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Bankruptcy Alternatives to Title II of the Dodd-Frank Act—Part II

By Paul L. Lee*

Part I of this article discussed the rationale for the new Orderly Liquidation Authority in Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act, the perceived inadequacies in a Bankruptcy Code approach to the resolution of large financial companies, the work of the Federal Deposit Insurance Corporation in implementing Title II, including the single-point-of-entry strategy, and the role of resolution planning under Title I. Part II discusses the various proposals to revise the Bankruptcy Code to make it a more viable alternative for resolving large financial companies, the contending views on such efforts, and the effects of such efforts on the prospects for the use of the Title II process.

Title II has been said by one observer (and critic) to be at the heart of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").[1] This sentiment appears to have been shared by other observers (and supporters) of the Dodd-Frank Act. These observers and supporters saw Title II as the answer to the too-big-to-fail problem presented by large interconnected financial institutions.[2] In the hierarchy of Dodd-Frank Act provisions, these observers and supporters viewed the resolution plan requirement in Title I principally as an adjunct or auxiliary to Title II. As discussed in Part I of this article, in the implementation of the Dodd-Frank Act, there has been a shift in emphasis away from resolution under Title II toward resolution under the Bankruptcy Code. The fulcrum for this shift is in fact the resolution plan requirement in Title I. The shift has gained momentum as commentators, legislators and regulators have come to appreciate the import of the credibility analysis required under Section 165(d)(4) of Title I and the uses to which the credibility analysis can be put.

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[1] *See* Peter J. Wallison, *The error at the heart of the Dodd-Frank Act* (Sept. 6, 2011), http://www.aei.org/publication/the-error-at-the-heart-of-the-dodd-frank-act/.

[2] *See, e.g.*, U.S. Senate, *Brief Summary of the Dodd-Frank Wall Street Reform and Consumer Protection Act* (2010), *available at* http://banking.senate.gov/public/_files/070110_Dodd_Frank_Wall_Street_Reform_comprehensive_summary_Final.pdf.

The shift in emphasis was perhaps predictable. Critics have assailed Title II since its enactment.[3] Skeptics, some of whom may be found even in the regulatory community, have concluded that reliance on Title II would be misplaced and that resolution of systemically important financial institutions should instead be pursued under the Bankruptcy Code.[4] This sentiment is in line with the observation that under the Dodd-Frank Act, bankruptcy remains the preferred resolution mechanism for the largest financial institutions. The statutory test for the invocation of Title II itself reflects this supposition. Title II by its terms can only be used if there is no viable private-sector alternative available to prevent the default of the financial institution and if resolution of a financial company under the Bankruptcy Code or other applicable law would have serious adverse effects on financial stability in the United States.[5]

There were other signs as well of a continuing focus on the Bankruptcy Code process in Title II. Title II called for multiple studies to determine whether amendments should be made to the Bankruptcy Code to enhance its ability to resolve financial institutions in a way that would minimize adverse effects on the financial markets. Section 202(e) of the Dodd-Frank Act called for the Administrative Office of the United States Courts ("AOUSC") and the Comptroller General of the United States through the Government Accountability Office (the "GAO") to conduct separate studies regarding the bankruptcy and orderly liquidation process for financial companies under the Bankruptcy Code.[6] These studies were to assess the effectiveness of Chapter 7 and Chapter 11 of the Bankruptcy Code in facilitating the orderly liquidation or reorganization of financial companies and ways to make the orderly liquidation process under the Bankruptcy Code more effective for financial companies. Section 202(f) called for the Comptroller General through the GAO to conduct an additional study regarding international coordination of the liquidation of financial companies under the Bankruptcy Code.[7] Separately,

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[3] *See, e.g.*, Failing to End "Too Big to Fail": An Assessment of the Dodd-Frank Act Four Years Later, Report Prepared by the Republican Staff of the Committee on Financial Services, U.S. House of Representatives (July 2014).

[4] *See, e.g.*, Jeffrey M. Lacker, President, Federal Reserve Bank of Richmond, Rethinking the Unthinkable: Bankruptcy for Large Financial Institutions, National Conference of Bankruptcy Judges Annual Meeting (Oct. 10, 2014).

[5] 12 U.S.C. § 5383(b)(2) and (3). *See also* Resolution of Systemically Important Financial Institutions: The Single Point of Entry Strategy, 78 Fed. Reg. 76,614, 76,615 (Dec. 18, 2013).

[6] 12 U.S.C. § 5382(e). Section 202(e)(2) required the AOUSC and the GAO to conduct this study in each of the first three years after the enactment of the Dodd-Frank Act and every fifth year after the enactment.

[7] 12 U.S.C. § 5382(f).

Section 216(a) called for the Federal Reserve Board in consultation with the AOUSC to conduct a study regarding the resolution of financial companies under the Bankruptcy Code.[8] As part of a general study of the effectiveness of Chapter 7 and Chapter 11 in facilitating the orderly resolution or reorganization of systemically important financial institutions, the Federal Reserve Board was directed by Section 216(a) to consider whether amendments should be made to the Bankruptcy Act to address the manner in which qualified financial contracts of financial companies are treated and to study the challenges and benefits of creating a new chapter or subchapter to the Bankruptcy Code to deal with financial companies. Finally, Section 217(a) directed the Federal Reserve Board in consultation with the AOUSC to conduct a study regarding international coordination of the resolution of systemic financial companies under the Bankruptcy Code and applicable foreign law.[9] Clearly, there would be no want of studies of the Bankruptcy Code conducted under Title II. There would be, however, a want of conclusions in those studies.

BANKRUPTCY STUDIES UNDER TITLE II

GAO Studies

The GAO produced its first analysis of the effectiveness of a bankruptcy approach to the resolution of financial companies required under Section 202(e) in July 2011 (the "2011 GAO Report").[10] The 2011 GAO Report identified several characteristics of complex financial institutions that make the liquidation or reorganization of these entities under the Bankruptcy Code difficult, such as the highly liquid nature of their funding sources, their use of derivatives not subject to the Bankruptcy Code's automatic stay, and their separate but interconnected legal structures (used for tax or regulatory purposes) that are not congruent with their integrated operational structures.[11] The 2011 GAO Report also observed that a liquidation or reorganization of a financial company under the Bankruptcy Code would be rendered more difficult because a financial company is likely to have regulated subsidiaries, such as bank or insurance subsidiaries, that are not themselves eligible to be

[8] Dodd-Frank Act, § 216(a).

[9] Dodd-Frank Act, § 217(a).

[10] U.S. Government Accountability Office, *Bankruptcy: Complex Financial Institutions and International Coordination Pose Challenges* GAO-11-707 (July 2011) [hereinafter 2011 GAO Report].

