Holding Company Act of 1956) and, if applicable, related to the ownership or control of one or more insured depository institutions, represents 85 percent or more of the consolidated assets of the corporation.".

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

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

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

(1) in subsection (b)—

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

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

(C) by adding at the end the following:

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

(2) in subsection (d)—

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

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

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

(d) CONVERSION TO CHAPTER 7.—Section 1112 of title 11, United States Code, is amended by adding at the end the following:

"(g) Notwithstanding section 109(b), the court may convert a case under subchapter V to a case under chapter 7 if—

"(1) a transfer approved under section 1185 has been consummated;

"(2) the court has ordered the appointment of a special trustee under section 1186; and

"(3) the court finds, after notice and a hearing, that conversion is in the best interest of the creditors and the estate.".

(e)(1) Section 726(a)(1) of title 11, United States Code, is amended by inserting after "first," the following: "in payment of any unpaid fees, costs, and expenses of a special trustee appointed under section 1186, and then".

(2) Section 1129(a) of title 11, United States Code, is amended by inserting after paragraph (16) the following:

"(17) In a case under subchapter V, all payable fees, costs, and expenses of the special trustee have been paid or the plan provides for the payment of all such fees, costs, and expenses on the effective date of the plan.

"(18) In a case under subchapter V, confirmation of the plan is not likely to cause serious adverse effects on financial stability in the United States.".

(f) Section 322(b)(2) of title 11, United States Code, is amended by striking "The" and inserting "In cases under subchapter V, the United States trustee shall recommend to the court, and in all other cases, the".

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

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

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

"§ 1181. Inapplicability of other sections

"Sections 303 and 321(c) do not apply in a case under this subchapter concerning a covered financial corporation.

"§ 1182. Definitions for this subchapter

"In this subchapter, the following definitions shall apply:

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

"(2) The term 'bridge company' means a newly formed corporation to which property of the estate may be transferred under section 1185(a) and the equity securities of which may be transferred to a special trustee under section 1186(a).

"(3) The term 'capital structure debt' means all unsecured debt of the debtor for borrowed money for which the debtor is the primary obligor, other than a qualified financial contract and other than debt secured by a lien on property of the estate that is to be transferred to a bridge company pursuant to an order of the court under section 1185(a).

"(4) The term 'contractual right' means a contractual right of a kind defined in section 555, 556, 559, 560, or 561.

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

"(6) The term 'special trustee' means the trustee of a trust formed under section 1186(a)(1).

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

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

"(1) by the debtor under section 301 only if the debtor states to the best of its knowledge under penalty of perjury in the petition that it is a covered financial corporation; or

"(2) by the Board only if the Board states to the best of its knowledge under penalty of perjury in the petition that—

"(A) the debtor is a covered financial corporation that—

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

"(ii) is insolvent;

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

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

"(B) the commencement of a case under this title and effecting a transfer under section 1185 is necessary to prevent serious adverse effects on financial stability in the United States.

"(b)(1) Unless the debtor consents to an order for relief, the court shall hold a hearing on the Board's petition under subsection (a)(2) as soon as practicable but not later than 16 hours after the Board files such a petition, with notice only to—

"(A) the covered financial corporation;

"(B) the Federal Deposit Insurance Corporation;

"(C) the Office of the Comptroller of the Currency of the Department of the Treasury; and

"(D) the Secretary of the Treasury.

"(2) Only the Board and the entities specified in paragraph (1) and their counsel may participate in a hearing described in this subsection. The Board or the trustee may request that pleadings, hearings, transcripts, and orders in connection with a hearing described in this subsection be sealed if their disclosure could create financial instability in the United States.

"(3) All pleadings, hearings, transcripts, and orders sealed under paragraph (2) shall be available to only the court, the appellate panel, the covered financial corporation, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency of the Department of the Treasury, the Secretary of the Treasury, and the Board. Notwithstanding paragraph (2), if the case is dismissed, all court documents, including pleadings, hearings, transcripts, and orders, shall be permanently sealed.

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

"(2) In a case commenced under subsection (a)(2), after notice and hearing required under subsection (b) and not later than 18 hours after the filing of the Board's petition, the court shall enter—

"(A) an order for relief—

"(i) if the Board has shown at the hearing under this subsection that the requirements under subsection (a)(2) are supported by a preponderance of the evidence; or

"(ii) if the debtor consents to the Board's petition under subsection (a)(2); or

"(B) an order dismissing the case.

"(d)(1) The covered financial corporation or the Board may appeal to the court of appeals from an order entered by the court under subsection (c)(2) not later than 1 hour after the court enters such order, with notice only to the entities specified in subsection (b)(1) and the Board. Such order shall be stayed pending such appeal.

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

"(3) The court may not, on account of an appeal from an order for relief under section 1183(d)(1), delay any proceeding under section 1185, except that the court shall not authorize a transfer under section 1185 before the determination of the appeal.

"(e) 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 or consenting in good faith to a petition with respect to 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.

"(f) Counsel to the debtor or the Board 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.

“§ 1184. Regulators

“The Board, the Securities Exchange Commission, the Office of the Comptroller of the Currency of the Department of the Treasury, and the Federal Deposit Insurance Corporation may raise and may appear and be heard on any issue in any case or proceeding under this subchapter.

“§ 1185. Special transfer of property of the estate

“(a) On request of the trustee or the Board, and after notice and a hearing that shall occur not less than 24 hours after the order for relief, the court may order a transfer under this section of property of the estate, and the assignment of executory contracts, unexpired leases, and qualified financial contracts of the debtor, to a bridge company. Upon the entry of an order approving such transfer, any property transferred, and any executory contracts, unexpired leases, and qualified financial contracts assigned under such order shall no longer be property of the estate. Except as provided under this section, the provisions of sections 363 and 365 shall apply to a transfer and assignment under this section.

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

"(1) the debtor;

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

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

"(4) counterparties to any debt, executory contract, unexpired lease, and qualified financial contract requested to be transferred under this section;

"(5) the Board;

"(6) the Federal Deposit Insurance Corporation;

"(7) the Secretary of the Treasury and the Office of the Comptroller of the Currency of the Treasury;

"(8) the Securities and Exchange Commission;

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

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

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

"(1) the transfer under this section is necessary to prevent serious adverse effects on financial stability in the United States;

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

"(3) the transfer does not provide for the transfer to the bridge company of any property of the estate that is subject to a lien securing a debt, executory contract, unexpired lease or agreement of the debtor unless—

"(A)(i) the bridge company assumes such debt, executory contract, unexpired lease or agreement, including any claims arising in respect thereof that would not be allowed secured claims under section 506(a)(1) and after giving effect to such transfer, such property remains subject to the lien securing such debt, executory contract, unexpired lease or agreement; and "(ii) the court has determined that assumption of such debt, executory contract, unexpired lease or agreement by the bridge company is in the best interests of the estate; or

"(B) such property is being transferred to the bridge company in accordance with the provisions of section 363;

"(4) the transfer does not provide for the assumption by the bridge company of any debt, executory contract, unexpired lease or agreement of the debtor secured by a lien on property in which the estate has an interest unless the transfer provides for such property to be transferred to the bridge company in accordance with paragraph (3)(A) of this subsection;

"(5) the transfer does not provide for the transfer of the equity of the debtor;

"(6) the party requesting the transfer under this subsection has demonstrated that the bridge company is not likely to fail to meet the obligations of any debt, executory contract, qualified financial contract, or unexpired lease assumed and assigned to the bridge company;

"(7) the transfer provides for the transfer to a special trustee all of the equity securities in the bridge company and appointment of a special trustee in accordance with section 1186;

"(8) after giving effect to the transfer, adequate provision has been made for the fees, costs, and expenses of the estate and special trustee; and

"(9) the bridge company will have governing documents, and initial directors and senior officers, that are in the best interest of creditors and the estate.

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

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

"(2) have equity securities that are property of the estate, which may be sold or distributed in accordance with this title.

"§ 1186. Special trustee

"(a)(1) An order approving a transfer under section 1185 shall require the trustee to transfer to a qualified and independent special trustee, who is appointed by the court, all of the equity securities in the bridge company that is the recipient of a transfer under section 1185 to hold in trust for the sole benefit of the estate, subject to satisfaction of the special trustee's fees, costs, and expenses. The trust of which the special trustee is the trustee shall be a newly formed trust governed by a trust agreement approved by the court as in the best interests of the estate, and shall exist for the sole purpose of holding and administering, and shall be permitted to dispose of, the equity securities of the bridge company in accordance with the trust agreement.

"(2) In connection with the hearing to approve a transfer under section 1185, the trustee shall confirm to the court that the Board has been consulted regarding the identity of the proposed special trustee and advise the court of the results of such consultation.

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

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

"(2) that the special trustee provide—

"(A) quarterly reporting to the estate, which shall be filed with the court; and

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

"(3) that for as long as the equity securities of the bridge company are held by the trust, the special trustee shall file a notice with the court in connection with—

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

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

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

"(i) recapitalization;

"(ii) a material borrowing;

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

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

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

"(4) that any sale of any equity securities of the bridge company shall not be consummated until the special trustee consults with the Federal Deposit Insurance Corporation and the Board regarding such sale and discloses the results of such consultation with the court;

"(5) that, subject to reserves for payments permitted under paragraph (1) provided for in the trust agreement, the proceeds of the sale of any equity securities of the bridge company by the special trustee be held in trust for the benefit of or transferred to the estate;

"(6) the process and guidelines for the replacement of the special trustee; and

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

"(c)(1) The special trustee shall distribute the assets held in trust—

"(A) if the court confirms a plan in the case, in accordance with the plan on the effective date of the plan; or

"(B) if the case is converted to a case under chapter 7, as ordered by the court.

"(2) As soon as practicable after a final distribution under paragraph (1), the office of the special trustee shall terminate, except as may be necessary to wind up and conclude the business and financial affairs of the trust.

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

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

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

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

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

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

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

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

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

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

"(II) of an affiliate during the period from the commencement of the case until 48 hours after such order is entered;

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

"(aa) the bridge company; or

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

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

"(aa) the bridge company; or

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

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

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

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

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

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

"(3) The stay under this subsection terminates—

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

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

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

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

"(iv) the time the case is dismissed; and

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

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

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

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

"(iv) the time the case is dismissed.

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

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

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

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

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

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

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

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

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

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

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

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

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

"(A) shall cure the default;

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

"(C) provides adequate assurance in connection with a transfer under section 1185 of future performance under the debt, contract, lease, or agreement, as determined by the court under section 1185(c)(4).

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

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

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

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

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

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

"(2) Any failure by a counterparty to any qualified financial contract of the debtor or any affiliate to perform any payment or delivery obligation under such qualified financial contract, including during the pendency of the stay provided under subsection (a), shall constitute a breach of such qualified financial contract by the counterparty.

"(c) Subject to the court's approval, a qualified financial contract between an entity and the debtor may be assigned to or assumed by the bridge company in a transfer under section 1185 if and only if—

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

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

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

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

"(d) Notwithstanding any provision of a qualified financial contract or of applicable nonbankruptcy law, a qualified financial contract of the debtor that is assumed or assigned in a transfer under section 1185 may not be accelerated, terminated, or modified, after the entry of the order approving a transfer under section 1185, and any right or obligation under the qualified financial contract may not be accelerated, terminated, or modified, after the entry of the order approving a transfer under section 1185 solely because of a condition described in section 1187(c)(1), other than a condition of the kind specified in section 1187(b) that occurs after property of the estate no longer includes a direct beneficial interest or an indirect beneficial interest through the special trustee, in more than 50 percent of the equity securities of the bridge company.

"(e) Notwithstanding any provision of any agreement or in applicable nonbankruptcy law, an agreement of an affiliate (including an executory contract, an unexpired lease, qualified financial contract, or an agreement under which the affiliate issued or is obligated for debt) and any right or obligation under such agreement may not be accelerated, terminated, or modified, solely because of a condition described in section 1187(c)(1), other than a condition of the kind specified in section 1187(b) that occurs after the bridge company is no longer a direct or indirect beneficial holder of more than 50 percent of the equity securities of the affiliate, at any time after the commencement of the case if—

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

"(2) the bridge company assumes—

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

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

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

"§ 1189. Licenses, permits, and registrations

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

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

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

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

"(4) a transfer under section 1185.

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

"§ 1190. Exemption from securities laws

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

"§ 1191. Inapplicability of certain avoiding powers

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

"§ 1192. Consideration of financial stability

"The court may consider the effect that any decision in connection with this subchapter may have on financial stability in the United States.".

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

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

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

"(a) Notwithstanding section 295, 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 an appeal under section 1183 of title 11 in a case under such title concerning a covered financial corporation. Appellate judges may request to be considered by the Chief Justice of the United States for such designation.

"(b)(1) Notwithstanding section 295, the Chief Justice of the United States shall designate not fewer than 10 bankruptcy judges to be available to hear a case under subchapter V of chapter 11 of title 11. Bankruptcy judges may request to be considered by the Chief Justice of the United States for such designation.

"(2) Notwithstanding section 155, a case under subchapter V of chapter 11 of title 11 shall be heard under section 157 by a bankruptcy judge designated under paragraph (1), who shall be assigned to hear such case by the chief judge of the court of appeals for the circuit embracing the district in which the case is pending. To the greatest extent practicable, the approvals required under section 155 should be obtained.

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

"(c)(1) The court of appeals shall have jurisdiction of appeals from all orders for relief and orders of dismissal under section 1183 of title 11.

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

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

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

"(3) If any of the judges of the appellate panel specified in paragraph (2) is not assigned to the circuit in which the appeal is pending, the judges shall be temporarily assigned to the circuit.

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

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

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

"(f) This section does not grant jurisdiction to the district court after a transfer pursuant to an order under section 1185 of title 11 of any proceeding related to a special trustee appointed, or to a bridge company formed, in connection with a case under subchapter V of chapter 11 of title 11.".

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

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

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

○

Mr. JOHNSON. Thank you, Mr. Chairman. H.R. 2947, the "Financial Institution Bankruptcy Act of 2015," amends the bankruptcy code to establish a process for the expedited judicial resolution of large financial institutions to soften the disruptive effects of their collapse.

I trust the courts and am sympathetic to the notion that a judicial process may be preferable to an administrative process for resolving systemically important financial institutions that present a risk to the economic stability of our Nation, but I'm concerned that the lack of a funding mechanism for H.R. 2947 may make the bill unworkable.

A key difference between an orderly resolution under Dodd-Frank and the resolution contemplated by this bill concerns the proper mechanism for funding the reorganization of the debtor. In a typical bankruptcy case, the debtor's reorganization may be funded by private parties or by the Federal Government as illustrated by the General Motors bankruptcy.

In many instances, liquidity provided by the U.S. Government to prevent the collapse of financial institutions has either returned a profit to the government or is likely to be repaid. The National Bankruptcy Conference (NBC), which includes the Nation's leading bankruptcy scholars and practitioners, explained in a letter to the Committee in June that, "meeting the liquidity needs of a distressed financial institution is essential to successfully resolving the firm without creating undue systemic risk."

This critical mechanism has prevented the collapse of several major financial institutions without cost to the taxpayer. It is my understanding that this element does not currently exist in the bill for jurisdictional reasons. Nevertheless, I remain optimistic that the Chair will continue to work across party lines to accommodate these concerns prior to the bill's consideration on the floor.

In addition to these concerns, I would caution the Chair against efforts to combine this bill with legislation that would strike Title II of the Dodd-Frank Act. Such efforts would be unacceptable and would meet strong opposition. As the National Bankruptcy Conference further noted, laws currently in place such as Title II of the Dodd-Frank Act should "continue to be available even if the bankruptcy code is amended to better address the resolution of systemically important financial institutions" because "the ability of U.S. regulators to assume full control of the resolution process to elicit the cooperation from non-U.S. regulators is an essential insurance policy against systemic risk and potential conflict and dysfunction among the multinational components of these institutions."

Title II of the Dodd-Frank Act also serves as a valuable backstop to the bankruptcy process should this bill become law. Additionally, as the conference has also noted, it is important that financial regulators have a very significant role in the timely resolution of a financial institution regardless of whether by bankruptcy or orderly liquidation.

As the Conference noted, the "heavy involvement of U.S. regulators would be critical if adverse systemic effects from the failure of the systemically important financial institution are to be prevented or minimized."

It would be unwise to overlook the expertise of financial regulators who are charged with considering the impact of a resolution on the economy and financial markets in favor of a process that is intended to produce maximum returns to creditors while facilitating the debtor's reorganization.

Thank you, Mr. Chairman, and I yield back.

Mr. MARINO. Thank you, Mr. Johnson.

The Chair now recognizes the Chairman of the full Judiciary Committee, Congressman Goodlatte of Virginia for his opening statement.

Mr. GOODLATTE. Thank you, Mr. Chairman. I appreciate your holding this hearing.

Our Nation's financial system provides the life blood for industry, small businesses, and our communities to develop, grow, and prosper. Ensuring that this system functions efficiently in both good times and bad is critical to the ongoing vitality of our economy. The recent financial crisis illustrated that the financial system and existing laws were not adequately prepared for the insolvency of certain institutions, which threatened the very stability of the global economy and our financial industry.

There has been considerable debate over whether Congress' main response to the financial crisis—the Dodd-Frank Wall Street Reform and Consumer Protection Act—is adequate to respond to a future crisis. Today's hearing, however, is not focused on that debate. Instead, we turn our attention to the private and public efforts to strengthen the Bankruptcy Code so that it may better facilitate the resolution of an insolvent financial firm while preserving the stability of the financial markets.

The subject of today's hearing, the "Financial Institution Bankruptcy Act of 2015," is a reflection of these efforts. The bill is calibrated carefully to provide transparency, predictability, and judicial oversight to a process that must be executed quickly and in a manner that is responsive to potential systemic risk.

Additionally, it incorporates the "single point of entry" approach, which a growing consensus of experts in public and private industry believes is the most effective and feasible method to resolve a financial institution that has a bank holding company. The Judiciary Committee has a long history of improving the Bankruptcy Code to ensure that it is equipped properly to administer all failing companies.

The Financial Institution Bankruptcy Act adds to this history by enhancing the ability of financial firms to be resolved through the bankruptcy process. The development of the legislation before us today has been a collaborative effort that included the financial and legal community, Members of Congress on both sides of the aisle, the Federal Reserve, the FDIC, the courts, and Treasury.

I applaud Congressman Trott for continuing the efforts of last Congress to strengthen the bankruptcy code and Chairman Marino for holding today's hearing on this important reform. I look forward to hearing from today's witnesses on the Financial Institution Bankruptcy Act and whether the passage of time has resulted in the need for any further revisions to the bill.

And at this time it is my pleasure to yield the balance of my time to the gentleman from Michigan, Mr. Trott, the chief sponsor of the legislation for any opening remarks that he might have.

Mr. TROTT. Thank you, Chairman. I also want to thank Chairman Marino and Ranking Member Johnson for holding this hearing, and also thank our witnesses for again providing their insight on this bill.

The health of our financial institutions, particularly large multinational players, is critical to not only our economy but also our citizens. Consequently, how we react when a systemically important financial institution fails is of particular concern.

The Financial Institution Bankruptcy Act of 2015 seeks to address those concerns and put in place a better process. The bill amends the bankruptcy code so as to allow the insolvency of a financial institution to be resolved through the Chapter 11 process. The Chapter 11 process provides rules that are designed to accomplish an equitable and predictable resolution of competing claims.

Chapter 11 is a relatively efficient process, and the integrity and transparency ensured by due process protections will reduce the risk to our overall economy and reduce the potential of a taxpayer funded bailout.

As an aside, my hometown is Detroit, Michigan, and I am here to tell you that the bankruptcy process can add great value to difficult financial situations that undermine our economy and our communities.

Thank you again, Chairman. I yield back my time.

Mr. GOODLATTE. And I yield back. Thank you, Mr. Chairman.

Mr. MARINO. Thank you, Chairman.

The Chair recognizes the full Judiciary Committee Ranking Member, Congressman Conyers from the State of Michigan for his opening statement.

Mr. CONYERS. Thank you, Mr. Chairman and Members of the Committee. I join in congratulating my colleague from Michigan, Mr. Trott, for his authorship of the measure that is before us. I support it, and I am a cosponsor of it. As a matter of fact, there are a number of reasons for my support.

Number one, the bill addresses a real need, recognized by regulatory agencies, bankruptcy experts, and the private sector that the bankruptcy law must be amended so that it can expeditiously restore trust in the financial marketplace as soon as possible after the collapse of a major financial institution.