[11] *Id.* at 28.

debtors under the Bankruptcy Code.[12]

The 2011 GAO Report concluded that whether resolving financial institutions through bankruptcy would be more or less effective than resolving them through Title II was not clear.[13] Here was the first sign of an agnosticism that would characterize all the bankruptcy studies under Title II. The 2011 GAO Report noted as a general matter that both the bankruptcy courts and the FDIC lacked experience in handling failures of large numbers of complex, internationally active institutions during a financial crisis.[14] It further observed that financial and legal experts had nonetheless proposed changes to the Bankruptcy Code to make it more effective in dealing with financial companies. The proposed changes principally related to (i) improving planning for a bankruptcy process, (ii) providing for regulatory input to the bankruptcy process, (iii) modifying the safe harbor provisions for financial contracts, (iv) treating financial companies on a consolidated basis in bankruptcy, and (v) improving bankruptcy court expertise on financial issues. In reference to these proposals, the 2011 GAO Report observed that "[e]xperts sometimes agree on the need for a particular type of action to address challenges posed by financial institutions, but they often do not agree on the effectiveness of specific proposals."[15] Differences in opinion on revising the Bankruptcy Code were particularly pronounced between bankruptcy practitioners and academicians.

The lack of agreement or sense of urgency among bankruptcy practitioners, academicians, and other commentators has impeded progress on making certain of the changes proposed for the Bankruptcy Code and has in some instances forced a recourse to other approaches. With respect to planning for a bankruptcy process, a measure outside the Bankruptcy Code, namely, Section 165(d) of the Dodd-Frank Act, has of course largely provided the answer for the Bankruptcy Code.[16] Similarly, the 2011 GAO Report discussed the disparate

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[12] *Id.* at 33.

[13] *Id.* at 37.

[14] *Id.* at 37–38.

[15] *Id.* at 39.

[16] 12 U.S.C. § 5365(d)(1). As discussed in Part I of this article, Section 165(d) of the Dodd-Frank Act requires all bank holding companies with consolidated assets of $50 billion or more and nonbank financial companies designated as systemically important under Section 113 of the Dodd-Frank Act to file resolution plans demonstrating how they could be resolved in an orderly manner under the Bankruptcy Code. The group of bank holding companies with consolidated assets of $50 billion or more covers the set of banking entities that would likely be thought to present systemic risk in the future event of their failure. Currently, there are only four nonbank financial companies designated as systemically important under Section 113 of the Dodd-Frank Act. Given the shape-shifting contours of systemic risk, it is possible that a nonbank

views of bankruptcy experts on the issues relating to the treatment of financial contracts. In the face of disagreement among bankruptcy experts and uncertain legislative prospects, the bank regulatory authorities have required institutions to adopt a contractual solution to the issue of a temporary stay on close-out and cross-default rights on derivatives and other financial contracts in bankruptcy.[17]

The other proposals discussed in the 2011 GAO Report, however, could only be addressed by amendments to the Bankruptcy Code. One proposal would be to provide for regulatory input to the Bankruptcy Code process as a precondition to a voluntary filing by a financial company. Another proposal would be to allow the primary regulator for a financial company to file an involuntary petition and to do so prior to the actual insolvency of the financial institution. Still another proposal would be to allow the primary regulator to propose a plan of reorganization for the company. The GAO discussed these proposals only at the most general level, noting differences of opinion among commentators and reaching no conclusions about the proposals. Potentially of greater significance was a proposal to remove the exclusions from the Bankruptcy Code for various regulated entities, such as banks, insurance companies, broker-dealers, and commodity brokers, as part of a parent company filing. Here the 2011 GAO Report reported that substantial doubt was expressed by regulatory experts that a bankruptcy process could provide the level of protection that the existing specialized resolution regimes provide for depositors, insurance policyholders, and customers of commodity brokers.[18]

In a subsequent report published in July 2013 (the "2013 GAO Report"), the GAO returned to several of the points discussed in the 2011 GAO Report and pursued them in greater depth.[19] The first point discussed was the proposal to give financial regulators a larger role in financial company bankruptcies, such as through

- requiring that a financial company notify and consult with the

financial company other than the four already designated might be thought to present systemic risk in the event of its failure. Such a company would not have been required to prepare a resolution plan under the Dodd-Frank Act.

[17] *See infra* note 28 and accompanying text.

[18] 2011 GAO Report, *supra* note 10, at 46.

[19] U.S. Government Accountability Office, *Financial Company Bankruptcies: Need to Further Consider Proposals' Impact on Systemic Risk* GAO-13-622 (July 2013) [hereinafter 2013 GAO Report]. The GAO also issued a report in July 2012. *See* U.S. Government Accountability Office, *Bankruptcy: Agencies Continue Rulemakings for Clarifying Specific Provisions of Orderly Liquidation Authority* GAO-12-735 (July 2012). The 2012 report did not contain a specific discussion of proposed changes to the Bankruptcy Code for the resolution of financial companies.

appropriate regulator before filing for bankruptcy;

- allowing regulators to commence an involuntary bankruptcy proceeding if a financial company is balance-sheet insolvent or has unreasonably small capital;
- allowing regulators to have standing to raise issues in a bankruptcy, including a right to propose a plan of reorganization; and
- providing the regulators a role in determining whether the bankruptcy court should consider the filing by a financial company as a whole similar to the doctrine of substantive consolidation and thus whether the existing bankruptcy exclusions for insurance companies, broker-dealers or commodity brokers should be retained.[20]

The 2013 GAO Report again dutifully recounted the views "pro" and "con" on these proposals, but reached no conclusions of its own on any of the proposals. It simply reported that the "[e]xperts generally agreed that [the] proposals need further consideration."[21]

The 2013 GAO Report also discussed in some detail the question whether the government should be allowed to provide financing to a financial company in bankruptcy. On that question, the GAO found more agreement among the experts that it consulted. A significant majority of the experts surveyed indicated that the proposal to provide a funding source was the most important change to be made to the Bankruptcy Code and that any change to the Bankruptcy Code to prevent a federal funding source in a bankruptcy would not be consistent with the objective of achieving an orderly and effective resolution.[22] These experts said that their support for a federal funding source rested on two propositions: (1) that private funding would likely be unavailable to finance the bankruptcy of a systemically important financial company, and (2) that the government should distinguish between funding a bailout of an insolvent company and funding the short-term liquidity needs of a solvent company on a fully secured basis. As to the first proposition, the experts noted that some of the techniques used to provide government funding in the 2008

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[20] *Id.* at 13–14.

[21] *Id.* at 18. The 2013 GAO Report did observe that the experts were generally opposed to having the regulators decide whether a financial company should be resolved on a consolidated basis. This opposition was based on several grounds, including most fundamentally the concern that it would undermine the concept of corporate separateness for subsidiaries. The experts also noted that the idea would conflict with the U.S. regulatory structure, which is specifically designed around separate legal entities and separate resolution regimes to protect depositors in banks and policyholders in insurance companies. *Id.* at 16–17.

[22] *Id.* at 22.

financial crisis would not be available because of subsequent legislative restrictions or would be otherwise strained because some firms had become much larger since the crisis. They also noted that obtaining private-sector funding would be especially difficult during a period of general financial distress when the firms large enough to provide the funding might be experiencing difficulties themselves.[23] As to the second proposition, the experts simply acknowledged the difficulty of distinguishing between an insolvent company and one experiencing temporary liquidity problems, particularly during a period of system-wide financial stress.[24]

The 2013 GAO Report also discussed a proposal from the Hoover Institution resolution project to add a new Chapter 14 to the Bankruptcy Code specifically for handling financial institutions. One of the elements in the Hoover Institution proposal was to allow the federal government to provide subordinated debtor-in-possession financing in a Chapter 14 case. A number of experts indicated doubts about the appropriateness of federal subordinated lending in a bankruptcy proceeding.[25]

A wide diversity of opinion was reflected in 2013 GAO Report's discussion of the safe harbor treatment of derivatives and other financial contracts. The options discussed by the GAO included a removal of all safe harbors for financial contracts; a partial roll-back of safe harbors on certain financial contracts; a temporary stay on all or certain financial contracts; and a process for a trustee to avoid payments on financial contracts made within specified periods prior to the bankruptcy filing if they are determined to be preferential or constructively fraudulent. The 2013 GAO Report reported that the experts had differing views on the advantages and disadvantages of the proposals and that the views of the experts were "still evolving as lessons learned from the treatment of these contracts during the Lehman Brothers bankruptcy remain unclear."[26] The 2013 GAO Report did note that most of the experts it consulted said that removing all the safe harbor provisions would detract from the orderliness and effectiveness of financial company bankruptcies. The experts, however, were split on the question whether the other proposals, such as imposing even a temporary stay on close-out rights, would enhance or detract from orderliness. The 2013 GAO Report concluded that the "experts are not ready to recommend specific changes to the Code [for financial contracts] and

[23] *Id.* at 22.

[24] *Id.* at 24.

[25] *Id.* at 25–27.

[26] *Id.* at 28.

the proposals require further consideration."[27]

The diffidence displayed in the 2011 and 2013 GAO Reports on the treatment of financial contracts was noted by the U.S. regulators, most particularly the FDIC. Several months after the release of the 2013 GAO Report, the FDIC, together with the Bank of England, the German Federal Financial Supervisory Authority, and the Swiss Financial Market Supervisory Authority, sent a letter to the International Swaps and Derivatives Association, Inc. ("ISDA"), urging it to revise its standard documentation to provide a short-term stay of early termination and other remedies based on the commencement of an insolvency or resolution proceeding.[28] The regulatory authorities said that such a contractual stay of early termination rights was essential to permit the exercise of resolution powers, especially the power to transfer derivative contracts and associated guarantee obligations to a bridge entity or other third party on an expedited basis. This contractual approach was proposed by the regulatory authorities as an expedient in the face of the difficulties likely to be encountered in achieving legislative changes even in some of the leading financial jurisdictions.[29]

The GAO was not the only party that was diffident in recommending changes to the safe harbor provisions in the Bankruptcy Code. In its discussion of proposed changes to the safe harbor provisions of the Bankruptcy Code, the 2013 GAO Report noted that the American Bankruptcy Institute (the "ABI") had established a Commission to Study the Reform of Chapter 11 and had appointed advisory committees to consider various subjects, including the

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[27] *Id.* at 38.

[28] *See* Press Release, Federal Deposit Insurance Corporation, Bank of England, German Federal Financial Supervisory Authority and Swiss Financial Market Supervisory Authority Call for Uniform Derivatives Contracts Language (Nov. 5, 2013), *available at* http://www.fdic.gov/news/news/press/2013/prl3099.html. In response to this regulatory request, ISDA developed a Resolution Stay Protocol, which many major bank members agreed to sign. *See* Press Release, ISDA, Major Banks Agree to Sign ISDA Resolution Stay Protocol (Oct. 11, 2014), *available at* http://www2.isda.org/news/major-banks-agree-to-sign-isda-resolution-stay-protocol.

[29] As discussed in Part I of this article, the FDIA and Title II provide for a temporary stay on action based on an insolvency default (in the case of the FDIA) or based on an insolvency default or cross-default (in the case of Title II). The Bankruptcy Code makes no provision for such a temporary stay. Hence, the need for an interim contractual solution to cover the Bankruptcy Code situation pending legislative action to amend the Bankruptcy Code. As discussed in Part I, a contractual solution would also be needed (even if the Bankruptcy Code were to be amended to provide a temporary stay) to cover financial contracts with a foreign choice of law provision.

treatment of financial contracts.[30] The ABI Commission issued its study and comprehensive recommendations for reform in December 2014.[31] With respect to the safe harbor provisions for financial contracts, the recommendations of the ABI study were less epic than imagined. Notwithstanding the prior call from the Financial Stability Board for action on the temporary stay issue and similar calls from leading U.S. regulatory authorities, such as the FDIC and the Federal Reserve Board, the ABI study did not address the issue of a temporary stay at all. The ABI study, however, did make several targeted recommendations for changes to specific aspects of the safe harbor provisions. The most significant recommendation was that the safe harbor provisions for repurchase agreements should be scaled back (to the state that existed prior to 2005) by eliminating from the coverage of the safe harbor provisions repurchase agreements for mortgages and mortgage-backed securities.[32]

AOUSC Studies

The AOUSC was scarcely more robust than the GAO in the reports that it issued under Section 202(e). The first report that the AOUSC issued in July 2011 (the "2011 AOUSC Report") expressed the Panglossian view that "the Bankruptcy Code appears to function well to address corporate distress, including in the context of bank holding companies and nonbank financial companies."[33] It further observed that

> [a]s a general matter, resolving distressed financial institutions, including those qualifying as covered financial companies under the [Dodd-Frank] Act, raises issues addressed on a regular basis by U.S. bankruptcy courts in the context of chapter 11 mega-cases.[34]

It reached at least one robust conclusion:

> The Bankruptcy Code and the bankruptcy courts appear well equipped to administer these cases in an orderly manner.[35]

The casual reader may be forgiven for thinking that the AOUSC was seeking

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[30] 2013 GAO Report, *supra* note 19, at 37.

[31] *See* American Bankruptcy Institute, *Commission to Study the Reform of Chapter 11*, *Final Report and Recommendations* (2014).

[32] *Id.* at 99–102.

[33] Administrative Office of the United States Courts, *Report Pursuant to Section 202(e) of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010*, at 3 (July 2011) [hereinafter 2011 AOUSC Report].

[34] *Id.* at 45.

[35] *Id.*

to exploit—in a very literal sense—a home court advantage.