Many of us recall the failure of Lehman Brothers in 2008 which caused a worldwide freeze on the availability of credit, which not only affected Wall Street but Main Street as well.

The near collapse of our Nation's economy because of Lehman's failure revealed that current bankruptcy law is ill equipped to deal with complex financial institutions in economic distress. H.R. 2947 would establish a specialized form of bankruptcy relief under Chapter 11 of the Bankruptcy Code by which the holding company of a large financial institution could voluntarily use or be forced to use by the Federal Reserve Board, under certain conditions.

The debtor's operating subsidiaries would continue to operate outside of bankruptcy while the debtor's principal assets—such as secured property, financial contracts, and the stock of its subsidiaries—would be transferred to a temporary bridge company. The bridge company, under the guidance of a trustee, in turn, would liquidate these assets to pay the claims of the debtor's creditors.

The legislation would also impose a temporary stay to prevent parties from exercising their rights in certain qualified financial contracts. Each critical step of this process would be under the supervision of a bankruptcy judge and subject to the right of appeal.

Another reason for my support is that it appropriately recognizes the important role of the Dodd-Frank Act in the regulation of large financial institutions. Without doubt, the Great Recession was a direct result of the regulatory equivalent of the Wild West. In the absence of any meaningful regulation of the mortgage industry, lenders developed high risk subprime mortgages and used predatory marketing tactics targeting the most vulnerable.

These doomed-to-fail mortgages were then securitized and sold to unsuspecting investors, including pension funds and school districts. The ensuing 2008 crash froze credit and trapped millions of Americans in mortgages they could no longer afford, causing waves of foreclosures, massive unemployment, and international economic upheaval.

The Dodd-Frank Act goes a long way toward reinvigorating a regulatory system that makes the financial marketplace more accountable and hopefully more resilient. In particular, Title II of Dodd-Frank establishes a mandatory resolution process to wind down large financial institutions, which is a critical enforcement tool for bank regulators to ensure compliance with the Act's heightened regulatory requirements.

Nevertheless, Dodd-Frank clearly recognizes that bankruptcy should be a first resort and that Title II's orderly resolution process should be a last resort. In fact, Title I of the Act explicitly requires these companies to write so-called living wills that must explain how they will resolve their financial difficulties in a hypothetical bankruptcy scenario. This is because bankruptcy law has, for more than 100 years, enabled some of the Nation's largest companies to regain their financial footing, including General Motors and Chrysler Corporations.

But to be a truly viable alternative to Dodd-Frank's resolution process, the bankruptcy law must be amended to facilitate the rapid administration of a debtor's assets in an orderly fashion that maximizes value and minimizes disruption to the financial marketplace.

And finally, I am pleased to note that this bill is the product of a very collaborative, inclusive, and deliberative process, which I hope would be more regularly employed in this Congress and not the exception when it comes to drafting legislation.

While an excellent measure, H.R. 2947 unfortunately does not include any provision allowing the Federal Government to be a lender of last resort, which nearly every expert recognizes is a necessary element to ensure financial stability. I recognize, however, that this is an issue not within the Committee's jurisdiction but more within the area of the jurisdiction of the Financial Services Committee.

I welcome the witnesses, particularly Mr. Levin, and I thank the witnesses for their participation here today, and I yield back the balance of my time.

Mr. MARINO. Thank you, Congressman Conyers.

Without objection, other Members' opening statements will be made part of the record. The Chair will begin by swearing in our witnesses before introducing them. Would you please rise and raise your right hand.

Do you swear that the testimony you're about to give before this Committee is the truth, the whole truth, and nothing but the truth, so help you God?

Let the record reflect that the witnesses have answered in the affirmative. Thank you. Please be seated.

I will now introduce each of the witnesses before anyone gives their opening statement. Mr. Don Bernstein is a partner at Davis Polk, where he heads the firm's insolvency and restructuring practice. During his distinguished 35-year career, he has represented nearly every major financial institution in numerous restructurings, as well as leading a number of operating firms through bankruptcy, including Ford, LTV Steel, and Johns Manville. Mr. Bernstein has earned multiple honors for his practice, including being elected by his peers as the chair of the National Bankruptcy Conference, the most prestigious professional organization in the field. Mr. Bernstein received his A.B. (Cum laude) from Princeton University and his JD from the University of Chicago Law School. Thank you, Mr. Bernstein, for being here

Mr. Stephen Hessler is a partner in the restructuring group of Kirkland & Ellis. His practice involves representing debtors, creditors, and investors in complex corporate Chapter 11 cases, out-of-court restructurings, acquisitions, and related trial and appellate litigation. In addition to practicing law, Mr. Hessler is an author and frequent lecturer on a variety of restructuring related topics, including, as a professor at the University of Pennsylvania, where he teaches a restructuring class to both law school and Wharton students. Mr. Hessler has been recognized by both Chambers and Turnarounds & Workouts as an outstanding restructuring lawyer. Mr. Hessler received his BA and JD from the University of Michigan, where he served as the managing editor of Michigan's Law Review. Welcome.

Mr. Richard Levin is a partner in the Bankruptcy, Workout and Corporate Reorganization Practice of Jenner & Block. Mr. Levin is the current chair of the National Bankruptcy Conference, a fellow of the American College of Bankruptcy, and a lecturer of bankruptcy law at the Harvard Law School. In almost 40 years of practice, Mr. Levin has gained a reputation as one of the foremost restructuring, bankruptcy and creditor/debtor rights lawyers. Notably, Mr. Levin served as a bankruptcy counsel to the House Judiciary Committee and was one of the principal authors of the 1978 U.S. Bankruptcy Code. Mr. Levin received his undergraduate degree from MIT and his JD from Yale Law School where he served as editor of Yale Law Review. Welcome, Mr. Levin.

Mr. LEVIN. Thank you, Mr. Chairman.

Mr. MARINO. Each of the witnesses' written statements will be entered into the record in its entirety, and I ask each of the witnesses to summarize their statements, you've been through this before, in 5 minutes or less. To help you stay within your time, you see the lights in front of you, but as I do, when I'm sitting at that table making a statement, I'm concentrating on making my statement and not watching the lights.

So what I will politely and diplomatically do if it gets too far over the 5 minutes, is I will reach for the gavel and just sort of raise it to get your attention, and ask you to succinctly come to a close in your statement.

I'm going to recognize our witnesses for their opening statement. Mr. Bernstein.

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

Mr. BERNSTEIN. Thank you, Chairman Marino, and thank you, Chairman Goodlatte, and also Congressman Trott for introducing and being a sponsor of the bill, as well as Congressman Conyers. I want to say that you have made my job easy in terms of meeting the 5-minute requirement because the statements were so good in terms of summarizing the bill. I'm just going to skip to my major points

So, just as a little bit of background, this idea of single point of entry resolution of a financial firm is a result of a lot of work that's been done at the FDIC and in other contexts, including under Title II of Dodd-Frank, with the idea that if you set up financial institutions correctly in the United States with bank holding companies, you should be able to recapitalize their operations if the operations have losses because there is loss absorbency at the holding company level.

And in fact, there are a number of features that are being added to the way bank holding companies are structured in order to facilitate resolution under the Bankruptcy Code, which has been an outgrowth of the resolution planning process under the Dodd-Frank Act. One of these is a concept that is being adopted globally, which is called, "Total Loss Absorbing Capacity."

That consists of two things. It consists of the capital of the bank and also a layer of debt that can effectively be bailed in or converted, in effect, to equity so that no capital needs to be infused from sources outside the firm, including no taxpayer funds would have to be infused to create the capital necessary.

The capital levels of financial institutions since 2008, especially the largest ones, have essentially doubled from where they were in 2008, and then if you add a requirement that is in the process of being developed and is likely to be imposed by regulators for total loss absorbing capacity, it will double again in effect and permit the use of bankruptcy and single point of entry resolution to use that loss absorbing capacity in order to resolve firms.

Most of the largest financial institutions actually have that layer of indebtedness already, so we are actually at a point where the resources are available to recapitalize these firms.

Secondly, there has been a massive increase in the amount of liquidity that's being maintained by all the firms. Congressman Conyers made the point about a liquidity source. I know the NBC makes that point in their letter and I make it as well in my testimony, my written testimony, but today, with the levels of liquidity that the banks are maintaining, they can resolve themselves in a severely adverse economic scenario based on the balance sheet liquidity that they are currently maintaining. So that is—and it's a huge increase from the way it was in 2008.

The third area that single point of entry requires is a clean holding company, a holding company that can be left behind in a bankruptcy proceeding when the operating subsidiaries have been recapitalized and then get transferred to a bridge company. And pursuant to regulatory requirements and also pursuant to the resolution planning process, the firms are also putting themselves in a place where they are not having material operations occurring in the holding company where there is little or no short-term debt in the holding company, and subsidiaries are not guaranteeing holding company debts. So that is another aspect of how the companies are putting themselves in a position to actually utilize the single point of entry process.

And finally, because the amendments that are in section 1188 of the proposed bill have not been enacted, there has been a very strong effort by both regulators and by the firms to amend financial contracts to remove cross defaults to a holding company bankruptcy so that the financial contracts cannot be terminated the way they were in Lehman Brothers and can continue in effect, of course with appropriate protections for counterparties, because the guarantees would be moved to the new bridge company and would therefore not be subject to the debt that's been left behind in the old bankrupt company.

So all of those features, and there were some others that I mention in my written testimony, are putting things in a position to actually accomplish single point of entry.

Now, there were two provisions in the bill that I wanted to mention that I think are worth just highlighting. The first one is the ability of the Federal Reserve to commence an involuntary case. One of the difficulties that's been raised with that provision is involuntary cases normally come with the right to oppose them and other parties need to be heard by the court, there might be appeals, and in my view, if the due process issues are so overwhelming with respect to that issue, it's not critically necessary to include that provision.

And I see you raising your gavel, so what I will do is wait for questions if there are questions on that issue or on the other provision that I wanted to address. Thank you.

Mr. MARINO. Thank you, Attorney Bernstein. See it works very subtilely.

[The prepared statement of Mr. Bernstein follows:]

STATEMENT OF

DONALD S. BERNSTEIN

BEFORE

SUBCOMMITTEE ON REGULATORY REFORM, COMMERCIAL AND ANTITRUST LAW

THE COMMITTEE ON THE JUDICIARY

U.S. HOUSE OF REPRESENTATIVES

WASHINGTON, D.C.

JULY 9, 2015

H.R. , THE "FINANCIAL INSTITUTION BANKRUPTCY ACT OF 2015"

Thank you for inviting me to testify once again on the subject of the resolution of financial institutions under the Bankruptcy Code. I am Donald S. Bernstein, co-chair of the Insolvency and Restructuring Group at Davis Polk & Wardwell LLP. I am on the Board of Editors of Collier on Bankruptcy, President and Chair of the International Insolvency Institute, a past Commissioner on the American Bankruptcy Institute's Commission on the Reform of Chapter 11, and a past Chair of the National Bankruptcy Conference.

I had the honor of appearing before this Subcommittee at an oversight hearing on this subject in December 2013 and at a subsequent hearing in December 2014 at which the Subcommittee considered a draft of the bill that became H.R. 5421, the Financial Institution Bankruptcy Act of 2014 ("FIBA"). FIBA was passed by the House during the closing days of the 113th Congress. I focus today on the anticipated introduction in the current Congress of a bill substantially similar to FIBA, "H.R. ____, the "Financial Institution Bankruptcy Act of 2015."

During the past few years, I have spent a significant portion of my time working on resolution plans for large financial firms under Section 165(d) of the Dodd-Frank Act. I have also represented financial industry organizations, such as The Clearing House Association and SIFMA on issues related to the resolution of financial firms. I am, however, here in my individual capacity and not on behalf of any client, though I expect to be asked by clients to help them evaluate the proposed bill we are discussing today. The views I express are my own, and not those of Davis Polk, any client or any organization with which I am affiliated.

The Single-Point of Entry Approach to Resolution

It will not surprise any of the members who attended last year's hearing that I continue to strongly support the idea that the Bankruptcy Code should be amended to add tools to facilitate speedy recapitalization of the largest financial firms. Because of the bank holding company structure used in the United States and the availability of substantial loss absorbing capacity at the holding companies of our largest and most systemic financial firms, the single-point-of-entry approach developed by the Federal Deposit Insurance Corporation under Title II of the Dodd-Frank Act ("Orderly Liquidation Authority" or "OLA") can be adapted for the resolution of such firms under the Bankruptcy Code. Improvements in the Bankruptcy Code would reinforce the idea that bankruptcy is the preferred method of resolving such firms and that Orderly Liquidation Authority is a backup to be used only in rare and unusual circumstances. I strongly agree, however, with the view expressed in the June 18, 2015 letter of the National Bankruptcy Conference addressed to, among others, the Chair of this Subcommittee that Orderly Liquidation Authority should be retained as a backup resolution tool even if FIBA is passed, but the goal of FIBA should be to add resolution tools to the Bankruptcy Code so that OLA is unlikely to be used.

The single-point-of-entry approach to the resolution of a financial firm involves commencing resolution or bankruptcy proceedings only with respect to the financial firm's top-level parent holding company, with all losses of the distressed financial firm being borne by shareholders and creditors of that entity and not by taxpayers. Material operating subsidiaries, like the firm's significant banking or broker-dealer subsidiaries, would not be placed in insolvency or resolution proceedings. They would be recapitalized using assets of the holding company and, promptly after the commencement of the holding company's bankruptcy proceedings, their stock would be transferred to a new, substantially debt free, bridge company. The subsidiaries would continue as going concerns, paying all of their obligations, until they are disposed of or have been wound down in an orderly way.

By recapitalizing the firm's operating subsidiaries with holding company assets at the outset of the process, the single-point-of-entry approach preserves the continuity of the financial firm's systemically critical operations and the value of its operating businesses, and pushes the firm's operating losses up to the old holding company to be absorbed by the holding company's shareholders and creditors. Customers and counterparties can continue to be served by the ongoing businesses of the firm or can migrate to competitors in an orderly fashion as businesses are wound down; fire sales of the firm's assets are avoided; and the residual value of the firm's operations is maximized for ultimate distribution to creditors and other stakeholders left behind in the holding company's bankruptcy proceedings.

Recent Progress Enhancing the Resolvability of Financial Firms

A number of concrete actions have been or are being taken to enhance the resolvability of the largest U.S. financial firms, whether under Orderly Liquidation Authority or under the Bankruptcy Code. Many of these steps were already in progress when I testified last year, and additional progress has been made since that time in a number of key areas.

Here are some of the key areas where progress has been made:

1. *Capital and Total Loss Absorbing Capacity.* A critical element of the ability to recapitalize a distressed U.S. financial firm is having sufficient loss absorbing capacity in the firm's bank holding company. This includes both capital and structurally subordinated capital structure debt issued by the firm's holding company that can be "bailed-in" in connection with the recapitalization of the firm. The capital levels of the largest U.S. bank holding companies are now more than double what they were in 2008, and the largest firms' holding companies currently have, even in advance of the issuance of so-called "TLAC" ("total loss absorbing capacity") requirements, substantial amounts of long-term capital structure debt in addition to their capital, effectively doubling again the loss absorbing capacity at their holding companies available for the recapitalization of the firm.
2. *Mitigation of QFC Cross-Defaults.* In October 2014, the Financial Stability Board announced another important enhancement in the resolvability of global financial firms. Eighteen global systemically important banking groups have adhered to a protocol (the "ISDA Protocol") that modifies the terms of ISDA Master Agreements to assure the cross-border enforceability of provisions in special resolution regimes, like OLA, that override cross-defaults in such agreements arising out of the resolution of an affiliated credit support provider, such as a parent holding company that guarantees the obligations of a subsidiary under the subsidiary's financial contracts. Regulations are expected to be issued by U.S. regulators in the near future mandating implementation of these

provisions with respect to a broader range of counterparties of financial firms and under a broader range of financial contracts. Importantly, the ISDA Protocol provides that, when the regulations take effect, the termination rights of adhering parties based on the commencement of bankruptcy proceedings by a holding company that is a credit support provider will also be overridden in a single-point-of-entry resolution if certain conditions designed to protect counterparties are met. These contractual provisions, which seek to eliminate disruptive financial contract closeouts in a single-point-of-entry resolution, address one of the major obstacles to orderly resolution identified in the aftermath of the Lehman Brothers bankruptcy. Market-wide implementation of these provisions would avoid the enormous losses reportedly suffered by Lehman Brothers in connection with such closeouts and also eliminate the possible contagion effects of the sale of large volumes of collateral by counterparties seeking to satisfy their claims.

3. *Increased Liquidity.* The amount of high quality liquid assets maintained on the balance sheets of the largest U.S. financial firms has increased substantially since 2008 and the reliance by the firms on short term wholesale funding (for example, overnight repurchase agreements) has been substantially reduced. These changes, which serve to reduce the severity of any run on the firm's liquidity and to increase the ability of the firm to meet a run, permit the firms to absorb extraordinary liquidity shocks even in severely adverse economic conditions. They are designed to meet the stringent liquidity coverage requirements imposed

by regulators since 2008 and also to provide a funding reserve that will sustain a single-point-of-entry resolution of the firm if necessary.

4. *Clean Holding Companies.* The largest U.S. firms are eliminating the issuance of short term runnable debt from their holding companies and minimizing operating activities conducted at the holding company level. This clean holding company structure will facilitate the separation of recapitalized ongoing operating subsidiaries from the distressed bank holding company in connection with a single-point-of-entry resolution.

5. *Continuity of Shared Services.* Because, in a single-point-of-entry resolution operating subsidiaries are recapitalized and do not enter into resolution proceedings, the single-point-of-entry resolution approach preserves the continuity of ongoing inter-company services among the members of the financial firm's corporate group. Nevertheless, the firms are doing detailed mappings of such inter-company services, and are formalizing inter-company contractual commitments with respect to such services, or, in some cases creating separately incorporated and capitalized service companies to further assure the continuity of such services in resolution.

6. *Operational Capabilities.* The firms are enhancing operational capabilities, including management information systems, to facilitate continuous access to real time information necessary for resolution of the firms.

7. *Financial Market Utilities.* The firms are engaged in an ongoing dialogue with financial market utilities ("FMUs") to develop playbooks to

assure continued access to the services of FMU's during a period of financial distress and in resolution.

8. *Greater Coordination Among Global Regulators.* Through the Financial Stability Board and direct bilateral and multilateral initiatives, regulators around the world have been actively engaged in efforts to coordinate their actions in the event of the need to resolve a global financial firm. FDIC Chairman Martin Gruenberg recently noted, for example, that the FDIC has worked closely with all major financial jurisdictions, including the United Kingdom, Germany, Switzerland and Japan, as well as newly created European resolution and supervisory entities, on identifying and addressing obstacles to cross-border resolution.[1]

Each of these actions addresses a potential obstacle to orderly resolution that has been identified based on the Lehman Brothers experience or based on the detailed analysis undertaken by both the firms and regulators in the resolution planning process. The firms have added TLAC and liquidity to help them effectuate a recapitalization of their operations and a single-point-of-entry resolution, whether under OLA or under the Bankruptcy Code. They are taking steps to assure the continuity of shared services and to put in place the necessary operational capabilities. They are in the process of eliminating financial contract

[1] Martin J. Gruenberg, Chairman, Fed. Deposit Insr. Corp., A Progress Report on the Resolution of the Systemically Important Financial Institutions (May 12, 2015), available at https://www.fdic.gov/news/news/speeches/spmay1215.html.

termination rights. They are developing plans to assure access to financial market utilities. And, importantly, global regulators are improving their coordination and cooperation, so that orderly resolution is not thwarted by precipitous action by local authorities. For all of these reasons, the feasibility of resolving a large financial firm without significant systemic disruption and without placing taxpayer funds at risk is far greater today that it has ever been before.

Resolution Tools and FIBA

While the steps identified above are designed to make single-point-of-entry resolution under the Bankruptcy Code feasible even under current law (for example, by maintaining the resources needed to recapitalize operating entities and by overriding bankruptcy-related cross-defaults under financial contracts), tools should nevertheless be added to the Bankruptcy Code to further enhance the ability to resolve large financial firms under the Bankruptcy Code using the single-point-of-entry approach. In my 2013 testimony, I identified four key additions I felt would be desirable. They were:

- Clarifying that bank holding companies can recapitalize their operating subsidiaries prior to the commencement of bankruptcy proceedings.
- Clarifying that section 363 of the Bankruptcy Code can be used to transfer the recapitalized operating subsidiaries to a new holding company using a bridge company structure.
- Adding provisions that permit a short stay of close-outs and allow the assumption and preservation of qualified financial contracts, and

overriding ipso facto (bankruptcy) defaults or cross-defaults that might impede the resolution process.

- Providing for some form of fully secured liquidity resource that would offer financing to help stabilize the recapitalized firm and prevent fire sales until access to market liquidity returns.

The first two of these features would increase the certainty of application of current law to actions that must be taken in connection with a single-point-of-entry resolution in bankruptcy.

The third of these features currently is being addressed by contractual workarounds like the ISDA Protocol, but it would be far better if the Bankruptcy Code were amended to include provisions similar to those contained in special resolution regimes, like OLA and the European Bank Resolution and Recovery Directive, that provide for the override of cross-defaults under financial contracts in a single-point-of-entry resolution.

The last of these features is being addressed by the substantially increased liquidity reserves on the balance sheets of the largest financial firms, though once they have been recapitalized in a single-point-of-entry resolution, there is no reason why traditional, secured lender-of-last-resort liquidity should not be available to non-bankrupt, fully capitalized, going concern subsidiaries of the firms. The availability of such liquidity, if properly structured, would involve no risk of loss to taxpayers, and would help to mitigate any panic run on subsidiary liquidity after the holding company commences its bankruptcy proceedings.

Although FIBA leaves the availability of lender-of-last-resort liquidity to otherwise applicable law, it would amend the Bankruptcy Code to add the first three features I have identified. For this reason I strongly support the enactment of FIBA in the form in which it was passed by the House during the last Congress.

Comments on Two Provisions of FIBA

It is worth highlighting two particular provisions of FIBA as to which further comment is warranted.

Right of Federal Reserve Board to File A Petition for Relief. The first provision of FIBA I want to comment on is in section 1183(a)(2), which provides for the commencement of a subchapter V proceeding by the Federal Reserve Board (the "FRB") if certain conditions are met. The commencement of such a proceeding by the FRB can be contested, but the timeline for entry of the order for relief and for an appeal from such order is necessarily very short. The timeline is dictated by the need to be able to create and transfer the stock of the firm's operating entities to a bridge company over a proverbial "resolution weekend." Any disputes over the commencement of the case must be resolved in sufficient time so the Bankruptcy Court can hear and approve a transfer motion under Section 1185 before the firm reopens for business on Monday morning.

While it is beneficial for the FRB to have the ability to act under the Bankruptcy Code if the financial firm is not doing so, the ability of the Federal Reserve to commence a subchapter V case is not integral to the purposes of subchapter V. If the shortness of the timeline to contest a bankruptcy petition filed by the FRB is deemed objectionable, rather than extending the timeline, which would adversely affect the ability to resolve the firm, defeating the purposes of subchapter V, the right to contest the FRB's petition could be eliminated or, alternatively, the ability of the FRB to commence a case under subchapter V could simply be removed from the bill. Selecting the latter option should not adversely affect the ability to achieve the goals of subchapter V. Even without the ability of the FRB to commence a subchapter V proceeding, U.S. regulators have more than sufficient supervisory and other authority, including the ability to commence proceedings under OLA, to assure that financial firms take the steps necessary to protect the U.S. financial system.

Suspension of Financial Contract Cross-Defaults. The provisions permitting the assumption and assignment of financial contracts within 48 hours after commencement of the case also deserve mention. As I have noted, based on the experience in the Lehman Brothers case, financial firms, regulators and commentators identified the inability to preserve and continue to perform financial contracts of operating subsidiaries due to cross defaults related to the commencement of bankruptcy proceedings by a holding company credit support provider as a significant impediment to the orderly resolution of systemically important financial firms. To address this impediment, it is essential that any procedure for the orderly resolution of financial firms provide for the ability of the failing firm to preserve its subsidiaries' financial contract books if it continues to perform its obligations in respect of such contracts and if appropriate protections for counterparties are provided. Provisions overriding financial contract termination rights are recommended by the Financial Stability Board's *Key Attributes of Effective Resolution Regimes For Financial Institutions*, and, as previously mentioned, are included in Orderly Liquidation Authority and the European Bank Resolution and Recovery Directive, among other resolution procedures. The absence of such provisions in the Bankruptcy Code is among the reasons that U.S. regulators have pressed vigorously for implementation of contractual workarounds like the ISDA Protocol.

While the volatility and purposes of financial contracts justify including appropriate protections for counterparties, Section 1188 of FIBA, which overrides cross-defaults relating to a credit support provider's bankruptcy, strikes a balance between preservation of the non-bankrupt recapitalized subsidiaries' financial contracts on the one hand and the protection of counterparties on the other. The counterparty protections in section 1188 include:

- Requiring the debtor or its affiliate under the qualified financial contract to perform all of its payment and delivery obligations thereunder during the short, temporary stay period pending approval of a transfer motion under Section 1185, and terminating the stay of termination rights if such obligations are not performed.
- Requiring all qualified financial contracts between the counterparty and the debtor to be assigned to and assumed by the bridge company in the transfer under section 1185, and all claims against the debtor in respect of such contracts to be assumed by the bridge company.
- Requiring all property securing or any other credit enhancements, such as guarantees, furnished by the debtor for qualified financial contracts, including those of subsidiaries transferred to the bridge company, to be assigned to and assumed by the bridge company.

Simply expressed, the counterparty's termination rights arising out of cross-defaults are overridden only if all payment and delivery obligations in respect of the counterparty's contracts continue to be performed and any guarantees or other credit support obligations of the bankrupt holding company are assumed by the fully capitalized, non-bankrupt bridge company. The counterparty's position is enhanced not only through the recapitalization of its subsidiary obligor, but also because any credit enhancements are now provided by the bridge company, free of the old holding company's capital structure debt, which has been left behind in the former holding company's bankruptcy proceedings. These provisions provide substantial protection to the counterparty whose cross-default rights are overridden to facilitate the orderly resolution of the firm.

Conclusion

While there is no one-size-fits-all strategy for effective resolution of a large financial firm, there is an increasing consensus that our largest financial firms can be resolved under the Bankruptcy Code in an orderly way without a taxpayer bailout if their holding companies maintain sufficient loss absorbency and liquidity resources and the firms and their regulators complete the actions they have undertaken to enhance the resolution-readiness of the firms. The enactment of FIBA would build upon these actions by providing a clearer and easier path to the single-point-of-entry resolution of the largest, most systemically important financial firms.

Mr. MARINO. Attorney Hessler, please.

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

Mr. HESSLER. Thank you. Chairman Marino, Chairman Goodlatte, Ranking Member Johnson, Ranking Member Conyers, other Members, thank you for inviting me to testify at today's hearing.

As noted in your very kind introduction, I'm a partner in the restructuring group of Kirkland & Ellis, LLP. Although my practice includes representing creditors, equity holders, and other constituencies in complex distressed matters, I mostly represented major corporations as company counsel in some of the largest and most challenging bankruptcies in history. I am speaking especially from that perspective this morning.

I am distinctly pleased to appear before this Subcommittee again regarding the Financial Institution Bankruptcy Act of 2015, also known as Subchapter V. It was my privilege to testify in July 2014 in support of the prior version. Given the comprehensive record scrutinizing Subchapter V, I will not repeat my prior testimony and will instead this morning focus on two issues.

First, the comparative benefits of a judicial process such as Chapter 11 versus a regulatory process such as Title II of the Dodd-Frank Act for addressing a major bank's failure, and second, how the 48-hour delay of the qualified financial contract safe harbors from the automatic stay is critical to the effectiveness of Subchapter V.

Turning to the first issue. The touchstone analytical framework for evaluating Subchapter V should not be as a stand-alone proposal, but rather, as compared to Chapter 11 in its current form, Chapter 11 as amended by Subchapter V and Title II. Among these 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.

The hallmarks of an optimal resolution regime for failing SIFIs must be clear and established rules administered by an impartial tribunal. Subchapter V is a financial corporation specific supplement to the existing reorganization provisions of Chapter 11 of the Bankruptcy Code. And thus, it builds upon decades of practice and precedent that have refined the code and that otherwise provide a well tested and proven successful reorganization framework for major corporations, including SIFIs and their stakeholders.

Importantly, 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 will ever be invoked.

Turning to my second point. 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, but the Bankruptcy Code currently provides that counterparties to so-called qualified financial contracts, such as derivatives, repurchase, and swap agreements enjoy a so-called safe harbor from the automatic stay.

Consequently, a Chapter 11 filing by a financial corporation with significant qualified financial contracts could be chaotic at the outset as counterparties that are 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 these safe harbors for 48 hours after the commencement of the case, which is consistent with the time period under Section 1185 for effecting the transfer of the subsidiary operating assets which include qualified financial contracts to the bridge company under the single point of entry approach highlighted by Mr. Bernstein.

I have previously criticized Title II for imposing too brief a stay on this front until only 5 p.m. Eastern on the business day following the FDIC's appointment as receiver, and as a general matter, my default position remains that safe harbors should not exist at all. That said, for the following four reasons, I am persuaded that Subchapter V proposes a workable construct in this context.

One, since passage of the Dodd-Frank Act in 2010, financial corporations have had 5 years to draft and refine their living wills. Ideally, the enactment of Subchapter V will reinforce the need to be prepared to make expedited qualified financial contract transfer and assignment decisions.

Two, Subchapter V requires that decisions on whether to transfer and assign all of the debtor financial corporation's assets, expressly including qualified financial contracts, must be made within 48 hours. It logically follows that 48 hours is a sufficient period to stay qualified financial contract counterparties from taking remedial actions that would interfere with these determinations.

Three, the implicit expectation of Subchapter V is that essentially all qualified financial contracts will be transferred to the bridge company. Because Subchapter V precludes cherry-picking only certain qualified financial contracts for assignment, this should reduce the burden of having to make transfer determinations for every individual agreement.

Lastly, the most likely alternative to a Subchapter V case, which is 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. This means Subchapter V's 48-hour stay is actually the most robust option under the current and potential SIFI insolvency regimes at issue.

I look forward to further careful consideration of the important issues addressed by Subchapter V. I thank the Subcommittee for allowing me to share my views on this legislation, and I welcome the opportunity to answer any questions about my testimony.

Mr. MARINO. Thank you, Attorney Hessler.

[The prepared statement of Mr. Hessler follows:]

STATEMENT OF

STEPHEN E. HESSLER

PARTNER, KIRKLAND & ELLIS LLP

BEFORE

THE SUBCOMMITTEE ON REGULATORY REFORM, COMMERCIAL AND ANTITRUST LAW

THE COMMITTEE ON THE JUDICIARY

THE UNITED STATES HOUSE OF REPRESENTATIVES

JULY 9, 2015

HEARING ON

H.R. ____, THE "FINANCIAL INSTITUTION BANKRUPTCY ACT OF 2015"

Overview

Introduction

Mr. Chairman and members of the Subcommittee, thank you for inviting me to testify at today's hearing. My name is Steve Hessler, and I am a partner in the Restructuring Group of Kirkland & Ellis LLP. 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

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1 More specifically, I have written about and critiqued at length the authority provided by Congress within Title II of the Dodd-Frank Act. *See* Stephen E. Hessler & James H.M. Sprayregen, *Too Much Discretion Exacerbates 'Too Big To Fail,'* WHO'S WHO LEGAL (July 2011); James H.M. Sprayregen & Stephen E. Hessler, *Orderly Liquidation Authority Under the Dodd-Frank Act: The United States Congress's Misdirected Attempt to Ban Wall Street Bailouts*, INSOL WORLD (Third Quarter 2010); James H.M. Sprayregen & Stephen E. Hessler, *Failing to Be Too Big to Fail*, THE 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.

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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

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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

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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(e)(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]

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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

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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.

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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

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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

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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]

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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.

* * * * *

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.

Mr. MARINO. Attorney Levin, did I—am I pronouncing it correctly? Levin or Levin?

Mr. LEVIN. It is Levin, Mr. Chairman

Mr. MARINO. Levin. I apologize for the mispronunciation.

Mr. LEVIN. Not a problem.

Mr. MARINO. Please, your opening statement.

TESTIMONY OF RICHARD LEVIN, ESQ., PARTNER, JENNER & BLOCK LLP

Mr. LEVIN. Thank you. Thank you, Mr. Chairman. Thank you for your kind introduction. I thank the Members of the Subcommittee for their attention here today.

I want to reiterate that as chair of the National Bankruptcy Conference, I am speaking here today only on behalf of the Conference, not on behalf of my own views or the views of my law firm, Jenner & Block, or the views of any clients of Jenner & Block.

You have our written statement, Mr. Chairman, which I understand will be included in the record. It covers many more things than I will address today orally, but I want to highlight a few points.

First, I would like to describe that the National Bankruptcy Conference is in general agreement with what Mr. Bernstein and Mr. Hessler have already said. There is a lot of—as there is within the Subcommittee—there is a lot of agreement within the financial and bankruptcy community about many terms of this bill. It was very carefully crafted and constructed to address many of the concerns that had been addressed, especially with respect to financial contracts.

That said, the National Bankruptcy Conference, which generally supports bankruptcy legislation, has concerns about the workability of this legislation considered in an isolated form. But what has happened over the last several years since the financial crisis is that many other structures have arisen that make this bill much more workable than it would have been had it been enacted say in 2009 or 2010, the single point of entry concept development, the provisions in financial contracts that provide for nontermination upon the guarantor's or the parent guarantor's bankruptcy and many other things that Mr. Bernstein and Mr. Hessler have addressed, but the Conference nevertheless is concerned about the workability of this legislation.

We do not oppose it. We are not, I will say, vigorous supporters of it. We are, I think, mild supporters of the legislation as a good alternative for the reasons that Mr. Hessler just described. But let me describe the few concerns that we have.

One is that the, the regulators in every other financial area of stockbrokers, insurance companies, usually have the speed and the agility and the expertise to take over and resolve a distressed financial institution. Here we are talking about the holding companies where the regulators, in normal times, have a lot of expertise. Bankruptcy courts do not have that expertise. They are going to be asked to move very quickly over what we call a resolution weekend. We all recognize that things have to move that fast. And we think that therefore the regulators should continue to play a major role in this process.

The judicial supervision is useful for transparency and due process, we agree with that, but we do not believe that given the speed that is required and the time it takes to get educated about the intricacies and complexities of these institutions that all of this can be put upon even a well trained bankruptcy judge and that the regulatory role is still very important in the process.

We believe it's also important because of cross border issues. Regulators in other countries are much more comfortable dealing with the regulators that they have worked with for years in supervising these institutions rather than with an unknown bankruptcy judge who might be every bit as qualified and capable as the regulators but is not a known quantity and therefore would create uncertainty and therefore risk.

So the next point is that—the point on involuntary petitions. We are concerned about due process with the amount of time that is available to deal with involuntary petitions, and we favor the voluntary route. I think we can witness the Lehman experience, which in a voluntary petition works, that we don't need a regulator in a voluntary because the regulators have enough tools to persuade management and a board of directors that a voluntary petition is necessary. So we support the idea of voluntary use of Subchapter V.

We are concerned about the lender of last resort issue. We know that's outside this Committee's jurisdiction, so I won't spend much time on it other than to say we think its availability will obviate the need for its use, and that's an important point.

And finally, we do support the provision in this bill, which was not—which has not been in some other proposals, that this proceeding take place before bankruptcy judges who are expert in financial reorganization rather than before the district court who does not have the same expertise as the bankruptcy court.

With that, Mr. Chairman, I'm happy to address any questions the Committee might have.

Mr. MARINO. Thank you, Attorney Levin.

[The prepared statement of Mr. Levin follows:]

STATEMENT

of

RICHARD LEVIN[1]

On behalf of the

NATIONAL BANKRUPTCY CONFERENCE

at the Hearing on

"Financial Institution Bankruptcy Act of 2015"

before the

SUBCOMMITTEE ON REGULATORY REFORM, COMMERCIAL AND ANTITRUST LAW

of the

COMMITTEE ON THE JUDICIARY

U.S. HOUSE OF REPRESENTATIVES WASHINGTON, D.C.,

July 9, 2015

[1] Chair, National Bankruptcy Conference and Partner, Jenner & Block LLP, New York, NY. The views expressed in this testimony are expressed solely on behalf of the National Bankruptcy Conference and do not necessarily represent the views of Mr. Levin or of Jenner & Block or any of its partners or clients.

The National Bankruptcy Conference ("**Conference**") appreciates the opportunity to participate in this hearing. The Conference is a voluntary, non- profit, non-partisan, self-supporting organization of approximately 60 lawyers, law professors, and judges who are leading scholars and practitioners in the field of bankruptcy law. Its primary purpose is to advise Congress on the operation of bankruptcy and related laws and any proposed changes to those laws. A Fact Sheet describing the Conference and listing its Members is attached to this Statement.

The Conference recognizes that a failing systemically important financial institution (**SIFI**) faces extraordinary challenges if it were to become a debtor under the current version of the Bankruptcy Code. For that reason, and in light of the importance of an orderly and effective resolution scheme for SIFIs to our country's economy and capital markets, the Conference has made it a priority to track developments in the efforts to modify the Bankruptcy Code to address and mitigate those challenges, starting with the chapter 14 regime first proposed as part of the Resolution Project at Stanford University's Hoover Institute Working Group on Economic Policy.[2] Its Members have also participated in some of those efforts, on behalf of the Conference or in their individual capacities, and in drafting various versions of possible legislation.

The Conference's previous participation has included correspondence with Congress regarding prior SIFI bankruptcy legislative initiatives, first in a letter dated January 29, 2014 to Senators Cornyn and Toomey, commenting on S. 1861, the Taxpayer Protection and

[2] *See, e.g.*, "Resolution of Failed Financial Institutions: Orderly Liquidation Authority and a New Chapter 14, located at http://www.federalreserve.gov/SECRS/2011/June/20110620/OP-1418/OP-1418_061511_81311_544434921739_1.pdf

Responsible Resolution Act ("**TPRRA**"), in the 113th Congress and in a letter dated June 18, 2015 to Representatives Marino and Johnson and Senators Grassley and Leahy, after the passage in the House of H.R. 5421, the Financial Institution Bankruptcy Act of 2014 ("**FIBA**"). FIBA addressed many of the technical, bankruptcy-specific aspects of TPRRA the Conference had commented on in its first letter. In our second letter, therefore, the Conference moved beyond the more technical aspects (most of which, as noted, had been addressed). It called for caution in fashioning any bankruptcy solution for resolving a SIFI, providing the Conference's suggestions for striking the right balance between the role of the judiciary and of regulators in the resolution of a SIFI; it recommended eliminating the involuntary bankruptcy process in light of due process concerns; and it noted the very real possibility that a SIFI's need for liquidity in bankruptcy might be beyond the market's funding abilities.

The more substantive concerns described in the Conference's second letter remain. Rather than summarize them here, for my testimony, I attach copies of the two letters and ask that they be included in the record as part of my testimony. The Worldwide Web references to the letters are also listed on the attached.

The Conference thanks you for this opportunity to appear to speak on this important topic and wishes to support this effort by providing any expertise and assistance you might request.

Attachments to Testimony of Richard Levin

on behalf of the

National Bankruptcy Conference

National Bankruptcy Conference Fact Sheet

Letter from National Bankruptcy Conference dated January 29, 2014 to Senators Cornyn and Toomey regarding S. 1861, 113th Congress, Taxpayer Protection and Responsible Resolution Act.
http://www.nbconf.org/images/NBC%20Ltr%20re%20s%201861%20(Ch%2014).pdf

Letter from National Bankruptcy Conference dated June 18, 2105 to the Representatives Marino and Johnson and Senators Grassley and Leahy regarding Proposed Amendments to the Bankruptcy Code Relating to Resolution of Systemically Important Financial Institutions.
http://www.nbconf.org/images/NBC_Ltr_to_Cong_re_SIFI_Bills.pdf

National Bankruptcy Conference

A non-profit, non-partisan, self-supporting organization of approximately sixty lawyers, law professors and bankruptcy judges who are leading scholars and practitioners in the field of bankruptcy law. Its primary purpose is to advise Congress on the operation of bankruptcy and related laws and any proposed changes to those laws.