The 2011 AOUSC Report discussed the treatment of financial contracts under the Bankruptcy Code, but in terms that can only be described as equivocal. It noted initially that "[m]ost commentators agree that the treatment of safe harbor contracts under the Bankruptcy Code is problematic."[36] The concerns of these commentators were discussed in the 2011 AOUSC Report as were the views of opponents of changes to the safe harbor treatment. The 2011 AOUSC Report, however, concluded that "neither proponents of maintaining the status quo nor those in favor of revoking the safe harbor protections have significant, tangible evidence to support the predicted effect of their respective positions on systemic risk."[37] The result in the 2011 AOUSC Report was stasis.

The 2011 AOUSC Report also analyzed the Hoover Institution proposal for a new Chapter 14 for financial institutions. As discussed further below, the work of the Hoover Institution resolution project team which commenced in 2009 represents the most extensive and detailed effort at amending the Bankruptcy Code to facilitate the resolution of large financial firms. It provides a thoughtful analysis of the competing considerations in making changes to the Bankruptcy Code to address the issues presented by large financial institutions. It should be noted, however, that other bankruptcy experts have not necessarily endorsed all aspects of the approach reflected in the Hoover Institution proposed Chapter 14.[38] The 2011 AOUSC Report noted various proposals included in the Hoover Institution work, such as the proposal to allow the primary regulator to commence an involuntary case against a financial company, to file motions to sell assets under Section 363, and to file a plan of reorganization without regard to the debtor's exclusivity period. The analysis of the Hoover Institution proposal in the 2011 AOUSC Report was relatively abbreviated and generally inconclusive. The 2011 AOUSC Report noted that the Hoover Institution proposal provides some interesting approaches for policyholders to consider. However, the closest that the 2011 AOUSC Report came to reaching a conclusion was its statement that "it is not clear that a new chapter [in the Bankruptcy Code] is necessary to implement some of [the] approaches" recommended by the Hoover Institution resolution group.[39]

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[36] *Id.* at 34 (citations omitted).

[37] *Id.* at 41.

[38] *See, e.g.*, Letter from the National Bankruptcy Conference to Hon. John Cornyn & Hon. Pat Toomey (January 29, 2014), *available at* http://www.nationalbankruptcyconference.org/images/NBC%20Ltr%20re%20s%201861%20(Ch%2014).pdf. (critiquing certain aspects of S. 1861 that are based on the Hoover Institution proposal).

[39] 2011 AOUSC Report, *supra* note 33, at 43.

Subsequent reports produced by the AOUSC in 2012 and 2013 pursuant to Section 202(e) were likewise inconclusive and contained no recommendations for changes to the Bankruptcy Code.[40]

Federal Reserve Board Studies

In July 2011, the Federal Reserve Board issued its report on the bankruptcy process as required under Section 216(a).[41] Like the GAO and the AOUSC studies, the Federal Reserve Board report did not make any recommendations for or against changes to the Bankruptcy Code. Instead, the Federal Reserve Board simply said that its report would "serve as a point of departure for further public debate and, potentially, legislative consideration of future reform."[42] The report catalogued the arguments raised by commentators for and against the effectiveness of the Bankruptcy Code in handling a systemically important financial institution. The report also surveyed the views of commentators on various proposed changes to the Bankruptcy Code to make it more effective in handling insolvent financial companies. For example, it discussed the proposal (which struck close to home) to provide a super priority in the Bankruptcy Code for a government entity providing financing in a bankruptcy proceeding and to allow the use of this financing to make partial or advance payments to some or all of the debtor's creditors.[43] The most extensive discussion in the Federal Reserve Board report related to the various proposals to revise the safe harbor treatment of financial contracts, presumably because Section 216(a) specifically called for a study of whether amendments should be made to the Bankruptcy Code and other insolvency law to address how financial contracts of financial companies are treated.[44] In line with its overall approach, the report took no position on any of the proposals to revise the safe harbor treatment. The trilogy of reports from the GAO, the AOUSC, and the Federal Reserve Board required under Title II did not produce a single recommendation for

[40] Administrative Office of the United States Courts, *Third Report Pursuant to Section 202(e) of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010* (July 2013); Administrative Office of the United States Courts, *Second Report Pursuant to Section 202(e) of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010* (July 2012).

[41] Board of Governors of the Federal Reserve System, *Study on the Resolution of Financial Companies under the Bankruptcy Code* (July 2011) [hereinafter the Federal Reserve Board Report]. The Federal Reserve also issued at the same time a report required under § 217(a) of the Dodd-Frank Act. *See* Board of Governors of the Federal Reserve System, *Study on International Coordination Relating to the Bankruptcy Process for Nonbank Financial Institutions* (July 2011).

[42] Federal Reserve Board Report, *supra* note 41, at 1.

[43] *Id.* at 13–14.

[44] *Id.* at 15–18.

change to the Bankruptcy Code. In at least one academic quarter, however, experts were already working on a detailed set of recommendations for changes to the Bankruptcy Code.

HOOVER INSTITUTION RESOLUTION PROJECT

In 2009 as Congress began considering financial reform legislation proposed by the U.S. Treasury, a resolution project group was established at the Hoover Institution to focus on ways for dealing with failing financial institutions.[45] The principal product of the resolution project group was the development of a proposed new chapter to the Bankruptcy Code specifically designed for handling the bankruptcy of financial institutions. The first iteration of this product was a proposal to add a new Chapter 11F to the Bankruptcy Code.[46] The general purpose of the proposed Chapter 11F was to forestall the creation of a new resolution regime for systemically important financial institutions as an exclusion from the Bankruptcy Code. Certain financial institutions such as banks and insurance companies are already excluded from eligibility for resolution under the Bankruptcy Code. In the words of the principal architect of the proposed Chapter 11F, "[b]ankruptcy reorganization is, for the most part, an American success story."[47] The supporters of this American success story did not want to see it despoiled by the creation of another large exclusion for systemically important financial institutions. The supporters of a bankruptcy approach were opposed to the idea of relying upon a regulatory resolution process that would operate outside "the predictability-enhancing constraints of a judicial process."[48] The specific purpose of the proposed Chapter 11F was to answer the objections of those commentators who maintained that the Bankruptcy Code as currently structured is not adequate or appropriate to the resolution of systemically important financial institutions.

The proposal for Chapter 11F was published in outline form in 2010. The proposal consisted of the following core elements:

- a new Chapter 11F specifically designed for financial institutions would be added to the Bankruptcy Code, using existing Chapter 11 or

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[45] THE HOOVER INSTITUTION: THE RESOLUTION PROJECT, http://www.hoover.org/research-teams/economic-policy-working-group/resolution-project.

[46] Thomas H. Jackson, *Chapter 11F: A Proposal for the Use of Bankruptcy to Resolve Financial Institutions, in* ENDING GOVERNMENT BAILOUTS AS WE KNOW THEM 217 (Kenneth E. Scott et al. eds., Hoover Institution Press 2010).

[47] *Id.* at 217.

[48] *Id.* at 219.

Chapter 7 procedures to the greatest extent possible, but modified as necessary for use in the reorganization or liquidation of financial institutions;

- the relevant government agency would be given the power to file an involuntary petition to place the financial institution into a Chapter 11F case;
- the existing bankruptcy exclusions for banks, insurance companies, broker-dealers, and commodities brokers would not apply in a Chapter 11F case so that the "entire" financial institution could be resolved or reorganized within the context of a single bankruptcy proceeding;
- upon commencement, a Chapter 11F case would be assigned by the chief judge of the relevant court of appeals to a member of a previously designated panel of special masters rather than to a bankruptcy judge;
- qualified financial contracts secured by cash or "cash-like" collateral would continue to enjoy the benefits of the safe harbor provisions; for all other qualified financial contracts, traditional Bankruptcy Code provisions (such as the automatic stay) would apply unless lifted by a court order;
- the relevant government agency would be given special standing in a Chapter 11F case to raise motions;
- the exclusivity period for the filing of a plan of reorganization provided to the debtor would be eliminated and the relevant government agency would be one of the parties allowed to file a plan of reorganization; and
- the relevant government agency would be allowed to provide debtor-in-possession financing subject to the usual bankruptcy rules regarding priority.[49]

These core elements in the proposed Chapter 11F would subsequently be revised and expanded as the Hoover Institution resolution project responded both to the enactment of Title II and to the subsequent development work of the FDIC on the single-point-of-entry ("SPOE") strategy.

In 2012 the Hoover Institution resolution project group released a revised version of its bankruptcy reform proposal in the form of a proposed Chapter 14

[49] *Id.* at 224–241. The feature recognizing a possible government financing role in a Chapter 11F case was presumably in response to the provision in H.R. 3310 (discussed in Part I of this article) that would have amended § 364 of the Bankruptcy Code to prohibit any direct or indirect funding by the federal government.

to the Bankruptcy Code.[50] The proposed Chapter 14 made various changes and additions to the approach outlined in the earlier proposal for Chapter 11F. The purpose of the proposed Chapter 14 was "to minimize the felt necessity to use the alternative government agency resolution process recently enacted as a part of the [Dodd-Frank Act]."[51] The Hoover Institution resolution group attributed the "felt necessity" to use the government agency resolution process in Title II of the Dodd-Frank Act to the perception that the default of a large financial institution is (i) outside the competence of the bankruptcy system, (ii) unable to be resolved in a timely fashion in a judicial proceeding, and (iii) likely to have systemic consequences to which an adversarial system with parties-in-interest standing before a court is ill-equipped to respond.[52] Proposed Chapter 14 was intended to respond to these perceived shortcomings in applying the Bankruptcy Code to the failure of large, complex financial institutions.

The principal provisions in the proposed Chapter 14 (in some instances, revised from those in the proposed Chapter 11F) included the following:

- Chapter 14 eligibility would be limited to financial institutions with $100 billion or more in consolidated assets;
- designated district court judges in the Second and District of Columbia Circuits would have exclusive jurisdiction over Chapter 14 cases; the district court judge would be precluded from referring cases and proceedings to a bankruptcy judge, but would be authorized to appoint a special master to hear the case and all proceedings under the case;
- the proposed Chapter 14, like proposed Chapter 11F, would not contain an exclusion for insurance companies, stockbrokers or commodity brokers; but unlike proposed Chapter 11F, proposed Chapter 14 would have an exclusion for banking entities;[53]
- the primary regulator would have the power to file an involuntary

[50] Thomas H. Jackson, *Bankruptcy Code Chapter 14: A Proposal*, *in* BANKRUPTCY *NOT* BAILOUT: A SPECIAL CHAPTER 14 (Kenneth E. Scott & John B. Taylor eds., Hoover Institution Press 2012).

[51] *Id.* at 26.

[52] *Id.* at 27–28.

[53] The change from proposed Chapter 11F to retain the exclusion for banking entities was presumably made in response to concerns raised by regulatory experts about making a fundamental change in the well-established regime for FDIC resolution of insured depository institutions. Although there are frequent conflicts and challenges arising from the separate bankruptcy process for a bank holding company and the regulatory resolution process for its bank subsidiary or subsidiaries (as witnessed most recently in the Washington Mutual case), the prospect of a bankruptcy judge administering a unitary bankruptcy proceeding for the holding company and its bank subsidiary with tens of millions of depositors and other claimants should

petition for a financial company on the ground that the company's assets are less than its liabilities (at fair valuation) or the company has an unreasonably small capital in addition to the existing Bankruptcy Code grounds for an involuntary petition;[54]

- the primary regulator would have standing to raise motions in a Chapter 14 case and would have the right, parallel with the trustee or debtor-in-possession, to file motions under Section 363 to use, sell or lease property of the estate;[55]
- the primary regulator would have the power to file a plan of reorganization at any time after the order for relief; and
- debtor-in-possession financing (including from government sources) would be permitted in a Chapter 14 case, but if the financing were used to make "advance" payments to creditors for systemic risk purposes, the provider of the financing would be subordinated in its right to repayment to the extent that the advance payments exceeded what the creditors would have been entitled to in the final bankruptcy calculation.[56]

The Chapter 14 proposal addressed the treatment of financial contracts with more specificity than the Chapter 11F proposal. Like the Chapter 11F proposal, the Chapter 14 proposal would exempt from the Bankruptcy Code automatic stay provision repurchase agreements secured by cash or cash-like collateral. The counterparty on a repurchase agreement would also have the right to petition the court to sell other non-firm-specific collateral in its possession upon the court's determination of the collateral's reasonable value. For derivatives and swaps, the Chapter 14 proposal would stay for three days the operation of netting or termination rights based on ipso facto provisions in the contracts. The three-day stay was intended to permit the possible transfer of financial

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strike fear in the hearts of regulatory experts and even in the hearts of not a few bankruptcy experts and judges.

[54] The Chapter 14 proposal envisioned that the company would have the opportunity to challenge the grounds for the petition filed by the primary regulator in court (in a closed hearing if the judge thought that appropriate) "without a truncated time frame". Kenneth E. Scott, *A Guide to the Resolution of Failed Financial Intuitions, in* BANKRUPTCY *NOT* BAILOUT: A SPECIAL CHAPTER 14, at 3, 9 (Kenneth E. Scott & John B. Taylor eds., Hoover Institution Press 2012).

[55] The Chapter 14 proposal envisioned that the primary regulator upon filing an involuntary petition could apply to the court to have the FDIC appointed as trustee. As trustee the FDIC would have the authority, for example, to file a plan of reorganization. *See* Scott, *supra* note 54, at 13.