History. The National Bankruptcy Conference (NBC) was formed from a nucleus of the nation's leading bankruptcy scholars and practitioners, who gathered informally in the 1930's at the request of Congress to assist in the drafting of major Depression-era bankruptcy law amendments, ultimately resulting in the Chandler Act of 1938. The NBC was formalized in the 1940's and has been a resource to Congress on every significant piece of bankruptcy legislation since that time. Members of the NBC formed the core of the Commission on the Bankruptcy Laws of the United States, which in 1973 proposed the overhaul of our bankruptcy laws that led to enactment of the Bankruptcy Code in 1978, and were heavily involved in the work of the National Bankruptcy Review Commission (NBRC), whose 1997 report initiated the process that led to significant amendments to the Bankruptcy Code in 2005.

Current Members. Membership in the NBC is by invitation only. Among the NBC's 60 active members are leading bankruptcy scholars at major law schools, as well as current and former judges from eleven different judicial districts and practitioners from leading law firms throughout the country who have been involved in most of the major corporate reorganization cases of the last three decades. The NBC includes leading consumer bankruptcy experts and experts on commercial, employment, pension, mass tort and tax related bankruptcy issues. It also includes former members of the congressional staff who participated in drafting the Bankruptcy Code as originally passed in 1978 and former members and staff of the NBRC. The current members of the NBC and their affiliations are set forth on the second page of this fact sheet.

Policy Positions. The Conference regularly takes substantive positions on issues implicating bankruptcy law and policy. It does not, however, take positions on behalf of any organization or interest group. Instead, the NBC seeks to reach a consensus of its members - who represent a broad spectrum of political and economic perspectives - based on their knowledge and experience as practitioners, judges and scholars. The Conference's positions are considered in light of the stated goals of our bankruptcy system: debtor rehabilitation, equal treatment of similarly situated creditors, preservation of jobs, prevention of fraud and abuse, and economical insolvency administration. Conferees are always mindful of their mutual pledge to "leave their clients at the door" when they participate in the deliberations of the Conference.

Technical and Advisory Services to Congress. To facilitate the work of Congress, the NBC offers members of Congress, Congressional Committees and their staffs the services of its Conferees as non-partisan technical advisors. These services are offered without regard to any substantive positions the NBC may take on matters of bankruptcy law and policy.

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NATIONAL BANKRUPTCY CONFERENCE

A Voluntary Organization Composed of Persons Interested in the Improvement of the Bankruptcy Code and Its Administration

January 29, 2014

Hon. John Cornyn
United States Senate
Washington, DC 20510

Hon. Pat Toomey
United States Senate
Washington, DC 20510

Re: S. 1861 – Taxpayer Protection and Responsible Resolution Act

Dear Senators Cornyn and Toomey:

The National Bankruptcy Conference (NBC) is a voluntary, non-partisan, not-for-profit organization composed of about 60 of the nation's leading bankruptcy judges, professors and practitioners. It has provided advice to Congress on bankruptcy legislation for over 75 years. I enclose a Fact Sheet, which provides further information about the NBC.

The NBC has reviewed S. 1861, the "Taxpayer Protection and Responsible Resolution Act" ("TPRRA"), which you introduced last month. We have considered both the substance of the bill and the technical and drafting issues. Our substantive comments follow immediately below. In addition, consistent with our mission of providing technical assistance to Congress in this very technical area of the law, and without regard to our substantive comments, we have reviewed the legislation for technical and drafting issues that might prevent the bill from achieving its policy objectives. Following the substantive comments is our report on technical and drafting issues and our suggested solutions. We hope this report is helpful in your deliberations.

Background

TPRRA creates a new chapter 14 of the Bankruptcy Code available only for "covered financial corporations", which are bank holding companies or financial institutions. The chapter 14 debtor is likely to be a parent entity with its operations and regulated activities conducted through subsidiaries or affiliates. The chief departure under TPRRA from general bankruptcy concepts is to permit an expedited transfer of potentially all the assets of the debtor at the beginning of the case, to be administered outside of the confines of the debtor's case and away from the jurisdiction of the court. This is accomplished through the rapid transfer of select assets and liabilities to a new bridge holding company, a "bridgeco," whose equity interests are held in trust for the chapter 14 estate and administered by a special trustee approved by the court. A temporary stay prevents the occurrence of certain destabilizing actions during the transfer process. The expectation is that the chapter 14 debtor in possession will thereafter complete a plan process using the same provisions as under a chapter 11 case, culminating in a plan to distribute any proceeds realized by the special trustee from the equity of the bridgeco to the creditors of the parent company whose debts have not been assumed by the bridgeco as part of the asset transfer.

The bridgeco mechanism attempts to set the stage for and enable what is now commonly referred to as the Single Point of Entry strategy for resolution of SIFIs. The TPRRA does not contain any special liquidity facility and repeals title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act, including the potential credit support guaranty facility and the ability of U.S. regulators to take over the resolution process if necessary to gain the cooperation of foreign regulators. The NBC has not studied the repeal of title II and thus takes no position on the repeal, focusing instead on the portions of TPRRA that contain the proposed chapter 14 provisions.

General Observations

At the outset we note that the NBC has not previously reviewed the TPRRA or any of the proposals on which it is based, so our comments and questions about the bill are necessarily preliminary and general given the limited time we have had for review. Based on our preliminary review, several members expressed serious reservations about whether the approach under TPRRA would work for SIFIs, raising as it does novel and difficult issues. We have provided a preliminary discussion of some of the most important issues below. We will continue to study the bill after submission of this initial letter and hope to provide more detailed drafting comments in the future.

The NBC generally supports the idea that resolution of covered financial corporations[1] should be done in a manner that (i) maximizes value for stakeholders, (ii) minimizes systemic disruption and moral hazard, yet (iii) protects taxpayers from loss. We accordingly support the growing global consensus that financial firms should be required to maintain a sufficient stack of loss absorbing, contractually or structurally subordinated equity and debt that can be utilized to quickly recapitalize the enterprise, as well as assets (such as intercompany loans) that can be contributed to the capital of distressed operating subsidiaries in connection with any such recapitalization. In contrast to the unitary bank model employed in some other countries, the bank holding company structure in the United States facilitates this approach by separating significant amounts of long-term unsecured debt from deposit and account-holding regulated entities, thereby adding an additional layer of loss absorbency at the holding company level.

[1] "Covered financial corporation" is the terminology used in the TPRRA, section 3(a), adding a new section 101(9A) to the Bankruptcy Code. The entity does not have to be a SIFI, since any bank holding company can qualify for chapter 14. Some of our concerns here, particularly with respect to the need for liquidity and global coordination, are aimed primarily at SIFIs and G-SIFIs. We recognize that a limited number of smaller bank holding companies holding only US assets have been able to restructure on an expedited basis under chapter 11, and if anything, chapter 14 as proposed would potentially make such restructurings easier.

The proposed chapter 14 takes advantage of the bank holding company structure to recapitalize the covered financial corporation by permitting the rapid transfer of select assets—equity in subsidiaries and other assets held at the parent holding company—to the bridgeco, leaving significant (if not most) liabilities of the parent behind. We believe that to be successful, any such recapitalization needs to be announced and accomplished with remarkable speed to stabilize the recapitalized firm and minimize any liquidity "run" or asset fire-sales. The TPRRA addresses this by including expedited procedures to create the bridgeco. (Our detailed comments below suggest ways in which the procedures can be further expedited.) We also believe the temporary stay prohibiting the exercise of rights by counterparties to qualified financial contracts ("QFCs") has the potential to substantially reduce the short-term liquidity and collateral needs of the covered financial corporation and avoid wholesale termination of QFCs on terms disadvantageous to the covered financial corporation, aiding in its near-term stability and ability to recapitalize. Given the interconnectivity of exposure between covered financial corporations which are SIFIs through QFCs, the temporary stay may also significantly reduce the risk of contagion.

Stabilizing and permanently restructuring any financial institution, though, will require some form of immediate liquidity source and/or credit support which the TPRRA does not provide. Despite the speed of the recapitalization proposed under TPRRA, we believe, even under the best of circumstances, it will take a period of time for the market to assimilate information about the financial restructuring of the covered financial corporation before the institution's full access to market liquidity returns.[2] Without some degree of certainty that the bridgeco has sufficient liquidity on its own taking into account the specific assets and liabilities assumed and discarded, that funding will be available at the time of filing, or failing both, without advance planning, communication and coordination among the debtor, the Federal Reserve Board, and regulators worldwide, the commencement of a chapter 14 case may cause ring-fencing by regulators worldwide, flight of short-term capital and value erosion. In severe cases, these events could cause the very sort of run on the regulated subsidiary entities that the Single Point of Entry strategy seeks to avoid.

The TPRRA needs to provide for an additional source of backstop interim liquidity for those covered financial corporations which will file without sufficient liquidity to prevent flight of short-term capital and stabilize the institution, particularly if there is a risk of contagion. The backstop can be limited to fully secured commitments or advances similar to the discount window currently available to banks. At a minimum, consideration should be given to incorporating provisions similar to section 364 to

[2] The regulated banks held by the bridgeco will have access to the discount window and their deposits will be supported by deposit insurance, both of which should prevent and/or fund any run on its liquidity resources. However, covered financial corporations that are diversified financial firms will have broker dealers, insurers, and other operating subsidiaries which lack access to any credit support other than through the public markets.

permit priming liens in the bridgeco's assets and first-out provisions for any new credit support provided to bridgeco, although we question whether even this will be sufficient to entice the public markets in the early stages of the recapitalization. In any event, all of the NBC's comments below must be understood in the context of our overriding concern that a successful recapitalization which achieves all of the goals stated at the outset of this memorandum cannot be achieved in all cases without some provision for potentially significant credit and collateral support.

Section-by-Section Comments

TPRRA Sec. 3(c). *Who May be a debtor:* The court should have the power to authorize the conversion of a case under chapter 14 to a case under chapter 7 once the transfer of assets to the bridgeco has occurred pursuant to section 1406. Section 1112 should be modified to permit conversion from chapter 14 to chapter 7. Chapter 7 will be necessary in those instances when a chapter 14 debtor is not able to satisfy the requirements for confirmation of a plan, for example, when the administrative expenses cannot be paid in full in cash.

TPRRA Sec. 3(b). *Applicability of chapters*: Rather than create a full plan process in chapter 14 or create the bridgeco mechanism within existing chapter 11, TPRRA adds a new section 103(m), which incorporates the chapter 11 plan process into chapter 14. Given this approach, section 1401 should be expanded in a manner similar to section 901 after a thorough review of provisions in the other chapters of the Bankruptcy Code to be sure their omission or inclusion is intentional.

Bankruptcy Code Sec. 1401. *Inapplicability of other sections*: See above.

Bankruptcy Code Sec. 1402. *Definition of "capital structure debt"*: The definition creates a category of liabilities that are not permitted to be transferred over to the bridgeco. It is critical to the success of a chapter 14 recapitalization that many liabilities presumptively do not get assumed by the bridgeco. But great care should be taken with this definition. Liabilities transferred over to bridgeco will presumably receive much better recoveries than those left behind. The potential preferential treatment of certain obligations and liabilities violates the fundamental bankruptcy policy of equality of distribution and should occur only in furtherance of the chapter 14 goals. We considered whether to approach the exercise by restricting the types of debts that bridgeco could assume rather than defining the liabilities that must remain with the chapter 14 debtor, but determined that the Bankruptcy Code should give the Federal Reserve Board and the special trustee flexibility in creating the optimum bridgeco. In any event, the NBC is concerned that debt can be too easily structured to avoid characterization as capital structure debt if the definition is based on the original maturity date and suggests that the following concept would not be as easily manipulated: all unsecured debt for borrowed money for which the debtor is the primary obligator.

Bankruptcy Code Sec. 1403. *Commencement of case*: The successful recapitalization under chapter 14 requires speed and certainty. After the fact challenges to either the appropriateness of the filing or the creation of the trust will undermine the very maintenance or restoration of market confidence and prompt access to sources of liquidity the bridgeco mechanism is designed to achieve. It is critical that the statute be unambiguous, standards clear and opportunity to undo non-existent. Similarly, we anticipate that before the chapter 14 petition is filed, most if not all of the planning for the creation of the bridgeco will have occurred by the Federal Reserve Board and the debtor in coordination with other relevant regulators, sources of funding and, in some cases, potential buyers. A meaningful judicial review process of even one day could jeopardize the process, and the NBC is concerned that the proposed one-day judicial process would not be meaningful in any event given the import of the findings the court is required to make.

We therefore propose here and in other places that certain actions would require Federal Reserve Board approval in lieu of a notice and hearing before a court. We would remove the requirement of a court determination in section 1403(a)(2)(B) and require that for any petition to be accepted, the Federal Reserve Board must make the finding and certification described in section 1403(a)(2)(A). Removing the judicial approval construct would also mean removing the appeal process. To the extent it is considered either necessary or desirable to limit the type of filing that is not subject to judicial review further, we would still recommend removing the judicial approval construct under section 1403(a)(2)(B) so long as the covered financial company has not objected to the Board's action within some very limited period of time. We also recommend that in the event the debtor has either filed the petition or consented to the petition at the time it is filed, the members of the board of directors and management involved in that decision should be able to make it free from any threat of recrimination or penalty from the constituents at the chapter 14 entity. The filing triggers an immediate transfer of potentially all the assets of the chapter 14 entity for a recapitalization process that will be largely without judicial review and will not be undertaken solely for the benefit of the chapter 14 constituents. It is easy to imagine that the constituents' representatives will challenge the decision-making process that results in the extraordinary transfer of assets without legally required approvals under constituent documents, exchange rules and state laws requiring shareholder approval and the like. We would therefore recommend that the statute include some form of safe harbor or exculpation protecting members of the debtor's board of directors and management for participating in the decision-making process, albeit a narrowly crafted one.

Bankruptcy Code Sec. 1404. *Regulator*: None.

Bankruptcy Code Sec. 1405. *Special trustee and bridge company.* As a preliminary observation, we believe the TPRRA anticipates that either the chapter 14 debtor will have created an intermediary entity which can act as the bridgeco shortly before the filing or one will be created simultaneously with the filing. In either event, the section should more clearly distinguish between (1) the new holding company to which the assets and certain liabilities of the chapter 14 debtor are transferred, (2) the trust, which holds the equity of the new holding company, and (3) the equity of the subsidiaries held, after the transfer, by the new holding company. Section 1405(a)(1) appropriately requires that the entity should not be a preexisting company which has liabilities and assets prior to the filing, For additional clarification, some consideration should be given to insulating this new bridgeco from preexisting liabilities that attach by operation of law on a joint and/or several basis (for example, certain tax liabilities). Ideally, the provision should also contemplate the transfer of lower-tiered equity interests in a multi-tiered enterprise, while skipping the assets and liabilities of intermediate funding entities, so that bridgeco can recapitalize not only by the conversion of the parent debt to equity but also by similar recapitalization of mezzanine type financing, for example, trust preferred securities, although this additional type of selection requires more detailed analysis.

Management of bridgeco and guardianship of the bridgeco interests will be significant factors in the effort to restore or maintain market confidence. In addition, similar to our comment with respect to section 1403, the designation of the special trustee and management of bridgeco must be rapid and certain. To the extent the Federal Reserve Board has appointed a person (or entity) to act as special trustee at the time the request to create the trust is filed, that appointment should be final, absent subsequent gross negligence, fraud, or similar misconduct. Likewise, the Federal Reserve Board's consent to the designation of senior management at bridgeco should be required, again with the expectation that these individuals will have been selected prior to the actual filing. Once the trust has been established and the selected assets and liabilities transferred, the powers of the special trustee would include the power to replace and appoint new senior management without further court approval. At the chapter 14 case level, we believe that once the bridgeco order has been entered, the mandatory appointment of a trustee rather than the continued control of prior management as a debtor in possession under section 1107 is appropriate. (This should not preclude any party in interest from seeking the appointment of a trustee sooner, and some consideration should be given to an expedited request process if the Federal Reserve Board wants a trustee at the chapter 14 debtor immediately upon filing.) The chapter 14 debtor is not an operating entity after the transfer, and there is no particular expertise existing management has for the negotiation of the allocation of value among the chapter 14 constituents or administration of the claims allowance process. Removal of existing management from the chapter 14 process should add to the perception of fairness in the overall process.

Section 1405(b)(3) requires the special trustee to provide notice to the parties in interest in the chapter 14 of certain corporate actions, including significant actions affecting the assets and liabilities of the bridgeco. Nothing further is provided for, leaving open the possibility that creditors and even equity interest holders in the parent can object in court but equally leaving open the possibility that there is no recourse beyond the ability to voice an objection. The special trustee will require extraordinary skills in executing its fiduciary duties under extreme stress and time constraints. It may seem beyond dispute that there is little a special trustee could do which would harm the chapter 14 constituents beyond the filing itself, but experience has taught us that it is a rare bankruptcy case in which valuation and strategy disputes do not exist. We would recommend that rather than such an open-ended process creating uncertainty both as to the finality of actions taken by the special trustee and the special trustee's potential legal exposure for taking those actions, the statute permit (but not require) the special trustee to specify any actions it intends to take in furtherance of the recapitalization of bridgeco and its subsidiaries and, so long as the Federal Reserve Board does not object to any of those actions, to allow the bridgeco order to reference such actions and immunize the special trustee and the bridgeco's directors and officers from any liability to the chapter 14 parties-in-interest for taking those actions.

The disclosure statement is a crucial element of the plan proposal process; informed consent is essential. There are known difficulties in gathering and understanding information when a debtor loses access to its books and records. Here, a significant portion of the debtor's books and records may be transferred to the bridgeco and no longer in the control of the chapter 14 entity. The standard for the chapter 14 trustee's access to that information in the current proposal seems unnecessarily high. We recommend that in lieu of "necessary" in section 1405(b)(2)(B), the special trustee should make the information available if "necessary or advisable".

Bankruptcy Code Section 1406: *Special transfer of property of the estate*. This section, authorizing transfers of assets into the trust, should make clear that once assets have been transferred into the trust, they are no longer part of the chapter 14 estate by adding a new sentence following the first sentence of section 1406(a): "Property ceases to be property of the estate once the court has ordered the transfer and the transfer has occurred." (Conforming clarifications may also be required to sections 1407 and 1408.) Section 1406(c)(3) should be deleted: the bridgeco will not be a deposit holding entity under any circumstances. To the extent that this provision refers to deposits which the chapter 14 entity itself holds as depositor at any of its subsidiaries, there should be no absolute requirement that all such deposits go over to the bridgeco. Once the bridgeco has been created and assets have gone over, the chapter 14 estate will have no access to cash flow. Conceivably, it might be able to get new (probably expensive) financing, but to the extent it has sufficient cash to fund its chapter 14 administrative expenses and fees, it should be allowed to retain at least some cash for that purpose.

Section 1406(c)(4) requires the court to find by a preponderance of the evidence that the Federal Reserve Board has certified as to adequate assurance of future performance of contacts, leases and liabilities assumed by the bridgeco. We are not certain that this requirement adds anything beyond the certification by the Federal Reserve Board itself, and in any event, believe that the Federal Reserve Board certification should be sufficient. We would therefore recommend substituting a requirement that the Federal Reserve Board provide the certification in a filing with the court for the current section 1406(c)(4). Further, as with our earlier comments on sections 1403 and 1405, we believe that the Federal Reserve Board's consent should also be required. While there is no time period prescribed for the judicial review in this section, the temporary stays in section 1407 and 1408 create a practical 48-hour limit for the review process. We believe it will be far more valuable for the statute to encourage an active dialogue between the Federal Reserve Board and the prospective debtor (whether as a continuation of the living will dialogue or otherwise) and to that end, the specifics of bridgeco should be in hand and approved by the Federal Reserve Board by the time the filing is made with the court.

We believe that the TPRRA should specifically address the treatment of liens in assets which are transferred to the bridgeco. Section 363(k) provides for credit bidding, but we do not expect that the transfer to bridgeco will occur in any sort of auction process. One possibility would be for the liens to transfer with the assets on a nonrecourse basis; there could also be a mechanism for bridgeco essentially to purchase the collateral by giving the secured creditor cash equal to the value of the lien (although this would have to be accomplished in a manner that did not interfere with the expedited transfer at the beginning of the case). As a practical matter, there may not be much of any secured debt at the chapter 14 entity, but to the extent there is, the transfer process currently leaves the treatment of liens uncertain.

Bankruptcy Code Section 1407. *Automatic stay; assumed debt*: See below.