[56] Jackson, *supra* note 50, at 66–69.

contracts with a going concern value to an acquirer, generally mirroring the approach for the resolution of a bank under the Federal Deposit Insurance Act (the "FDIA") and for a financial company under Title II. After the expiration of the three-day period, a counterparty would have the right to close out the contract and sell collateral along the same lines as outlined above for repurchase agreements. The Chapter 14 proposal would also generally eliminate the safe harbor exemption from the constructive fraudulent conveyance and preference provisions for repurchase agreements, derivatives and swaps.[57]

As the Hoover Institution resolution project group was developing its proposal for Chapter 14, the FDIC itself was breaking new ground in the development of the SPOE strategy and the related concept of total loss-absorbing capacity ("TLAC"). (These developments are discussed in Part I of this article.) The development of these innovations by the FDIC prompted the Hoover Institution resolution project team to extend its work to incorporate them into the Bankruptcy Code reform effort.[58] The principal objective of the Hoover Institution project team was to make bankruptcy a viable alternative to the use of Title II because the project team believed that a bankruptcy process under the rule of law had significant advantages over an administrative process run by a government agency.[59] A related objective was to improve the prospects that a bankruptcy process would be seen as credible for purposes of the living will requirement under Title I. The Hoover Institution project team worried that without a clear mechanism for a SPOE resolution in bankruptcy, "Title II—and its SPOE process—would become the default, not the extraordinary, process, which runs counter to the express preference in Dodd-Frank for bankruptcy as a resolution process for financial institutions."[60]

In 2014 the Hoover Institution project team published a revised version of the Chapter 14 proposal that was expanded to reflect an SPOE and TLAC approach. They called their revised proposal "Chapter 14 2.0." The essence of Chapter 14 2.0 was to revise the Bankruptcy Code to provide a speedy process

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[57] *Id.* at 69–70.

[58] *See* Thomas H. Jackson, *Building on Bankruptcy: A Revised Chapter 14 Proposal for the Recapitalization, Reorganization, or Liquidation of Large Financial Institutions, in* MAKING FAILURE FEASIBLE: HOW BANKRUPTCY REFORM CAN END "TOO BIG TO FAIL" 15 (Kenneth F. Scott et al. eds., Hoover Institution Press 2015).

[59] *Id.* at 21.

[60] *Id.* at 22 (footnote omitted). For a discussion of how Chapter 14 would assist the largest financial institutions in meeting their Title I requirement for producing credible resolution plans, see William F. Kroener III, *Revised Chapter 14 2.0 and Living Will Requirements under the Dodd-Frank Act, in* MAKING FAILURE FEASIBLE: HOW BANKRUPTCY REFORM CAN END "TOO BIG TO FAIL" (Kenneth E. Scott et al. eds. Hoover Institution Press 2015).

by which a company could be reorganized over a "resolution weekend." Chapter 14 2.0 was designed to accommodate both a conventional reorganization of an operating company and a "two-entity" recapitalization of a holding company and its operating subsidiaries as envisioned under an SPOE strategy.[61] The Hoover Institution project team characterized the basic mechanic for a two-entity recapitalization as a "quick sale" recapitalization of the holding company via a sale or transfer of its assets and liabilities (other than those representing its TLAC) to a bridge company.[62] This "quick sale" recapitalization would occur immediately following the commencement of the Chapter 14 case. The ultimate effect of the quick sale recapitalization would be to remove the assets transferred to the bridge company from the bankruptcy process while leaving the beneficial ownership rights in the bridge company (as between the former shareholders and holders of TLAC debt of the debtor) to be realized over time in the bankruptcy estate.[63]

Chapter 14 2.0 would permit the debtor to file a voluntary petition. Chapter 14 2.0 would also permit the Federal Reserve Board (or other primary regulator) to file what would be tantamount to a voluntary petition with respect to the company if the Federal Reserve Board or other primary regulator certifies that certain conditions (such as impairment of capital) are met. The petition would be tantamount to a voluntary petition because it would result in an immediate order of relief and would not be subject to a challenge by the debtor in light of the very tight schedule necessary to approve a "quick sale" transfer to a bridge company over a resolution weekend.[64] Chapter 14 2.0 would permit the debtor or the Federal Reserve Board (or the primary regulator for the debtor if other than the Federal Reserve Board) to file a "quick sale" motion for the wholesale transfer of the assets of the debtor in a bridge company. A hearing to consider the transfer motion would occur upon 24-hour notice to the debtor, the 20 largest holders of "capital structure" debt (*i.e.*, subordinated debt and

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[61] Jackson, *supra* note 58, at 25.

[62] *Id.* at 30.

[63] *Id.* at 30–32.

[64] *Id.* at 35. The original Chapter 14 proposal envisioned that the primary regulator could file an involuntary petition that would be subject to challenge by the debtor before a court. *See supra* note 54 and accompanying text. The addition in Chapter 14 2.0 of procedures for a "quick sale" meant that a challenge process for the filing of an involuntary petition could prejudice the ability from a timing perspective of achieving the "quick sale" over a resolution weekend. Under the Chapter 14 2.0 proposal, the court would retain jurisdiction subsequently to hear a claim that the regulator's certification in support of the "quick sale" motion was not supported by substantial evidence and to award ex post damages, presumably to the former debtholders and shareholders of the debtor. *Id.* at 36.

long-term senior debt), the FDIC, the Federal Reserve Board, and each primary financial regulatory authority (U.S. or foreign) of the debtor or any subsidiary, the ownership of which is proposed to be transferred to the bridge company.[65]

The decision on the "quick sale" motion would as a practical matter have to be made within 48 hours of the commencement of the case to benefit from a 48-hour stay provided in other provisions of Chapter 14 2.0 on acceleration, close-out and cross-default rights on qualified financial contracts.[66] The court would have to find (or the Federal Reserve Board or the primary regulator would have to certify) *inter alia* that the bridge company provides adequate assurance of future performance of debt agreements, qualified financial contracts and other contracts being transferred to the bridge company. After the "quick sale" or transfer motion is granted, the bridge company would not generally remain subject to the jurisdiction of the court, but the court would retain jurisdiction for one year to consider an application from the bridge company for financing on terms and conditions applicable to a debtor-in-possession financing.[67]

To facilitate the transfer of the operating subsidiaries to the bridge company, Chapter 14 2.0 also provided that *ipso facto* clauses in contracts based on the commencement of the case or on credit-rating downgrades would be overridden as would change-of-control provisions.[68] Similarly, Chapter 14 2.0 provided that licenses, permits and registrations could not be terminated based on a change-of-control provision. These provisions were intended in the words of the Hoover Institution working group to allow the transfer of the ownership of the debtor's subsidiaries to the bridge company to occur "seamlessly."[69] Chapter 14 2.0 was intended by its creators to be a worthy competitor to a Title II SPOE process.

CONGRESSIONAL CONSIDERATION

Legislative Proposals in 113th Congress

S. 1861

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[65] *Id.* at 31–32.

[66] *Id.* at 32.

[67] *Id.* at 33.

[68] *Id.* at 40–43.

[69] *Id.* at 43. Title II provides that the transfer of the assets and liabilities of the failed firm to a bridge company or other third party can be effected without any further approval under federal or state law, assignment or consent with respect thereto. *See* 12 U.S.C. § 5390(h)(2)(E).