Bankruptcy Code Section 1408. *Treatment of qualified financial contracts and affiliate contracts*: Both this section and section 1407 create special stay provisions and are addressed together here. These special stay provisions go beyond established bankruptcy concepts by staying actions against nondebtors and their assets which would otherwise occur because of the condition of the chapter 14 debtor and the transfer to the bridgeco. They also significantly curtail actions by counterparties under QFCs, which normally are protected by a variety of safe harbor provisions under the Bankruptcy Code, safe harbors which include, importantly, special carveouts from the automatic stay under section 362. Both of these new special stay provisions are in our view appropriately limited in duration and scope; they are necessary to give the Single Point of Entry approach to recapitalization a brief moment in time to freeze the effect of the chapter 14 filing until the bridgeco is up and running and has assumed the liabilities, contracts and leases it wants in order to recapitalize.

The transfer provisions are similar to, but not identical to, section 365. Significantly, the bridgeco has the power to assume notwithstanding any state or contractual restrictions, but not the power to assign in a subsequent transaction. We considered whether these special provisions should extend to a subsequent transfer, and concluded that on balance, because of the indeterminate duration of the bridgeco and the myriad of potential transactions it may engage in during that time, it was better not to give special treatment to subsequent transfers.[3]

[3] Sections 1407 and 1408 identify assumptions, assumptions and assignments, and assignment in various places. We believe the intent in each case is in connection with the transfer to bridgeco and not a subsequent transfer. It is possible that a more consistent use of the different terminology is required. As time permits, we recommend a thorough review of this terminology to avoid confusion later.

We note that in a number of places, these special provisions preclude the termination or modification of rights or obligations during the period in which the special stay provisions are in effect. We believe particularly in light of the fact that debt instruments are included in these special provisions, that the sections should specifically reference acceleration (that is, eliminate or stay any acceleration) and any other modification that occurs automatically upon the occurrence of one the specified events. For example, most debt instruments provide for automatic acceleration of debt upon the debtor's (and sometimes, any of its significant affiliate's) bankruptcy filing. There is no need for this automatic acceleration for debt that is assumed by the bridgeco within the prescribed time limits, and unwinding it may be more than a matter of simply reinstating the debt. Likewise, some securitizations have "flip" or "extinction" clauses which purport to change contractual entitlements to waterfalls upon a bankruptcy filing. These should also not be triggered automatically upon the filing. In other words, the concepts termination and modification should clearly include any alteration in the contractual or legal status quo that occurs because of the events specified, and for the periods specified, in the applicable subsections of sections 1407 and 1408.

The NBC does not have substantive comments on any of the sections following section 1408.

Technical and Drafting Comments

As a general comment, the NBC believes it would be preferable to include the provisions on covered financial corporations in a new subchapter V of chapter 11, instead of adding a new chapter 14. Most of the provisions of chapter 11 are applicable to such cases, fewer Bankruptcy Code sections would have to be amended, and it would cause less confusion if the new provisions on covered financial corporations were placed in a new subchapter of chapter 11.

Other comments relate to specific provisions. References are to the new provisions of titles 11 and 28, rather than the bill sections.

§ 103(*l*) – As proposed ("Chapter 14 of this title applies only in a case under this title concerning a covered financial corporation"), this subsection suggests that chapter 14 would apply if a covered financial institution files a chapter 7 or chapter 11 petition (even though section 109 would not make it eligible for such a filing). To make it clearer, we suggest: "Chapter 14 of this title applies only in a case under such chapter." That also conforms to the style of section 103 (see 103(i) and (j)).

§ 103(m) – The new section 103(m) is fine, but if it is added to the Code it will conflict with section 103(g). Therefore, section 103(g) should be amended as follows: "Except as provided in sections 103(m) and ~~section~~ 901 of this title,..."

§ 109(i) – To conform to the style used in other subsections of section 109 (see section 109(d), (e) and (f)), change section 109(i) to: "Only a covered financial corporation may be a debtor in a case under chapter 14 of this title."

§ 1401 – Change to read: "Sections 321(c) and 322(b) of this title do not apply in a case under this title."

§ 1402(2) – Change to read ".... under section 1405(a) of this title."

§ 1402(4) – First, the list of sections referenced in this provision should include section 561. Also, the referenced sections do not define "contractual right." Therefore, change section 1402(4) to the following: "The term 'qualified financial contract' means any contract ~~as defined~~ of the kind described in section 555, 556, 559, ~~or~~ 560, or 561 of this title."

§ 1402(5) – Change to "The term 'qualified financial contract' means any contract of a kind ~~specified~~ defined in paragraph (25) ..." Note that the sections cited do contain definitions. Also, add "of this title" after "section 761).

§ 1402 – The use of the word "trustee" used in sections 1405, 1406 and elsewhere is confusing. Chapter 11 uses that term to mean a person appointed or elected under section 1104. Although section 1107 generally gives the debtor in possession the rights and powers of a trustee, it is unclear whether "trustee" in chapter 14 is meant to include a DIP when a trustee has not been appointed. For example, see section 1405(a), which says "On request of the trustee or the Board, the court may order the trustee to appoint ..." Is it intended that a DIP can make that request if there is no trustee? Does the court order the DIP to appoint the special trustee? To make it clear, we suggest that a definition of "trustee" be included in section 1402. If it is intended that "trustee" mean a DIP if there is no trustee, section 1402 can define "trustee" to mean "a person that has been appointed or elected under section 1104 of this title, and that has been qualified under section 322 of this title, to serve as trustee in the case or, in the absence of such person, the debtor in possession."

§ 1403(a)(2) – The way the proposed provision is organized, a Board petition certifying circumstance (IV) requires a duplicate certification of imminent financial harm to financial stability in the US (see 1403(a)(2)(A)(i)(IV) and (a)(2)(ii), which are both required). We suggest that (IV) be changed by ending it after "sufficiently soon", thereby deleting "such that the immediate commencement of a case .... financial stability in the United States." An alternative fix would be to move the provision that is now 1403(a)(2)(A)(ii) to follow (a)(2)(A)(i)(III) and then have what is now (a)(2)(A)(IV) as an alternative basis for a Board petition.

§ 1403(a)(2)(B) – This refers to the "bankruptcy court" making a determination that the requirements for commencing the case have been satisfied. Is it intended that 28 USC § 157 does not apply? Does the bankruptcy court's authority to make this determination depend on a reference under section 157(a)? Can a district judge withdraw the reference under section 157(d)? If not, perhaps section 1403(a)(2)(B) should start with "Notwithstanding section 157 of title 28." If it is not intended that section 157 be displaced, it may be better to say "court," instead of "bankruptcy court." This also applies in other places where "bankruptcy court" is used. Similarly, section 1403(c)(1) and (2) refer to the "district court" hearing an appeal. If a district judge withdraws the reference and there is an appeal, it should go to the court of appeals.

§ 1403(b)(1) – As proposed, the hearing must be within 12 hours after a certification under section (a)(2)(A), but there is nothing that prevents the certification from being made (signed) before the petition is filed. To avoid the 12-hour period from expiring prepetition, change "makes a certification under subsection (a)(2)(A)" to "files a petition under subsection (a)(2)." The certification must be in the petition. In addition, on lines 19-20, will the wording "with notice only to" create a potential problem if someone else (other than the listed entities) gets actual notice? Would the court proceeding then not be a "hearing described in this subsection"? It may help to insert "given by the Board" between "notice" and "only". This also seems like an indirect way to prohibit notice to other parties (which is apparently the intent). Perhaps change section 1403(b)(2) to directly prohibit such notice ("Only the Board and the entities listed in paragraph (1) may receive notice, attend, or participate in a hearing…").

§ 1403(b)(2) – Change the last sentence as follows: "Transcripts of such hearings shall be sealed until the ~~end of~~ the case is closed." The "end of the case" is ambiguous and not consistent with Code style.

§ 1403(c) – First, the provision is silent about further appeals to the court of appeals. If the intent is to limit appeals to the district court level, an exception should be provided to make the relevant provisions of title 28 (§§158, 1291, 1292) inapplicable. If an appeal to the court of appeals is contemplated, providing for an expedited appeal should be considered. Second, (c)(1) says that a covered financial corporation may file an appeal, but it is silent on whether the Board may file an appeal if the bankruptcy judge dismisses the case because it finds that the Board has failed to meet its burden to prove that the requirements for the filing have been satisfied? The negative inference is that the Board does not have the right to appeal, but it is not clear? Are they to be treated as the SEC is under section 1109(a)? This should be clarified. It could be clarified by amending proposed section 1404(a). Third, section 1403(c)(2) is missing language specifying within 12 hours of *what* shall the district court review the determination. Should it be "within 12 hours of such determination?

§ 1403(d)(2) – Though this may be a substantive comment, it has been suggested that "bankruptcy court shall immediately order" should be changed to "bankruptcy court shall promptly order" to give the court some leeway if it is impractical to issue the order exactly when the time to appeal has expired or when the district court affirms.

§ 1403(d)(2)(B)(i) – Change it to read "the period for appeal … has ~~passed~~ expired without an appeal."

§ 1404 – The provisions regarding the Board's and the FDIC's standing are unclear. Does "case or proceeding under this title" mean only a proceeding that arises under title 11, or does it have a broader meaning (any proceeding arising under title 11, or arising in or related to a case under title 11)? The "in connection with" phrase is also unclear in section 1404(b). Also, the authority should be limited to chapter 14 cases (similar to the limitation in section 1109 to "a case under this chapter"). We believe it would be clearer if changed to: "The Federal Deposit Insurance Corporation may raise and may appear and be heard on any issue ~~in any case or proceeding under this title in connection with~~ involving a transfer under section 1406 in a case under this chapter or in any proceeding within such a case." Similar changes should be considered for section 1404(a).

§ 1405(a)(2) – It is unclear as to which "estate" this paragraph is referencing. It probably should be changed to "... are property of the estate of a debtor under this chapter" or something similar. We make the same comments with respect to sections 1405(b)(1), 1406, 1408(f)(1), 1408(f)(3), and 1409(a).

§ 1405(b)(1) – The special trustee is supposed to be paid "from the assets of the trust and not from property of the estate," but under (a) the assets of the trust are the equity securities of the bridge company and those equity securities are property of the estate (and to be held by the special trustee for the sole benefit of the estate, so the estate continues to hold the beneficial interest of the equity securities). Which assets of the trust would not be property of the estate and, therefore, could be used to pay the special trustee? Consider clarifying this paragraph.

§ 1406(b)(8) – Change to "the United States trustee or bankruptcy administrator."

§ 1406(c)(3) – The proposed transfer must provide for "the transfer of any accounts of depositors of the debtor..." Since the debtor is the bank holding company, not the bank, how can the debtor transfer deposit accounts (which are not property of the estate in the holding company's bankruptcy case)?

§ 1406(c)(4) – Change "leased" to "lease" on lime 14 (typo).

§ 1407(a)(1) – Change as follows: "... any debt, contract, lease, or agreement of the kind described in paragraph (2) ...." This conforms to the phrasing in section 1407(c)(1) and in (c)(2) on page 20, lines 11-12, and page 21, lines 9-10.

§ 1407(a)(1)(B)(iv)(III) – on page 18, lines 1-2, delete "of the bridge company" because the phrase repeats in (a)(a) on line 3.

§ 1408(a) – The list of sections referenced at the beginning of section 1408(a) probably should include section 362(o). Consider changing the subsection as follows: "Notwithstanding sections 362(b)(6), 362(b)(7), 362(b)(17), 362(b)(27), 362(o), 555, ..."

§ 1408(c)(1) – We believe the intent is to nullify certain provisions in a debt, contract, lease, or agreement once it has been assumed by bridgeco, and we recommend that this clarification be made. (This would be similar to the language in section 1408(d) which does specify that the relevant agreement must have been assumed and assigned to the bridgeco.)

§ 1408(e) – We question whether the reference to section 1407(b) was intended to be a reference to section 1407(a)(1).

28 U.S.C. § 298(b)(1) – The phrase "bankruptcy judges who are experts in cases under title 11 in which a financial institution is a debtor" may be either too high a standard or too unclear? Does taking a course on such cases (perhaps one to be offered by the Federal Judicial Center) make a judge an expert? Does one become an "expert" only by presiding over at least one such case? Assuming it does, are there as many as 10 bankruptcy judges sitting at the same time that have presided over such cases? Should the standard be made clearer and also lowered a bit so that judges who have never presided over a financial institution case, but have completed an FJC course of study or another reputable course of study designed for such cases, and/or have backgrounds in private practice involving financial institutions, be eligible (which would result in a greater pool and in more geographic diversity among the judges)?

28 U.S.C. § 298(f)(1) – The reference to "bridge company formed under section 1405" (page 30, lines 18-19) should be changed because the bridge company is not "formed" under section 1405. We assume it is formed under state law (such as a Delaware corporation). The phrase "formed under section 1405" should be deleted. Since "bridge company" is defined in section 1402, the sentence in section 298(f)(1) should work well without that phrase.

Conclusion

We hope these comments are useful in your deliberations. We conclude by noting that this is important legislation, one that is deserving of far more attention and study than we have been able to give it in the time allotted. To the extent the legislative time table permits, the NBC would welcome the opportunity to continue its analysis and submit further recommendations.

With best regards.

Sincerely,

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cc. Tonnie Wybensinger (by email)
Noah Phillips (by email)
Andrew Siracuse (by email)

NATIONAL BANKRUPTCY CONFERENCE
A Voluntary Organization Composed of Persons Interested in the Improvement of the Bankruptcy Code and Its Administration

June 18, 2015

Honorable Tom Marino
Chairman
Subcommittee on Regulatory Reform, Commercial and Antitrust Law
House of Representatives
Washington, DC 20515

Honorable Chuck Grassley
Chairman
Committee on the Judiciary
United States Senate
Washington, DC 20510

Honorable Hank Johnson
Ranking Member,
Subcommittee on Regulatory Reform, Commercial and Antitrust Law
House of Representatives
Washington, DC 20515

Honorable Patrick J. Leahy
Ranking Member
Committee on the Judiciary
United States Senate
Washington, DC 20510

Re: **Proposed Amendments to Bankruptcy Code Relating to Resolution of Systemically Important Financial Institutions**

Dear Reps. Marino and Johnson and Sens. Grassley and Leahy,

The National Bankruptcy Conference (**NBC**) is a voluntary, non-partisan, not-for-profit organization composed of about 60 of the nation's leading bankruptcy judges, professors and practitioners. It has provided advice to Congress on bankruptcy legislation for nearly 80 years. I enclose a Fact Sheet, which provides further information about the NBC.

In 2013 and 2014, two bills were introduced to amend the Bankruptcy Code to add special procedures for the resolution of systemically important financial institutions ("**SIFIs**")—the Taxpayer Protection and Responsible Resolution Act, S. 1861 ("**TPRRA**"), which would have added a new chapter 14 to the Bankruptcy Code, and the Financial Institution Bankruptcy Act of 2014, H.R. 5421 ("**FIBA**"), which would have added a new subchapter V to chapter 11 of the Bankruptcy Code. The Senate did not take any action on TPRRA. FIBA was passed by the House just before adjournment of the 113th Congress, on December 1, 2014.

In a letter dated January 29, 2014 to Senators John Cornyn and Pat Toomey, the Conference commented on TPRRA (the "**NBC TPRRA Letter**"). Later in 2014, members of the Conference's Capital Markets Committee met with the House Judiciary Committee staff to provide technical comments regarding FIBA, but the Conference did not provide written comments regarding FIBA. Because bills similar to TPRRA and FIBA might be introduced in the current Congress, the Conference wants to provide several additional comments regarding certain aspects of TPRRA and FIBA, and more generally on the subject of the resolution of SIFIs in a bankruptcy case.

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The Conference appreciates the efforts of the last Congress to improve the Bankruptcy Code to facilitate the resolution of SIFIs. However, the problems entailed in resolving a SIFI in a bankruptcy case are very difficult, and, under the proposals introduced during the last Congress, could be intractable. While TPRRA and FIBA offered tools to address some of these problems (for example, by facilitating the use by SIFIs of single point of entry recapitalization[1] and by limiting early termination rights in qualified financial contracts if certain conditions are met), other obstacles and issues were not addressed at all or were not addressed adequately in either of the bills.

The Conference has a number of significant concerns, including the following:

- Generally, the Conference believes a bankruptcy process might not be best equipped to offer the expertise, speed and decisiveness needed to balance systemic risk against other competing goals in connection with resolution of a SIFI. The Conference strongly believes that laws in place with regard to a regulator-controlled SIFI resolution process, like the Federal Deposit Insurance Act ("**FDIA**") and Orderly Liquidation Authority under Title II of the Dodd-Frank Act ("**OLA**"), should continue to be available even if special provisions are added to the Bankruptcy Code to attempt to facilitate the resolution of SIFIs in bankruptcy. The Conference accordingly opposes provisions that would suspend or limit the powers regulators now possess with regard to the resolution of SIFIs.

- For similar reasons, the Conference believes regulators should be afforded significant involvement in and supervision over the ongoing operations of a SIFI being resolved in a bankruptcy case. Regulators should have the authority to appoint a trustee and to closely supervise and, if necessary, specify limitations and conditions on the ongoing operations of the firm. The Conference believes that any amendments to the Bankruptcy Code relating to the resolution to SIFIs should make it clear that regulators have these powers despite the pendency of the bankruptcy.

- On the other hand, while the Conference believes regulators should have a more significant role in a SIFI's bankruptcy, the Conference believes regulators should not be granted authority to commence a bankruptcy case against a SIFI. FIBA, which provided the Federal Reserve with authority to file an involuntary petition against a SIFI, made clear that, as practical matter, there would be no meaningful opportunity to contest such a petition or to appeal entry of the order for relief. While the Conference considered the possibility of authorizing regulators to file ta *voluntary* petition on behalf of a SIFI, the Conference concluded that a regulator's ability to exercise its

[1] Of course, effective recapitalization as an element of SPOE requires a firm to have a sufficient amount of loss absorbing unsecured debt that is contractually or structurally subordinated to operating liabilities of the SIFI (for example, unsecured debt issued by the firm's bank holding company). Requirements to maintain such debt are expected be established by the Federal Reserve's proposed rule establishing the nature and amount of the unsecured subordinated debt at the holding company level that is necessary to make SPOE effective.

authority under the FDIA, SIPA, OLA and other special resolution regimes would provide a sufficient incentive for a SIFI to timely commence a voluntary bankruptcy case.

- The Conference believes that any procedure contemplating use of bankruptcy proceedings to recapitalize a SIFI should not include provisions, like those in TPRRA, limiting the availability of lender-of-last-resort liquidity for a recapitalized firm and in fact should include provisions to facilitate making lender-of-last-resort interim liquidity, on a fully secured basis, available to all members of the SIFI group, including the bank and broker-dealer operations of the recapitalized firm.

- The Conference believes that a bankruptcy case for resolving a SIFI, like any other reorganization case, should be handled by a bankruptcy judge with expertise reorganizing insolvent firms, not by a district judge, and the Conference supports both the appointment of panels of judges who can develop the necessary relevant expertise and a judicial selection process like the one contained in FIBA.

We address each of the above concerns in greater detail below.

Existing Non-Bankruptcy Resolution Regimes Should Not Be Repealed

As a preliminary observation, the Conference notes that in virtually all countries, including the United States, regulators have historically controlled the process of resolving distressed banks. In the United States, for example, insured depositary institutions have been resolved by the Federal Deposit Insurance Corporation (FDIC) under the FDIA. On the other hand, until recently, the involvement of national regulators in the resolution procedures for bank holding companies and broker-dealers has been less uniform. In the United States, for example, the bankruptcy of a bank holding company has been addressed using a conventional bankruptcy case under the Bankruptcy Code, and, while broker-dealers are eligible to be liquidated under chapter 7 of the Bankruptcy Code, the resolution of larger broker-dealers has typically proceeded under the supervision of a trustee selected by the Securities Investor Protection Corporation ("SIPC") in proceedings under the Securities Investor Protection Act (SIPA), in which SIPC plays a major ongoing role.

Since the financial crisis that began in 2008, many countries, including the United States, have enacted "special resolution regimes" that give financial regulators greater control of the resolution of large financial firms, including not only OLA in the United States, but also the Bank Resolution and Recovery Directive in the European Union, and legislation in the United Kingdom, Germany and Japan, among other countries.[2]

[2] For a summary of international legislative developments through late 2014, *see* Financial Stability Board, *Towards full implementation of the FSB Key Attributes of Effective Resolution Regimes for Financial Institutions, Report to the G20 on progress in reform of resolution regimes and resolution planning for global systemically important financial institutions (G-SIFIs)* (FSB, 12 November 2014) (the "FSB Progress Report").

Importantly, the new legislation typically includes authority for regulators to supervise the resolution of broker-dealers as well as banks, which, for these foreign countries, is a departure from the state of affairs that existed in 2008, where, for example, local broker-dealers affiliated with Lehman Brothers were placed in ordinary insolvency proceedings supervised by a variety of administrators, liquidators and other controlling persons in many parts of the world.

This global trend of providing national regulators with authority to control not just the resolution of banks, but also the resolution of broker-dealers and other operations of global financial firms has had the beneficial effect of encouraging cross-border coordination and advance planning among regulators for the orderly resolution of such firms, reducing the risk of conflict between the administration of a multi-national SIFI's domestic and foreign components. Through the Financial Stability Board and other official channels, global regulators have developed common approaches to the effective resolution of SIFIs, including such matters as key attributes of effective resolution regimes, requirements for capital and total loss absorbing capacity (TLAC), and bail-in (recapitalization) techniques.[3] Regulators have also coordinated to impose requirements that market practices be changed to enhance resolvability. They have, for example, advocated a protocol (announced prior to the Brisbane G-20 Summit in November 2014) for international recognition by contract of provisions in special resolution regimes that limit termination rights in over-the-counter derivatives contracts.[4] Such termination rights were among the major impediments to the orderly resolution of Lehman Brothers and reportedly a source of tens of billions of dollars of value-erosion in that case.[5] In addition, regulators are coordinating firm-specific resolution planning by forming "Colleges of Regulators" for individual firms. In short, lines of communication are now open and there is increasing alignment in approaches among regulators around the world who will control the resolution of parts of a SIFI in key countries, making it far more likely that a multi-national SIFI can be resolved in a speedy and coordinated manner should it ever become necessary.

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[3] *See* the above cited FSB Progress Report.

[4] This protocol, known as the "ISDA Protocol" has already been subscribed to by eighteen G-SIFIs and adherence to the protocol is expected to be expanded pursuant to regulations expected to be promulgated by regulators in jurisdictions where those firms are based, including the United States. The approach contained in the protocol is also expected to be extended to other types of financial contracts, such as repurchase agreements. *See* http://www2.isda.org/news/major-banks-agree-to-sign-isda-resolution-stay-protocol (announcement by ISDA that 18 global banks have agreed to adhere to the ISDA Protocol).

[5] One recent source cites estimates for the loss in value to the Lehman Brothers bankruptcy estate from the close-out of the firm's derivatives ranging from $50 to $75 billion. *See* Mark J. Roe and Stephen D. Adams, *Restructuring Failed Financial Firms in Bankruptcy: Selling Lehman's Derivatives Portfolio,* (April 24, 2015, 32 Yale Journal on Regulation, forthcoming) at http://poseidon01.ssrn.com/delivery.php?ID=676067083085098093122026068120065078034050019023060074029023106088102016030125088099032060018032059046053102106092029017124010126023030041068069029117101029092070078041003091025067082106121078027064002072099004121028075008086065006104007026072&EXT=pdf&TYPE=2

While these developments do not mean that the Bankruptcy Code should not be improved to better address the resolution of SIFIs, the Conference strongly believes that laws in place with regard to a regulator controlled SIFI resolution procedure, like the FDIA and OLA, should continue to be available even if the Bankruptcy Code is amended to better address the resolution of SIFIs. In all circumstances effective resolution of a SIFI will be heavily dependent on the confidence and cooperation of regulators in other countries where the SIFI operates, and the ability of U.S. regulators to assume full control of the resolution process to elicit the cooperation from non-U.S. regulators is an essential insurance policy against systemic risk and potential conflict and dysfunction among the multinational components of a SIFI. Greater control of U.S. regulators over any bankruptcy resolution procedure (as suggested below) and the knowledge that U.S. regulators can, if necessary, invoke regulator-controlled resolution procedures are both essential to obtaining the necessary support and cooperation from non-U.S. regulators for the orderly resolution of the firm.

Regulatory Supervision and Control of the Recapitalized Firm

To benefit from all of the work that has been done to coordinate the resolution of a SIFI in multiple countries and to benefit from regulators' expertise regarding how best to resolve the firm, the Conference also believes that regulators should have a very significant role in any bankruptcy case seeking to resolve a SIFI. The expertise of U.S. regulators, who will be "on site" at the financially distressed firm at the time resolution proceedings are commenced and the need for U.S. regulators to coordinate the firm's resolution with controlling regulators in other countries means heavy involvement by U.S. regulators will be critical if adverse systemic effects from the failure of the SIFI are to be prevented or minimized. Put another way, the ability to elicit cooperation from regulators controlling the resolution of the foreign components of a multinational SIFI will likely be compromised if such regulators believe U.S. regulators will not able to exercise an appropriate level of supervision and control over the U.S. components of the SIFI.

Moreover, bankruptcy courts are not experts in the operations of global financial firms, and after a firm has failed, it is unlikely they will be qualified to exercise necessary supervision over the firm. The firm's primary regulators will, among other things, be in the best position to appoint the controlling manager (whatever the title of the officeholder) and, as under Title II of the Dodd-Frank Act, they should be given the authority to do so.

Finally, unlike normal bankruptcies, where equality of treatment of similarly situated creditors, preservation of going concern value and rehabilitation of the firm are the principal goals, in SIFI resolutions the goal of minimizing systemic risk is the most important goal. Regulators are not only best situated to identify systemic risk, but also in the best position to determine how to balance that risk against other goals. This is not to say that regulators should be given total carte blanche to ignore traditional bankruptcy goals, but they need to be in a position to act expertly, quickly and decisively, taking into account both the interest of stakeholders and the public interest, so an appropriate balance can be struck.

For all of the above reasons, the Conference believes regulators should be afforded significant involvement in and supervision over the ongoing operations of a SIFI being resolved in bankruptcy case.

Filing of a Petition by Regulators

While the Conference believes regulators should have greater involvement in a bankruptcy case regarding a SIFI, the Conference is concerned about granting regulators authority to commence a bankruptcy case against a SIFI. FIBA, for example, provides for the commencement of an involuntary case against a SIFI under proposed subchapter V of chapter 11. It provides for a very truncated (16 hour) period to contest the petition and, if necessary, obtain a ruling on an appeal from the order for relief in the case. While the Conference understands the reasons for the abbreviated process due to the need to implement the recapitalization of the firm over the proverbial "resolution weekend" to provide certainty to markets and counterparties and prevent contagion, the Conference submits it is unrealistic to think that such a compressed process for vetting petitions for involuntary relief will afford an opponent of the petition, be it the SIFI itself or a holder or a claim or interest, any real opportunity to contest the petition or the courts any real opportunity to make an informed and reasoned decision on the merits. The limited time for a hearing on and appeal of the order for relief is unrealistically short.

One alternative considered by the Conference was the possibility of allowing regulators to step into the shoes of the SIFI and file a voluntary bankruptcy petition on its behalf, just as regulators could commence regulator-controlled resolution proceedings under other laws, but the Conference concluded that entirely removing the parties' opportunity to contest the regulator's decision to invoke the bankruptcy process was not a real solution to the lack of a sufficient time to contest the petition. The articulated justification for allowing regulators to act is to prevent the SIFI's management from delaying its own petition if necessary to assure orderly resolution of the firm. However, the Conference believes the authority of regulators to act under existing laws, like OLA, the Federal Deposit Insurance Act and the Securities Investor Protection Act, sufficiently serve this purpose. Consequently, the Conference concluded that regulators should not be provided with authority to commence a bankruptcy case against a SIFI, but instead regulators should retain the threat of proceeding under other laws if the SIFI fails to act.[6]

[6] If limitations were placed on the availability of regulator-controlled resolution procedures, which, as noted above, the Conference opposes, the Conference would favor the ability of a regulator to commence a case by filing a voluntary petition on behalf of the debtor in lieu of commencing an involuntary case. If the provision of FIBA affording regulators the ability to commence involuntary proceedings is nonetheless retained, the Conference believes that judges should be given the longest practicable time period to consider and render a decision on the appropriateness of an involuntary petition, and the Conference believes the requisite 48-hour minimum notice should be given to the Chief Judge of the Circuit in which the bankruptcy judge sits, rather than to the Administrative Office of the U.S. Courts.

Lender-of-Last Resort Liquidity

As suggested in the NBC TPRRA Letter, meeting the liquidity needs of a distressed SIFI is essential to successfully resolving the firm without creating undue systemic risk. The business of a SIFI is "maturity transformation"—taking short term loans from depositors and other stakeholders and turning them into long term investments in the economy, like mortgages and corporate loans. When a financial firm becomes distressed, depositors and customers panic and, rather than risk their savings and investments, they make precipitous withdrawals from the firm. In short, they "run." Unlike the typical debtor, where creditors can be stayed from collecting debts until the reorganization is completed, staying a SIFI's depositors and customers from making withdrawals creates systemic disruption and contagion risk. If the firm is to be reorganized, the firm needs to be recapitalized virtually overnight (i.e., over a "resolution weekend"), and the recapitalized firm has to open up on the next business day with sufficient liquidity to meet withdrawals until the "run" subsides and confidence in the firm is restored. By facilitating the creation of a new, non-bankrupt bank holding company to which the recapitalized bank and broker dealer operations of a debtor bank holding company can be speedily transferred for the benefit of the estate, both FIBA and TPRRA seek to facilitate this type of recapitalization. If, however, the recapitalized firm is forced to sell assets to meet a run, market prices will be further depressed, imposing additional losses on the firm and creating losses at other firms who mark their balance sheets to market. The only way to prevent this type of transmission of balance sheet losses and the resulting contagion is for the recapitalized firm to borrow against its unencumbered assets as necessary to meet the outflows, instead of dumping its assets on the market. Secured lender-of-last-resort lending to fully capitalized banks has long been thought justified for just this reason.[7]

A crucial distinction needs to be made between a government bailout of shareholders and creditors by adding equity capital to an insolvent firm on the one hand, and traditional secured lender-of-last-resort liquidity provided to a recapitalized firm on the other. In the former case, taxpayers absorb the firm's losses. In the latter case, private sector shareholders and creditors absorb the firm's losses, and fully secured loans are made only to a recapitalized firm.

The Conference strongly believes that to be successful, any recapitalization procedure, whether under the Bankruptcy Code or under a special resolution regime like OLA, requires a non-market backstop liquidity source as a bridge for the recapitalized firm until liquidity outflows abate and access to market liquidity returns. For this reason, the Conference opposes provisions (like those in TPRRA) that do not provide for lender-of-last-resort liquidity even after a firm's bank and broker-dealer operations have been recapitalized, and supports instead adding provisions that provide assurance that some form of lender-of-last-resort liquidity will be available, on a fully secured basis, for use in all entities in the SIFI group, including the bank and broker-dealer businesses of the recapitalized firm.

[7] Bagehot, Walter, *Lombard Street: A Description of the Money Market* (1873). *See also* Bipartisan Policy Center, *Too Big to Fail: The Path to a Solution (May 2013).*

Selection Procedure for Judges

In its review of FIBA, the Conference considered the judicial selection process for the resolution of SIFIs under the Bankruptcy Code. The Conference believes that, for the reasons outlined above, specialized expertise and advance judicial training is required for the judge who would preside over the resolution of a SIFI. Moreover, the Conference believes that bankruptcy judges, who regularly deal with the reorganization of financially distressed firms, are better equipped than federal district judges to deal with insolvencies of financial firms. However, even bankruptcy judges do not share regulators' financial-institution specific expertise, and they would require special training to address resolution of a SIFI.

The Conference accordingly supports the idea that, if special procedures are added to the Bankruptcy Code to facilitate the resolution of SIFIs, expert panels of court of appeals judges and bankruptcy judges should be designated in advance by the Chief Justice to address such cases, as provided in Section 4 of FIBA. The Conference also favors a mechanism for selecting a presiding judge from among the designated judges that is similar to the one included in FIBA (where the chief judge for the court of appeals in the circuit where the case is pending selects the presiding judge). The designation of panels of judges is, of course, best coupled with training to help the designated judges develop the requisite expertise to handle complex SIFI bankruptcies, and the Federal Judicial Center might consider offering regular educational programs and written materials to assist the designated judges in addressing issues likely to arise in such cases.

Conclusion

We hope that these comments are useful if bills are proposed in the 114th Congress seeking to amend the Bankruptcy Code to address SIFI resolution. As noted above, the prior legislative proposals did not address various significant issues and failed to effectively mitigate the risk of cross-border dysfunction and conflict in connection with the resolution of multinational SIFI's. The NBC welcomes the opportunity to review and analyze legislation on this subject introduced in the current Congress and to submit further comments and recommendations, including those addressing the issues not previously covered.

Sincerely,

/s/ Richard Levin

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Mr. MARINO. The Chair will now start by asking questions of the panel, and I ask my colleagues to keep their questions at 5 minutes or less and give you ample time to answer

Mr. Bernstein, I would like to start with you for a moment. We know that banks have increased their liquidity reserves, but if a bank were to fail and the bridge company—would the bridge company still have to receive some type of loan to cover the issue concerned, or do banks have enough liquidity to keep those loans at a minimum?

Mr. BERNSTEIN. Thank you. At current liquidity levels, which have been enhanced since 2008, the banks have used severe stress testing of those liquidity models in a resolution context, and they show that they do have enough liquidity. I agree with Mr. Levin's point that if there were a liquidity backstop, it wouldn't be used, but having it there would help to stabilize the firm more quickly simply because it exists.

So I think the need for—there is no need for liquidity because of the current balance sheet levels, but having a liquidity backstop would serve the purpose of helping to facilitate the resolution and getting the company to be stabilized more quickly to give the market confidence.

Mr. MARINO. Thank you. Attorney Hessler, you stated in your last, I think, testimony about your reservations concerning the single point of entry approach, and have you come up with an alternative to that? Would you please explain that in a little more detail? I did it get it in your opening statement, but could you elaborate on it, please?

Mr. HESSLER. Sure. I have not come up with an alternative way, but I would say—and this was emphasized in my testimony submitted for today. Over the last year since my testimony last summer, I spent significant additional time contemplating the bill, and I am at this point comfortable with the single point of entry approach, and I guess very quickly I'll tick off four reasons why I think it is——

Mr. MARINO. Please.

Mr. HESSLER [continuing]. A viable construct.

First of all, a point that was highlighted by Mr. Bernstein in his opening statement. SIFIs have corporate structures that don't comport with conventional bankruptcy practice. Many of the operating subsidiaries either cannot be filed for bankruptcy or need to be liquidated in a regulatory proceeding.

So Subchapter V, the single point of entry approach actually facilitates and accommodates the unique corporate structure of systemically important financial institutions.

The second point is while the discreet steps of single point of entry may be a unique addition to Chapter 11, the transfer determination, that in and of itself is subject to Bankruptcy Code and bankruptcy court approval within well established and applicable law under the legal principles of sections 363 and 365 of the Bankruptcy Code.

The third point is more of a practical matter, which is, again, although single point of entry would be a novel addition to the Bankruptcy Code, as already noted, versions of this very rapid sale have been happening already. Lehman is the most extreme example, which was the sale of all the operating assets within, you know, four to 5 days of the petition, but there have been other sort of lightning fast with the "melting ice cube sales" that are already happening under the Bankruptcy Code, and so understood, the single point of entry approach actually just formalizes and codifies something that's already going on.

And then lastly, and I talk about this at great length in my testimony, if you actually walk through the expectations of various creditors, secured creditors, unsecured creditors, and equity interest holders, the distributional scheme that is effected by single point of entry is consistent with typical Chapter 11 principles.

Mr. MARINO. Thank you. Attorney Levin, you talk about the regulators having a role in this, and I do agree that they should have a role in this, but their decisions, in part, are subjective. How can we assure that at least their subjective findings are going to be consistent? I have a concern when so many subjectivity is involved in this situation by someone who is not a judge or an experienced bankruptcy judge, please.

Mr. LEVIN. Fair point, Mr. Chairman. I'd note, however, that in a lot of these areas, even in the bankruptcy courts, the decisions are discretionary, and therefore, to a large degree, subjective. The courts set out broad rules for what kinds of transactions are permitted, but within those broad rules, there is tremendous subjectivity in their application. And I would note that the regulators themselves have begun adopting regulations on how this process would work, so it is controlled as well. If you have the combination of the regulators and the bankruptcy court supervising this process, I think you get the best of both worlds in that area.

If I might follow up on Mr. Hessler's last——

Mr. MARINO. Quickly, please

Mr. LEVIN [continuing]. Remark. There is a real—there is a dividing line that's very important in the single point of entry concept. The dividing line is the transfer of the operating assets to the bridge company.

From that point, what goes on in the bankruptcy case is purely bankruptcy. It's not regulatory. It's not financial institution. The financial institution has been moved to the bridge company, and the bridge—what's going on in the bridge company is totally outside of the bankruptcy realm. It should be a healthy operating financial institution that will be subject to regulatory control.

I think Subchapter V, meaning no pun, bridges that nicely and separates them and therefore works to facilitate both systems in due process and transparency and protection of creditors and protection of systemically important—protection of the system with a systemically important financial institution, and that, I think, addresses the fourth of Mr. Hessler's points that he made.

Mr. MARINO. Thank you. My time is expired. The Chair recognizes the Ranking Member, the gentleman from Georgia, Congressman Johnson.

Mr. JOHNSON. Thank you. Mr. Levin, in a letter that the NBC sent to our Subcommittee last month, the conference stated that any amendments to the Bankruptcy Code relating to the resolution of SIFIs should make it clear that regulators retain Title II's orderly liquidation authority despite the pendency of bankruptcy.

Does H.R. 2947 sufficiently ensure that regulators retain their Title II authority, notwithstanding the pendency of the bankruptcy?

Mr. LEVIN. Yes. I haven't—the bill was introduced this week, and I haven't had a chance to review it, but my understanding was that it does not affect the regulators' other authorities for liquidation.

Mr. JOHNSON. All right. Thank you. Can a Subchapter V operate as intended if there is no secured lender of last resort such as the Federal Government?

Mr. LEVIN. Possibly. It's a far riskier proposition. Mr. Bernstein notes that the banks are far better capitalized now than they were 6 or 7 years ago, very true. I would expect that a SIFI that winds up in Subchapter V probably would not be as well capitalized as most banks are today, and therefore, there would be a need for liquidity. That liquidity might be supplied by the recapitalization of the subsidiaries when they are transferred over to the bridge company and they're recapitalized by contribution of the parent from the assets, but at the same time it might not be adequate and therefore liquidity could be important.

To the extent it's a bank subsidiary, the Federal Reserve discount window provides that. To the extent it's a broker/dealer or an insurance company or another kind of financial institution such as a derivatives trading institution, there is no apparent source of liquidity, and that could create risk in the bridge company.

As I said earlier, and this is the important point to stress, the market is less likely to run if it knows the liquidity facility is there than if there isn't one. If the market knows that the liquidity facility is there, people will feel protected, and therefore, there will be less need for a liquidity facility. I sometimes characterize it as akin to our nuclear arsenal. The fact that we have it means that we don't have to use it.

Mr. JOHNSON. Thank you. Mr. Hessler, your response to that same question?

Mr. HESSLER. I agree with the general thrust of Mr. Levin's response. I think it's possible that the absence of the Federal funding mechanism would not impair the ability of the bridge company to operate effectively because of the recapitalization that occurs upon the transfer of the assets. To the extent that is otherwise available, though, that could be reassuring to the market.

Mr. JOHNSON. Thank you. Mr. Levin, in a letter that the NBC sent to our Subcommittee last month, the conference described several significant concerns. Among them, the NBC stated that under certain circumstances the bankruptcy process might not be best equipped to offer the expertise, speed, and decisiveness needed to balance systemic risks against other competing goals in connection with resolution of systemically important financial institutions and thus Title II of Dodd-Frank should be retained even if H.R. 2947 becomes law.

And as you've stated, it appears that this legislation does retain—or I mean, it doesn't repeal it, so I mean, legislation is retained, but there is an ability of the regulators to assert authority during the pendency of the Subchapter V action. Please describe what types of companies or circumstances might warrant the application of Title II's orderly liquidation authority in lieu of a resolution in bankruptcy?