The work of the Hoover Institution resolution group served as the catalyst for Congressional consideration of legislation to amend the Bankruptcy Code. In December 2013, Senators Cornyn and Toomey introduced the Taxpayer Protection and Responsible Resolution Act, S. 1861, which provided for a new Chapter 14 modeled in large part on the Hoover Institution Chapter 14 proposal.[70] S. 1861 departed, however, from the approach in the Hoover Institution Chapter 14 proposal in at least two significant respects. First, S. 1861 would repeal Title II.[71] Second, S. 1861 would amend the Federal Reserve Act to prohibit a Federal Reserve Bank from making any advances to a financial company that is a debtor in a Chapter 14 case or to a bridge company for the purpose of providing debtor-in-possession financing.[72] In other respects, S. 1861 followed the broad outlines of the Hoover Institution proposal for Chapter 14, but with some embellishments on the Hoover Institution proposal. For example, S. 1861 provided that the Federal Reserve Board could file an involuntary petition based on a certification that the company had depleted all or substantially all of its capital or would be in that condition sufficiently soon that immediate commencement of the case was necessary to prevent imminent substantial harm to financial stability in the U.S. The company would have the right to challenge the involuntary petition in a confidential hearing before the bankruptcy court.[73] This hearing would occur not later than 12 hours after the Federal Reserve Board filed the petition. The company could then file an appeal from the bankruptcy court determination to the district court, which would have to hear the appeal within 12 hours of the bankruptcy court determination. S. 1861 specified no time by which the bankruptcy court determination on the petition had to be made or by which the district court had to decide any appeal. Upon a request from the trustee or the Federal Reserve Board, after notice and hearing not less than 24 hours after the commencement of the case, the bankruptcy court could order a transfer of the assets of the debtor to a bridge company.[74] The notice and hearing process for the transfer petition apparently could occur contemporaneously with the hearing on the petition filed by the Federal Reserve Board and any appeal from the bankruptcy court determination of that petition. However, because the stay of termination rights on qualified financial contracts as provided in other provisions of S. 1861 would terminate

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[70] Taxpayer Protection and Responsible Resolution Act, S. 1861, 113th Cong. (2013).

[71] *Id.* § 2.

[72] *Id.* § 6.

[73] *Id.* § 4. The bankruptcy court would apply a preponderance of the evidence standard in its review of the petition.

[74] *Id.*

48 hours after the filing of the petition, the court review of the petition and the hearing on the transfer motion would as a practical matter have to be completed within 48 hours of the filing of the petition.[75]

Although there were no hearings on S.1861 in the 113th Congress, the legislative proposal received close scrutiny. The National Bankruptcy Conference (the "NBC") provided a detailed set of substantive and technical comments on S. 1861 in a letter to Senators Cornyn and Toomey in January 2014.[76] The NBC letter began with a number of overarching policy comments. The NBC observed that S.1861 did not contain any special liquidity facility and that it repealed Title II, which has such a facility.[77] The NBC letter said that the NBC had not studied the repeal of Title II and thus took no position on the repeal, but noted nonetheless that several members of the NBC had expressed serious reservations about whether the approach in S. 1861 would work.[78] The NBC warned that the restructuring of a large financial company would require some form of immediate liquidity or credit support, which S. 1861 did not provide. The NBC noted that despite the speed of recapitalization proposed under S. 1861, "even under the best of circumstances" it would take a period of time for the market to assimilate the information about the restructuring before the bridge company's full access to market liquidity would return.[79] The NBC also noted that in the absence of "some degree of certainty" about access to such liquidity, the commencement of a Chapter 14 case might cause ring-fencing by foreign regulators and a run on the operating subsidiaries.[80] The conclusion of the NBC was that S. 1861 needed to provide for an additional source of backstop liquidity to the bridge company, such as fully secured advances similar to the discount window currently available to banks.[81] This statement was presumably directed at the provision in S. 1861 that would amend the Federal Reserve Act to further restrict the availability of financing from the discount window. The NBC cited an "overriding" concern that "a

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[75] *See* Thomas Jackson, *supra* note 58, at 32 for a discussion of these timing issues in the Chapter 14 2.0 proposal.

[76] Letter from the National Bankruptcy Conference to Hon. John Cornyn & Hon. Pat Toomey (January 29, 2014) [hereinafter National Bankruptcy Conference 2014 Letter], *available at* http://www.nationalbankruptcyconference.org/images/NBC%20Ltr%20re%20s%201861%20(Ch%2014).pdf.

[77] *Id.* at 2.

[78] *Id.*

[79] *Id.* at 3.

[80] *Id.*

[81] *Id.* at 3–4.

successful recapitalization . . . cannot be achieved in all cases without some provision for potentially significant credit and collateral support."[82] Other bankruptcy experts reached similar conclusions on S. 1861, particularly in respect of its failure to recognize the liquidity needs of a financial company in resolution.[83]

The NBC offered another comment that went to the heart of the effort to impose a judicial process on resolution in substitution for the administrative process in Title II. Noting that a successful recapitalization under Chapter 14 requires speed and certainty, the NBC observed that challenges to the commencement of the case or the creation of the trust to hold the shares of the bridge company would undermine the maintenance or restoration of market confidence and the prompt access to sources of liquidity that the bridge company structure is designed to achieve.[84] The NBC concluded that "[a] meaningful judicial review process of even one day could jeopardize the process" and 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."[85] The NBC thus proposed that the requirement for a court hearing to review a filing by the Federal Reserve Board be removed (along with debtor's right of appeal) and instead that reliance be placed on the Federal Reserve Board certification of the financial grounds for the petition and the need to avoid imminent substantial harm to the financial stability of the U.S.[86] Likewise, the NBC noted that the designation of the special trustee and the appointment of the management of the bridge company must be rapid and certain in order to maintain market confidence in the bridge company. The NBC suggested that the court approval for these appointments be provided in effect on the basis of strong deference to the Federal Reserve Board if it had already chosen a special trustee and the directors and senior management of the bridge company (as the NBC anticipated would be the case).[87] Similarly, the NBC suggested that the court approval for the transfer of assets to the bridge company be based simply on a certification of the Federal Reserve Board rather than on a hearing process

[82] *Id.* at 4.

[83] *See, e.g.,* Bruce Grohsgal, *Case in Brief Against "Chapter 14"*, ABI Journal (May 2014) at 44; Keith J. Larson, *Bankruptcy or Bailout: Senators Seek to Replace Title II of Dodd-Frank with a New Bankruptcy Chapter 14* (May 2014), http://www.abi.org/committee-post/bankruptcy-or-bailout-senators-seek-to-replace-title-ii-of-dodd-frank-with-a-new.

[84] National Bankruptcy Conference 2014 Letter, *supra* note 76, at 4–5.

[85] *Id.* at 5.