Mr. LEVIN. Subchapter V would address most of the problems that Title II would address. The fact that it was there and Dodd-Frank says that bankruptcy is the preferred alternative might make bankruptcy workable and probably will make bankruptcy workable in that circumstance. But none of us is prescient enough to know all of the bad things that could happen in a rapidly evolving crisis. And I don't have a specific answer for the particular circumstances that might require a different regulatory regime than Subchapter V, but what is called the triple key entry for Title II as well as the statutory preference for bankruptcy, we think it's useful to have that backup which would only be used in the most extreme circumstances, which are difficult to imagine and lay out at this point.

The fact is, the banks are well capitalized now. Things are going pretty well. This is not likely to be used for many years. We don't know what the system will look like several years from now if and when it ever becomes necessary for a SIFI to be resolved in a crisis situation. So that—I think that is what lies behind our position more than any specific circumstances.

Mr. JOHNSON. All right. Thank you, and I yield back.

Mr. MARINO. Thank you. The Chair now recognizes the Vice-Chairman of the Subcommittee on Regulatory Reform, the gentleman from Texas, Mr. Farenthold.

Mr. FARENTHOLD. Thank you very much, Mr. Chairman.

And actually Mr. Levin has a great lead in to my question. We are a bunch of lawyers up here that spend a lot of time looking at this and getting into the weeds. I want to take a step back and look at the big picture of this.

We recently enacted Dodd-Frank, which is a very burdensome regulatory scheme, which went—from what I hear from a lot of banks and from a lot of people, seeking to borrow from banks. We got a situation where just recently we had the increased liquidity rules that we've been talking about. We really are looking at a very worse case scenario, something that none of us can imagine at this point.

Can—maybe Mr. Bernstein, can you give me an idea? What kind of bankruptcy events are we talking about here?

Mr. BERNSTEIN. Yes. So I actually think this is less related to the facts on the ground at the time of any particular resolution than it is to—it's, frankly, almost a foreign policy issue. In the context of my practice, I've been dealing a great deal with foreign regulators.

Foreign regulators do not understand bankruptcy. The main benefit and the primary benefit, I think, of retaining Title II is to give confidence to foreign regulators that if something is going wrong in the bankruptcy process, the regulators do have the ability to step in. Simply because they deal with the U.S. regulators every day, there is active dialogue with them, they think they understand where the U.S. regulators are coming from, so it's not necessarily something that will need to be used because this bill actually has the appropriate process.

But in terms of preventing a foreign regulator from seizing a foreign subsidiary when we're trying to keep them out of bankruptcy, it may go a long way in giving the regulator confidence that they don't have to do that because they know that the U.S. regulators can step in.

Mr. FARENTHOLD. All right. Now, again, I think we're kind of get into the weeds now. And then again, this may be a little bit off topic of the bill, but would all of you agree that we really are dealing with a worse-case scenario situation here, something that is very—is not foreseeable at this point, would anybody disagree with that on the panel? I see no one does, so let me go on to my second question and——

Mr. LEVIN. I don't disagree with that, but as I said a moment ago, Mr. Farenthold, had anybody asked us this question in the 1990's, we would have given the same answer.

Mr. FARENTHOLD. Okay. Let me go on to my second question. Mr. Hessler—or did you want to weigh in on this first?

Mr. HESSLER. There is one thing that I think would be hopefully clarifying about the interrelationship between Title II and Subchapter V. So nothing in Subchapter V diminishes Title II.

Mr. FARENTHOLD. Right.

Mr. HESSLER. It doesn't touch it. However, I think it's important that Subchapter V also be examined on its own merits because there's a critical provision, which is Section 1184, which provides standing to Federal Government regulators to be involved in a bankruptcy case. That presently does not exist within Chapter 11.

Mr. FARENTHOLD. And obviously the taxpayers could potentially be left holding the bag if the Federal regulators aren't——

Mr. HESSLER. Well, the decision on that, the Federal Government at present can only participate in a bankruptcy case to the extent it is a creditor——

Mr. FARENTHOLD. Right.

Mr. HESSLER [continuing]. Not the debtor. So the point I want to make is sort of irrespective of Title II and what it does and doesn't provide or the future of Title II, whether it has one or not, just within Subchapter V, it specifically and on its own provides that critical grant of standing for Federal regulators to advance their public interest mandates in a Chapter 11 case.

Mr. FARENTHOLD. Got you. All right. My other question is, one of the objections we're hearing to Subchapter V is it actually increases the incentive for private regulation, which I would guess is say the creditors putting more creditor favorable terms, you know, regulations are by the creditors rather than by the government.

Do you believe the bill increases the incentive for the creditors of banks to put in these more burdensome requirements for the banks or no?

Mr. HESSLER. Subchapter V? No, I think—I actually believe that it puts a disincentivization for risky creditor behaviors. Creditors understand Chapter 11. It's well established and the governing principles are highly effective and highly proven. I actually think it's Title II, which is much more of an unknown quantity and an unknown entity that actually increases creditor uncertainty as to how a Title II untested proceeding would go, so I actually think Subchapter V, which really just adds additional clarifying facets to

Chapter 11, I actually believe that's helpful for maximizing responsible creditor behavior.

Mr. FARENTHOLD. And Actually Mr. Bernstein wants the weigh in on this as well.

Mr. BERNSTEIN. Yes. I think the one thing about whether it's the provisions of this bill or the fact that the FDIC has made it clear that holding company creditors rather than taxpayers will absorb losses, that will increase the level of monitoring by creditors, and they will be making decisions about whether to invest based on how they see the institution operating rather than based on the feeling that they are going to be bailed out.

And I think that is a very important aspect of this bill. It is probably a good thing.

Mr. FARENTHOLD. Thank you very much. I see my time has expired, Mr. Chairman.

Mr. LEVIN. If I may add, Mr. Chairman, the fact that the ISDA has adopted this protocol that provides a stay in the financial contract itself of 48 hours shows exactly the opposite kind of creditor behavior. The creditors are helping to facilitate the process.

Mr. FARENTHOLD. Thank you.

Mr. MARINO. Thank the Chair recognizes the Ranking Member of the full Judiciary Committee, Congressman Conyers.

Mr. CONYERS. Thank you, sir. Mr. Levin, the National Bankruptcy Conference states regulators should not have the power to commence an involuntary Subchapter V. Do you have any reasons to let us know why the Conference takes this position?

Mr. LEVIN. Yes, Mr. Conyers.

Mr. CONYERS. Please.

Mr. LEVIN. An involuntary petition is like any lawsuit. It entitles the defendant, here the alleged debtor, to a defense. The amount of time necessary available for a resolution, we call it the resolution weekend, is so short that there really can be no meaningful defense. And there can be no meaningful appeal if the transfer process to the bridge company is to occur over a resolution weekend in response to an involuntary petition. So we think it undercuts due process to allow an involuntary bankruptcy petition.

As I said earlier in my openings statement, we believe the regulators have enough tools at their hands to persuade a board of directors why it is important to file a voluntary petition at the beginning of a resolution weekend, rather than go through the contested in voluntary process. And we think that will suffice to protect the system.

Mr. CONYERS. Thanks. Now Subchapter V, could it operate as intended if there is no secured lender of last resort, Mr. Levin, such as the Federal Government. How would you respond to those who would say that this could amount to a taxpayer funded bailout of Wall Street people.

Mr. LEVIN. We don't think it is a bailout because of the nature of lender-of-last-resort funding. Lender-of-last-resort funding has three requirements; one, that there be good collateral so that the lender, whether it is the Federal Reserve, or the Federal Government, or whether it is some other Federal corporation or agency is fully protected by the collateral it receives.

The second is that the interest rate be what is referred to in literature as a punitive interest rate so that it is higher than—so there is no desire to access it for convenience. And for a moment I'm drawing a blank on the third and I'm going to ask Mr. Bernstein to help me on the third requirement.

Mr. BERNSTEIN. Above market interest rate.

Mr. LEVIN. That was——

Mr. BERNSTEIN. You already said that? Then I don't remember the third one.

Mr. CONYERS. All right, two then.

Mr. LEVIN. In any event, the point is this is not a bail out in the sense that the Federal Government or any agency is contributing money, taking an equity position, taking an equity risk. This is helping the financial institution take valuable assets that it has and make them liquid until those assets can be sold in a orderly market, rather than be dumped at fire sale prices and depress the market for everybody.

Mr. CONYERS. Well, do you think that by allowing it—if there is no secured lender of last resort—that we may be in some ways rewarding irresponsible behavior?

Mr. LEVIN. I don't think a bankruptcy is a reward for irresponsible behavior whether or not there is a lender of last resort.

Mr. CONYERS. Now, going to Mr. Bernstein for his response to this question. If Subchapter V was in existence when Lehman failed, would it have achieved a better result with respect to the case's impact on the Nation's financial marketplace?

Mr. BERNSTEIN. It is a complicated question because many other things that are in place today weren't in place at that time. I think one of the things that it would have helped is this bill would have potentially permitted Lehman to adopt a different strategy. It could have used a single point of entry strategy and could have preserved its derivative contracts.

The problem with Lehman at the time, though, is it didn't have the total loss absorbing capacity and might not have been able to recapitalize the subsidiaries. So that piece of it, which is now being required, not only in the U.S. but by global regulators, is very important. And if you have both of those pieces, the provisions in this bill or in the contractual ISDA to protocol, plus the total loss absorbing capacity, you would have had a totally different result in Lehman Brothers, I think.

Mr. CONYERS. So your answer is a substantially yes.

Mr. BERNSTEIN. That's correct, your Honor. Your Honor—Congressman.

Mr. CONYERS. Thank you. Thank you, Mr. Chairman.

Mr. MARINO. Thank you. The Chair recognizes the gentleman from Michigan, Congressman Trott.

Mr. TROTT. Thank you, Chairman.

Mr. Levin, so you raised a few concerns, one concern was the lack of experience potentially in a bankruptcy judge and the need for regulators to be involved. Didn't like the involuntary provision, which I agree with your comments in that regard. The lender of last resort concerns and then I think also then the need for experienced judges, not district judges.

So the first concern is what surprised me a little bit. You know, Dodd-Frank came upon us in 2010, the FDIC has been working on rules for single point of entry since then. So you have, you know, you believe regulators are going to be able to act more efficiently and quickly because of their experience than a bankruptcy judge?

Particularly under section 298 we have one of the 10 experienced bankruptcy judges has been appointed for this purpose to deal with complex insolvency. I don't know if I understand why you have more confidence in the ability of regulators to move quickly and react than a bankruptcy judge who essentially does it every day?

Mr. LEVIN. I'll tell you that the Conference had the view back in 2009 and 2010 of great concern about the regulators being able to do what you just described. But I think we've all learned a lot in 5 years, and the regulators have learned a lot. And we've watched them evolve in their thinking and learn and write regulations so they are in a much better position now to deal with this kind of circumstance than they would have been 5 or 6 years ago. But with that said, I want to go back to what I said in my opening statement. I think Subchapter V gives us the best of both worlds.

The bankruptcy judge does not have enough knowledge about the company to be able to do it alone—the regulator—and does not have enough knowledge about the systemic affects of whatever is done. The regulators do not have the same process and remove that a bankruptcy judge has. And by combining the efforts of the two of them, I think you get a much better result than one alone. And this applies only to the resolution weekend and the transfer to the bridge. That's where the important difficult decisions have to be made. After that happens, the bankruptcy judge is fully well qualified to handle all of the rest of the case.

Mr. TROTT. Okay. Appreciate that clarification. Mr. Hessler made a comment about uncertainty as it relates to Title II. Mr. Levin, you made a comment, it will be many years before this perhaps even comes into play and we don't know, you know, how things will play out and how soon the provisions will be interpreted.

Would you agree with Mr. Hessler's comments that the same can be said of Title II.

Mr. LEVIN. Oh, yes, definitely. I mean there are parts of the Bankruptcy Code, Subchapter IV of Chapter 11 railroad reorganization is very rarely used, one case recently, nobody could have envisioned in 1978 what a Chapter 9 of Detroit might have looked like in 2013. So we have to think way into the future, and there's going to be uncertainty whichever way we go.

Mr. TROTT. Mr. Bernstein, so let's say H.R. 2947 was in place and we have a Lehman type insolvency. Can you just discuss for a moment how that would have played out differently?

Mr. BERNSTEIN. Yes. And this relates to Congressman Conyers' question. I think if we had this bill, plus all the other changes that are being made in the resolution planning process, I think we would have had an extremely different outcome in Lehman Brothers. Lehman Brothers holding company would have filed, the subsidiaries would have been recapitalized so that they would have sufficient capital not to go into bankruptcy.

The subsidiaries would have been transferred to a new bridge holding company. And the derivatives contracts importantly would not have terminated, which would avoid enormous losses that would threaten the viability of those subsidiaries. So there wouldn't have been the systemic disruption that occurred at the time of Lehman Brothers, which is very important.

Mr. TROTT. So to that point I got delivered yesterday a copy of Hoover institute's book on making failure feasible. I read their mission statement in terms of the resolution project. And it said if a clear and credible measure can be put in place that convinces everyone that failure will be allowed, then expectations of bailouts will disappear. If we get rid of the risk reducing behavior that are fostered by guarantees, then that would be a good thing. And then also a clear process to reduce panic, H.R. 2947 would have accomplished that in Lehman?

Mr. BERNSTEIN. Yes, it would have. In fact, as you'll see in that Hoover book, there are several chapters devoted to this type of single point of entry resolution and their conclusion is it would be very effective in that way.

Mr. TROTT. It is a fascinating book, I'm not too far into it yet.

But Mr. Hessler, one quick question, I am out of time. Ranking Member Johnson raised a concern about the funding. So back to Lehman, you know, the professional fees in Lehman were $2 billion, I believe. Can you just speak for a moment on funding concerns specifically as it relates to Ranking Member Johnson and this bill?

Mr. HESSLER. Yeah, I think it is what Mr. Levin is hopefully clarifying for me. There are two funding questions at issue in Subchapter V proceeding. Upon the transfer of the assets to the bride company, it is the access to liquidity of the bridge company.

Mr. TROTT. We've talked about that plenty.

Mr. HESSLER. That's not governed by Subchapter V because that is not in the jurisdiction of the bankruptcy. There is potentially the issue of for the purposes of finding the wind down——

Mr. TROTT. Do you have any concerns in that regard?

Mr. HESSLER. No. There is regular DIP lending capacity and there that will be a significantly more limited funding need because what at issue the wind down of undesirable assets. That's what's happening in the Chapter 11 case upon single point of entry transfer.

Mr. TROTT. Thank you, sir.

Mr. HESSLER. Thank you.

Mr. MARINO. The Chair now recognizes the Congresswoman from the State of Washington, Ms. DelBene.

Ms. DELBENE. Thank you Mr. Chairman. Thanks to all of you for being here with us today. Some of my questions were asked already, but I just had a quick question for you Mr. Hessler on living will requirements and I just wondered what your thoughts were on this legislation in terms of whether or not it would help facilitate the Dodd-Frank living will requirements?

Mr. HESSLER. I believe it will. I think the living will practices today have already begun to put in place the road map for what a Subchapter V proceeding would look like. And I think this is a point I want to augment that we've been talking how would Lehman have looked under a Subchapter V proceeding, and thus far really all that we have focused on is what would the cause have looked have looked like once it's filed.

The one thing I'd want to mention to the Committee is from what we do in the vast majority of our work is spent preparing debtors for a soft landing into bankruptcy. So perhaps the most important consideration that I would urge lawmakers to keep in mind is with legislation what sort of incentives and disincentives does it put in place for directors and officers to confront restructuring challenges and begin to prepare and address those issues as early as possible.

And this is something I talked about in my testimony. Title II has the provision that directors and officers are effectively all wiped out, the are all going to get fired and compensation is going to get clawed back and it's sort of all types of punitive measures. I actually think that creates a disincentive for directors and officers to begin taking responsible actions that are otherwise necessary to maximize stakeholder recoveries in a bankruptcy.

And so I think that's a very important part in Subchapter V I think it very, very hopefully incentivizes management to begin to prepare for bankruptcy because it sees an orderly path forward to otherwise affect a resolution of a failing bank.

Mr. LEVIN. We sometimes refer to what Title II does as requiring management to sign its own death warrant.

Ms. DELBENE. Any other feedback on that one?

Mr. BERNSTEIN. I think this bill would definitely facilitate structures already being used in the living wills of the largest financial institutions and I think that that is a very positive development.

Ms. DELBENE. Thank you. Thank you Mr. Chair. I yield back.

Mr. MARINO. Thank you, the Chair recognizes the gentleman from Texas, Congressman Radcliffe.

Mr. RADCLIFFE. Thank you, Chairman. I would also like to thank my friend and colleague, the gentleman from Michigan, Congressman Trott for his work on this issue.

The 2008 financial crisis hurt a lot of folks in Northeast Texas. And some of the families in my district are frankly still working to get back on solid financial footing. And I'll be the first to admit that I'm not an expert on bankruptcy issues. But following that crisis I think it became obvious to all of us that these technical, complicated bankruptcy issues are having a huge impact on everyday Americans. And issues that impact everyday Americans are the ones that we as policymakers certainly want to make sure that we're addressing.

There were a lot of questions and frustrations that have come out of the financial crisis. For example, why did distressed financial firms receive government bailouts, instead of being forced to seek resolution through the bankruptcy process? Now I know in the years since this crisis this Committee has worked very hard to improve the Bankruptcy Code and make sure that it is equipped to handle all failing companies. I appreciate all of you witnesses being here today to provide your expertise on the proposed legislation. I want to find out whether it is in fact going to achieve its intended goal.

So I want to kick things off by asking about a provision in the bill that would allow the Federal Reserve to initiate a bankruptcy case over the objection of a financial institution.

Now, a lot of folks in my district have a real distrust of the Federal Reserve. They see it as a dangerously powerful body, one with little oversights and little transparency. So if you gentleman were chatting with my constituents about possibly giving the Federal Reserve this new authority, how would you allay their concerns? And what would you tell them about how this new authority would help them?

Mr. BERNSTEIN. Yes, there is a lot of uncertainty as a financial crisis develops and boards of directors may hesitate to act. I do not believe that the Federal Reserve will end up ever using the power if they are granted the power to file involuntary petitions, because the fact that the Federal Reserve can do it if it's necessary will cause corporate managements to be very focused on when the right time to go into Chapter 11 is. And that, taken together with the living will process, I think the two together make it very unlikely it will ever be used. And it is really only a failsafe for a situation where the company management may be paralyzed at that time.

That being said, I don't think it is an essential part of this bill for the reasons that Mr. Levin stated, which is there are other supervisory powers that the Federal Reserve has. And the Federal Reserve is going to be intimately involved in the living will process, and they have been, so I think there is going to be a constant dialogue with the regulators and the financial institutions that make this provision almost unnecessary.

Mr. RADCLIFFE. Mr. Hessler.

Mr. HESSLER. Yeah, no, I would add to that. I think the involuntary provision is an unhelpful distraction to what is otherwise a very good bill. Already there are provisions in the Bankruptcy Code that provide creditors the express right to file an involuntary case against a debtor to commence an involuntary Chapter 15. Those are exceedingly rare and the reason they are is debtors are very aware of those creditor powers and they are usually already very engaged in dialogue with the creditors, debtors do not like to get tossed into bankruptcies on a timeline and terms that are not of their own making. So they will file voluntarily before involuntary can be initiated. I fully expect that's what would happen here in the context of SIFIs, that they would be well aware of what Feds otherwise can do and even without the express involuntary rates, the Feds could probably force a bankruptcy anyway, and the company is going to file in advance of that so that it can maintain control of its own case.

Mr. RADCLIFFE. Mr. Levin, anything you'd like to add? I will give you a chance.

Mr. LEVIN. Nothing to add. The Conference agrees with both of those.

Mr. RADCLIFFE. Terrific. Mr. Hessler, I spend a considerable amount of my time these days listening to constituents who have to deal with the immense burdens and expense of complying with Dodd-Frank. Personally I'd like to get rid of Dodd-Frank all together, but at the very least I would like to see us moving forward with respect to solving some of its challenges.

So let me ask you this, in your opinion, would the bill before the Committee today reduce the necessity for regulators to initiate a Title II resolution proceeding under Dodd-Frank?

Mr. HESSLER. Yes, it would. I addressed it in my testimony and in my opening statement. I think the availability of Subchapter V will effectively render the need for a Title II unnecessary.

Mr. RADCLIFFE. Mr. Bernstein, will you comment on that?

Mr. BERNSTEIN. I agree, I agree with Mr. Hessler.

Mr. RADCLIFFE. Thank you. I see that I'm out of time and I yield back.

Mr. MARINO. Seeing no other Congressmen or women, this concludes today's hearing. I want to thank the witnesses for attending, I want to thank our guests for attending. And each time I have an opportunity to listen to you gentlemen I learn something so thank you very much for today's testimony.

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

This hearing is adjourned.

[Whereupon, at 11:30 a.m., the Subcommittee was adjourned.]

A P P E N D I X

Material Submitted for the Hearing Record

Response to Questions for the Record from Donald S. Bernstein, Esq., Partner, Davis Polk & Wardwell LLP

Responses to Written Questions

Subcommittee on Regulatory Reform, Commercial and Antitrust Law

The Committee on the Judiciary

U.S. House of Representatives

H.R. 2947 – Financial Institution Bankruptcy Act of 2015

Donald S. Bernstein
Davis Polk & Wardwell LLP
August 18, 2015

Question 1: The strongest argument in support of a concept like subchapter V is that large, complex bank holding companies present unique issues that are no[t] optimally accounted for under the current Bankruptcy Code.

Please elaborate on what these unique characteristics are.

Answer:

Large financial holding companies presents unique issues because they are in the business of "maturity transformation." They raise significant portions of their funding by incurring short term liabilities, like deposits, and through short term securities financing (for example, repos), and invest in long term assets, like home mortgages and corporate loans.

This mismatch between the maturity profiles of financial holding companies' assets and liabilities, coupled with risk aversion and ambiguity aversion of their liquidity sources (depositors, mutual funds and other financial market participants), means financial firms are vulnerable to runs on their liquidity, where depositors and other sources of short term funding abruptly withdraw funds from the firm. Even a well-capitalized firm can suffer a liquidity run due to a financial panic triggered by adverse market news or financial distress at another firm.

Bankruptcy's basic tool to facilitate the orderly reorganization or liquidation of a troubled business is the suspension (stay) most pre-bankruptcy liabilities so the firm's value can be maximized and its liabilities can eventually be restructured and satisfied in a fair and equitable manner (for example under a chapter 11 plan of reorganization). While this tool is very effective for non-financial firms, it is not effective for financial firms. There are at least two reasons for this. First, much of the liquidity run described above occurs prior to failure, as depositors and other financing sources lose confidence in the firm. As a consequence, the bankruptcy stay can take effect too late to stabilize the runoff of a significant portion of a financial firm's liabilities. Second, after a financial *firm's failure, payments to depositors and financial market participants cannot be suspended without creating systemic risk. So applying the bankruptcy stay to suspend payments to such creditors is an unattractive option.*

These problems are amplified because the Bankruptcy Code contains safe harbors for close-outs of financial contracts, which lead to the crystallization of contingent liabilities and the abrupt sale of large quantities of collateral, with an adverse impact on market prices and the value of the firm. As witnessed during the Lehman Brothers bankruptcy, such closeouts result in further depletion of the firm's liquidity and large additional losses due to the dumping of collateral at depressed prices.

In sum, the normal tools available to non-financial debtors in bankruptcy are ineffective when it comes to financial firms because of the nature of their business and because the provisions of the Bankruptcy Code allowing financial contract close-outs have a disproportionate impact on such firms.

Question 2: What lessons were learned from the failure of the Lehman Brothers firm?

Answer:

While Lehman Brothers' failure holds multiple lessons, the one most relevant to this legislation is that, with the legal tools available in 2008, the abrupt liquidation of a large financial firm through multiple bankruptcy and resolution proceedings was necessarily systemically disruptive. There are at least three reasons for this:

- ***Fragmentation of Control.*** *Under then applicable legal regimes, the Lehman Brothers entities were balkanized by the commencement of separate, multiple insolvency and resolution proceedings against different entities around the world, each controlled by a different party (the debtor in possession for the U.S. holding company, a SIPC trustee for the U.S. broker-dealer, and multiple regulators, administrators and receivers for foreign operations). The controlling parties had disparate processes and goals, and given those processes and goals, their interests often were adverse to each other, making it difficult or impossible to avoid systemic disruption and maximize creditor recoveries.*

- ***Discontinuance of Critical Operations.*** *Because of the multiplicity of liquidation proceedings, which in many cases mandated discontinuation of operations, it was impossible to continue systemically critical operations of the Lehman Brothers after its failure and until customers of the firm could be transferred in an orderly way to alternative providers of services.*

- ***Uncontrolled Asset Liquidations.*** *Because runnable liabilities had to be paid during the period leading up to failure, and because financial contracts could be terminated and collateral for such contracts could be abruptly liquidated upon the bankruptcy of the firm, the assets of Lehman Brothers were dumped on the market in a disorderly way while market prices were depressed, further depressing market prices and* *leading to the destruction of the firm's value. This created further losses for Lehman and its creditors, and further disrupted financial markets and other financial firms.*

As noted in my testimony, the single point of entry approach to resolution of a financial holding company contemplated by the bill, in which the holding company maintains sufficient loss-absorbing capacity so that its operating subsidiaries can be recapitalized and remain outside of bankruptcy until they can be disposed of or wound down in an orderly way, is designed to address each of the above issues. Multiple competing insolvency proceedings are avoided, critical operations are continued without interruption, and abrupt asset liquidations are avoided.

Question 3: How would subchapter V interface with the living will requirement of Dodd-Frank?

Answer:

In their living wills, some financial firms rely on existing tools under the Bankruptcy Code, such as Section 363, to effectuate the rapid and orderly transfer of the stock of operating subsidiaries to a newly created bridge holding company in a single point of entry recapitalization of the firm. In addition, living wills currently rely on contractual workarounds, like the ISDA protocol, to amend financial contracts to eliminate early termination rights triggered by the parent holding company's bankruptcy. Proposed Subchapter V provides Bankruptcy Courts with a procedural roadmap to effectuate a rapid single point of entry recapitalization of a financial firm and provides statutory tools for preserving financial contracts, eliminating the need for contractual workarounds. Living wills that seek to utilize a single point of entry structure under current law would be facilitated by the enactment of Subchapter V, and such living wills would likely be adjusted to utilize the provisions the Subchapter V once they become available.

Question 4: By allowing a failed bank holding company to spin off its operating subsidiaries so that it can continue to function unimpeded by the holding company's bankruptcy, does that present a possible issue of moral hazard?

Answer:

In my opinion, the transfer of the operating subsidiaries of a financial firm to an independent bridge company owned by a private trust for the sole benefit of the bankruptcy estate, as contemplated by the bill, does not present a moral hazard issue, and indeed is wholly consistent with how non-financial debtors are treated under current chapter 11. Single point of entry resolution under Subchapter V is merely an efficient means of reorganizing a financial firm. As in other chapter 11 cases, the firm's business can continue, the firm's value and the jobs of its employees can be preserved, and the losses of the firm can be imposed in an orderly way on shareholders and junior (holding company) creditors in the order of their priorities. The procedure has the added benefits of minimizing disruption of the systemically important operations of the firm and avoiding bailouts.

A Subchapter V case thus accomplishes the same objectives as other chapter 11 cases, but recognizes that the tools of current chapter 11 do not adequately serve those objectives with respect to distressed financial firms. The purpose of Subchapter V is to add tools to chapter 11 that better accomplish those objectives.

As in other chapter 11 cases, junior creditors and shareholders will know they are the parties who will absorb any losses if the firm fails. They will accordingly have every incentive to impose discipline on and exercise oversight over the firm so it is operated in a prudent manner and avoids financial distress, and they will expect returns commensurate with the risks they are taking. Bailouts become unnecessary, market discipline is restored and moral hazard is avoided.

Question 5: Both of your colleagues on today's witness panel appear to oppose giving regulators the authority to commence an involuntary subchapter V case. You also suggest that this option be eliminated or the right of the debtor to contest such petitions should be eliminated.

a. Would the regulators be content with eliminating their authority to commence an involuntary subchapter V case?

Answer:

Involuntary bankruptcy petitions presume an opportunity for the debtor and creditors to contest the petition. Concerns have been raised by some commentators, such as the National Bankruptcy Conference, over the speed with which any objections to the petition would have to be resolved. As I indicated in my testimony, I have no objection to allowing regulators to commence chapter 11 proceedings against the debtor, but I too am troubled by the procedural concerns. I do not know how regulators would react to eliminating from the bill the provisions granting them the right to commence bankruptcy proceedings. Their ability to commence proceedings under Title II of the Dodd-Frank Act if bankruptcy proceedings are not timely commenced may be an important factor that affects their view.

b. If we eliminated the right of the debtor to contest an involuntary subchapter V, how would we ensure that the regulators were not abusing their authority to do so?

Answer:

I think abuse is unlikely for several reasons. First, under the bill, regulators will be required to make certain findings before employing their authority. Second, the commencement by regulators of Subchapter V proceedings is a drastic action that would only be exercised in cases of absolute necessity. Third, unlike regulatory proceedings, the regulator does not control the bankruptcy process once the case is commenced; the action of the regulator merely places the financial firm under court supervision. For all of these reasons, I believe eliminating the right to contest a petition by regulators is not likely to lead to abuse.

Response to Questions for the Record from Stephen E. Hessler, Esq., Partner, Kirkland & Ellis LLP

Questions Submitted for the Record
Representative Henry C. "Hank" Johnson, Jr., Ranking Member, Subcommittee on Regulatory Reform, Commercial and Antitrust Law, and Representative John Conyers, Jr., Ranking Member, Committee on the Judiciary

1. In your prepared testimony, you note that subchapter V's single point of entry process would effectuate "a very fast separation of 'good' from 'bad' assets."

   Please provide some examples, respectively, of "good" and "bad" assets.

Response

The key distinction is whether the subject asset provides accretive value to the post-transfer nondebtor bridge financial company. For instance, liquid, unencumbered, and/or income-producing assets, that the bridge financial company is able to monetize and/or that creditors are willing to lend against, are "good" assets. On the other hand, illiquid, encumbered, or cash flow negative assets that would presently impede the bridge financial company's ability to transact with counterparties, may be "bad" assets—at least until market conditions improve—and that could be liquidated by the debtor within the Chapter 11 cases.

   Is there a risk that this "fast separation" could occur too fast?

Response

Of course it is not possible to eliminate all risk that a critical reorganization tool such as a transfer determination under proposed section 1185 could be employed too hastily—but that risk is not limited to asset transfers under Subchapter V. Further, it is important to note, as I did in my testimony, that the transfer determination is subject to the safeguards of Bankruptcy Court authorization, applying well-established Chapter 11 legal principles. These include: the provisions of sections 363 and 365 shall apply to a transfer of estate property and the assignment of executory contracts, unexpired leases, and qualified financial contracts; the bridge financial company must obtain Bankruptcy Court approval of its governing documents, including the agreement governing the trust; and, significantly, the ultimate distribution of the trust assets (including the equity in the bridge financial company) shall be done in accordance with otherwise governing Chapter 11 plan of reorganization confirmation requirements and protections.

2. Are there sufficient safeguards in place to ensure that subchapter V is not subject to abuse by either a SIFI or a regulator?

Response

As a threshold matter, the Subchapter V provision that might be most susceptible to abuse is the proposed ability of the Federal Reserve to file an involuntary petition against a financial company. And as stated in my testimony, regulators already have myriad methods of effectively requiring that a financial company commence a voluntary case under the Bankruptcy Code—and for various legal and practical reasons, even if Subchapter V obtains final passage in its current form, it is highly unlikely there would ever be an involuntary case. In any event, it is my understanding that the involuntary filing provision is likely to be removed from the legislation. Otherwise, importantly, the fact that Subchapter V does not disturb the litany of fundamental safeguards applicable via Chapter 11—such as cases administered by experienced Bankruptcy Court judges, the imposition and protection of the automatic stay, the exclusive right to file a chapter 11 plan, to cite just a few—means there are, in my view, sufficient safeguards against abuse by either a SIFI or regulator in a Subchapter V proceeding.

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

Response

Because I am a restructuring practitioner, I need to defer to financial services counsel for a granular response as to potential regulatory reforms that may help facilitate the provisions of Subchapter V. That said, I have represented distressed companies in multiple highly-regulated industries—such as energy, gaming, and telecommunications—and, in my experience, the interplay between Chapter 11 and applicable regulatory regimes typically operates smoothly, and the federal judiciary is amply capable of addressing possible friction between the Bankruptcy Code and potentially conflicting regulatory requirements.

Response to Questions for the Record from Richard Levin, Esq., Partner, Jenner & Block LLP

Questions submitted for the Record
Representative Henry C. "Hank" Johnson, Jr., Ranking Member, Subcommittee on Regulatory Reform, Commercial and Antitrust Law, and Representative John Conyers, Jr., Ranking Member, Committee on the Judiciary

It is important to note at the outset that the National Bankruptcy Conference ("NBC") has not taken a position with respect to the application of subchapter V to financial firms other than Significantly Important Financial Institutions ("SIFIs"). The NBC's letter of June 18, 2015 ("NBC Letter") was limited to SIFIs and this response is so limited as well. The issues raised by bankruptcy resolution of financial firms that are not freighted with the potential risks that SIFIs present to the financial system present different practical issues and policy trade-offs. For a full statement of the NBC position, please refer to the NBC Letter.

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

__Answer__: As stated in our earlier letter to the Committee, the Conference strongly believes that to be successful, any recapitalization procedure, whether under the Bankruptcy Code or under a special resolution regime like OLA, requires a non-market backstop liquidity source as a bridge for the recapitalized firm until liquidity outflows abate and access to market liquidity returns. The absence of such a facility would increase the risk substantially that the proceeding would not be successful. A liquidity run may take time to abate, even after the transfer of the stock of the firm's operating subsidiaries to a bridge company as contemplated by H.R. 2947. Financing to meet any run may be temporarily unavailable from market sources even if the bridge company or the entity suffering the run has more than sufficient unencumbered assets to insulate lenders from any risk of loss. Under such circumstances, it would be appropriate for the federal government to provide interim secured lender of last resort liquidity directly to the bridge company or the entity suffering the run on appropriate terms. The availability of such liquidity will help to mitigate any run, which in turn will help to reduce the extent, if any, to which such financing will be used.

a. How would you respond to those who say this would amount to a taxpayer funded bailout of Wall Street?

__Answer__: As noted above, if the lender of last resort liquidity facility is properly structured, there would be no risk of loss to the lender, and the lender would be fairly compensated for providing the financing. In addition, because the financing would be available only to the non-bankrupt bridge company and its open and fully capitalized subsidiaries, equity owners and creditors left behind in the bankrupt holding company, who are structurally subordinated to subsidiary creditors, would absorb the firm's losses and would not be bailed out. In addition, the NBC recommends that the regulators have the power to require the appointment of new management for the bridge company acceptable to the regulators. See answer to Question 4, below.

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b. Similarly, how would you respond to the criticism that allowing the government to serve as a lender of last resort rewards irresponsible behavior and presents an issue of moral hazard?

<u>Answer</u>: **The moral hazard associated with the availability of secured lender of last resort financing is minimal if properly structured. See answer to Question 1(a) above. Lender of last resort liquidity should be provided only if it is fully secured and interest is payable at an appropriate risk-adjusted rate. It should be made available only to open, fully capitalized entities, and not to the failed debtor holding company that is left behind in the chapter 11 proceedings. When they extend credit, the holding company's pre-bankruptcy creditors would be aware of the risks they are taking and would insist on an appropriate return for taking such risks. They would also have strong incentives to engage in ex ante monitoring of the firm to prevent irresponsible behavior, thereby avoiding moral hazard.**

2. Some question whether the expedited time frames for the bankruptcy court's determination of whether or not to grant subchapter V relief in a contested involuntarily commenced case as well as the appellate review process may not ensure that the judicial role is meaningful given the import of the findings that the court has to make.

a. What is your response?

<u>Answer</u>: **As noted in the NBC's Letter, (the NBC believes the timeframe for the court's determination and appeals in a contested involuntary case commenced by regulators under subchapter V is unrealistically short. The NBC believes the provisions authorizing the Federal Reserve to commence such an involuntary case should be removed from the bill. Regulators have the ability to commence proceedings under Title II of the Dodd-Frank Act should it become necessary, and this, together with their general supervisory authority, gives regulators sufficient ability to cause a distressed SIFI to timely commence subchapter V proceedings.**

3. In a letter that the NBC sent to our Subcommittee last month, the Conference described several "significant concerns." Among them, the NBC stated that under certain circumstances "a bankruptcy process might not be best equipped to offer the expertise, speed and decisiveness needed to balance systemic risks against other competing goals in connection with resolution of a" systemically important financial institution and, thus, Title II of the Dodd-Frank Act should be retained even if H.R. 2947 became law.

a. Please describe what type of companies or circumstances might warrant the application of Title II's orderly liquidation authority in lieu of a resolution in bankruptcy.

<u>Answer</u>: **The circumstances of a future financial crisis cannot be known today, and it is impossible to assure that resolution under regulatory supervision will not be required. Among other things, although there has been substantial discussion between U.S. and non-U.S. regulators of mutual cooperation with home country resolution procedures in connection with a single point of entry resolution, there cau be no assurance that foreign regulators will cooperate with a court supervised bankruptcy process that differs**

substantially from their own regulator-controlled resolution procedures. As noted in the NBC Letter, the power of U.S. regulators to invoke Title II of the Dodd-Frank Act as a last resort will serve to provide comfort to foreign regulators and will facilitate obtaining their support and cooperation with the unfamiliar bankruptcy process.

4. In a letter that NBC sent to our Subcommittee last month, the Conference stated that "any amendments to the Bankruptcy Code relating to the resolution of SIFIs should make it clear that regulators have these powers despite the pendency of bankruptcy."

   a. Does H.R. 2947 sufficiently ensure that regulators retain their authority notwithstanding the pendency of bankruptcy?

      <u>Answer</u>: Under existing regulatory legislation, regulators should continue to have supervisory authority over non-bankrupt regulated subsidiaries of a bankrupt bank holding company and over any bridge company created in a Subchapter V case. We do not view H.R. 2947 as eliminating that supervisory authority, although to avoid any misperception, section 1189(b) could be revised to make clear that the new bridge company not only has all the rights and obligations under licenses, permits and registrations, but is also subject to all laws, regulations and rules associated with those licenses, permits and registrations that the debtor was subject to. Additionally, as noted in the NBC letter, the NBC supports significant regulator involvement in and supervision over the operations of SIFI being resolved during the bankruptcy case, and the NBC accordingly believes that amendments to the Bankruptcy Code should make it clear that regulators would have the authority to require the appointment of new management for the bridge company acceptable to the regulators and to closely supervise and, if necessary, specify limitations and conditions on the ongoing operations of the firm while the case is pending.

   b. If a subchapter V case is pending, does H.R. 2947 authorize these regulators to terminate the bankruptcy case and convert it to a resolution under Title II?

      <u>Answer</u>: H.R. 2947 does not include such authorization. However, Section 208 of the Dodd-Frank Act provides for dismissal of a bankruptcy case with respect to a covered company if Title II proceedings are commenced with respect to the covered company. Specifically, Section 208(a) of the Dodd-Frank Act provides that:

      > **Effective as of the date of the appointment of the Corporation as receiver for the covered financial company under section 202...any case or proceeding commenced with respect to the covered financial company under the Bankruptcy Code...shall be dismissed, upon notice to the bankruptcy court...and no such case or proceeding may be commenced with respect to a covered financial company at any time while the orderly liquidation is pending.**

It should be noted, however, that a receivership under Title II may be commenced only after, among other things, the Secretary of the Treasury (in consultation with the President) has made a determination, in accordance with Section 203(b) of the Dodd-Frank Act, that "the failure of the financial company and its resolution under otherwise applicable Federal or State law would have serious adverse effects on financial stability in the United States." In making this determination, the Secretary would have to take into account the resolvability of the firm in the Subchapter V case.

5. The NBC states that regulators should not have the power to commence an involuntary subchapter V.

    a. Please explain the reason why NBC takes this position.

    Answer: See response to Question 2 above.

6. Given recent U.S. Supreme Court decisions regarding the jurisdiction of the bankruptcy courts, does H.R. 2947 pass constitutional muster by allowing Article I bankruptcy judges, rather than Article III district judges, handle subchapter V case?

    Answer: While the NBC has not taken a position on the issue, I believe that the Bankruptcy Court should have jurisdiction to handle the time sensitive transfer motion at the outset of a subchapter V case, and, as to other matters, they can be handled by the Bankruptcy Court or the District Court in conformity with the Supreme Court decisions, as they are in other bankruptcy cases.