[86] *Id.*

[87] *Id.* at 6.

requiring a court finding based on a preponderance of the evidence.[88] The comments from the NBC reflect the inherent tension between the need for rapid action in the resolution of a large financial institution and the desire for reliance on a judicial process in a bankruptcy proceeding. The need for speed (and expertise) in the case of a resolution of a large financial institution appeared to many observers to argue for significantly more involvement and deference to the relevant regulatory authorities than would be customary in bankruptcy cases.

H.R. 5421

In the same month that S. 1861 was introduced in the Senate, a subcommittee of the House Judiciary Committee began a set of hearings on the use of the Bankruptcy Code to resolve financial institutions.[89] In the first subcommittee hearing in December 2013, President Jeffrey Lacker of the Richmond Federal Reserve Bank provided strong support for amendments to the Bankruptcy Code. He noted that "the Dodd Frank Act envisions bankruptcy without government support as the first and preferable option in the case of a failing financial institution . . ."[90] He spoke in favor of relying on a robust planning process under Title I to resolve financial institutions under the Bankruptcy Code rather than relying on Title II. He noted that there was a frequently heard claim that the large liquidity needs of failing financial institutions would be a stumbling block to resolving such institutions in bankruptcy.[91] His conclusion was that if a resolution in bankruptcy for a large firm would be dependent upon a large amount of debtor-in-possession financing that would be difficult to obtain, the regulators would be warranted to require less reliance by financial institutions on short-term funding in the first place.[92] One process for requiring the largest financial institutions to place less reliance on short-term financing sources would of course be the resolution

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[88] *Id.* at 7.

[89] *See Bankruptcy Code and Financial Institutions Insolvencies: Hearing Before the Subcomm. on Regulatory Reform, Commercial and Antitrust Law of the H. Comm. on the Judiciary*, 113th Cong. (2013).

[90] *Bankruptcy Code and Financial Institutions Insolvencies: Hearing Before the Subcomm. on Regulatory Reform, Commercial and Antitrust Law of the H. Comm. on the Judiciary*, 113th Cong. 14 (2013) (statement of Jeffrey Lacker, President, Federal Reserve Bank of Richmond).

[91] *Id.* at 15.

[92] *Id.* President Lacker specifically spoke against government-provided debtor-in-possession financing. He said that privately provided debtor-in-possession financing was better than government-provided debtor-in-possession financing because market participants and court review made it likely that the financing would be fairly priced and unsubsidized unlike the financing that might be provided under Title II. *Id.* at 16.

planning process under Section 165(d).

At the same hearing, an academician testified in favor of significant changes to the safe harbor treatment of derivatives and short-term financing such as repurchase agreements.[93] His conclusion was that the safe harbor provisions for derivatives and short-term financing "make effective resolution in a bankruptcy without regulatory support difficult, and for some financial firms, impossible."[94] Among his many criticisms of the safe harbor provisions was that existing safe harbor provisions in the Bankruptcy Code subsidize unstable short-term loans over more stable longer-time financing for financial institutions.[95] He also asserted that the safe harbor provisions encouraged excessive risk-taking by the largest financial firms. He cited the example of Lehman Brothers, which had one-third of its liabilities in short-term, bankruptcy exempt, safe harbor debts at the time of its failure.[96] As a general matter, he urged a significant narrowing of the safe harbor provisions. As a specific matter, he recommended a temporary stay of rights to close out financial contracts to facilitate the use of an SPOE strategy in bankruptcy.

A leading bankruptcy practitioner provided the most comprehensive testimony at the December 2013 hearing.[97] This practitioner emphasized in his testimony the importance of the SPOE strategy that the FDIC had developed for use under Title II. The SPOE has the important advantages of minimizing the disruptions in the operating subsidiaries, avoiding the liquidation of businesses and assets at fire-sale prices, and preserving the going-concern value of the operating subsidiaries.[98] These are all advantages that should be sought in a bankruptcy approach as well. He observed that Title II included special tools that facilitate the implementation of an SPOE strategy. He described the tools as the bridge holding company tool, the liquidity support tool, and the

[93] *Bankruptcy Code and Financial Institutions Insolvencies: Hearing Before the Subcomm. on Regulatory Reform, Commercial and Antitrust Law of the H. Comm. on the Judiciary*, 113th Cong. 94 (2013) (statement of Mark J. Roe, Professor of Law, Harvard Law School).

[94] *Id.* at 95.

[95] *Id.* at 96. He also testified that the safe harbors weaken market discipline and provide a competitive advantage to the largest financial institutions that dominate the derivatives markets by virtue of the safe harbor for multi-product master netting agreements. *Id.*

[96] *Id.* at 97.

[97] *Bankruptcy Code and Financial Institutions Insolvencies: Hearing Before the Subcomm. on Regulatory Reform, Commercial and Antitrust Law of the H. Comm. on the Judiciary*, 113th Cong. 72 (2013) (statement of Donald S. Bernstein, Partner, Davis Polk & Wardwell LLP).

[98] *Id.* at 77–78.

financial contract preservation tool.[99] He observed that the absence of express provision for these same tools in the Bankruptcy Code would make it harder for financial companies to implement a pure SPOE approach in bankruptcy. Companies filing living wills under Title II have had to adopt hybrid approaches in an effort to replicate aspects of an SPOE approach in bankruptcy.[100] Because these hybrid approaches entail execution risk and the likelihood of larger losses for the holding company creditors and shareholders than a pure SPOE strategy, this practitioner urged that various changes be made to the Bankruptcy Code to:

- clarify that bank holding companies can recapitalize their operating subsidiaries prior to the commencement of bankruptcy proceedings;
- clarify that Section 363 of the Bankruptcy Code can be used to transfer recapitalized entities to a new holding company as a bridge company;
- add provisions that permit a short stay of close-out rights on qualified financial contracts and that override ipso facto bankruptcy defaults or cross-defaults; and
- provide some form of fully secured liquidity resource to stabilize the recapitalized firm and prevent fire-sales until access to market liquidity returns.[101]

Finally, this practitioner joined the swelling chorus of those who argued that even if the Bankruptcy Code were to be revised to facilitate an SPOE recapitalization, it was crucial to retain Title II as a backup resolution option for large financial firms. Among the reasons he cited for retaining Title II was that host country regulators who are less familiar with the U.S. bankruptcy system would take comfort from the fact that if all else fails, the U.S. regulators have the power to implement a recapitalization of a large distressed financial firm.[102]

In March 2014 another panel of bankruptcy experts testified before the subcommittee.[103] One of these experts was the principal architect of the Hoover Institution Chapter 14 proposal who is also a member of the FDIC's

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[99] *Id.* at 81–82.

[100] *Id.* at 84–86.

[101] *Id.* at 89.

[102] *Id.* at 90.

[103] *See Exploring Chapter 11 Reform: Corporate and Financial Institution Insolvencies; Treatment of Derivatives: Hearing Before the Subcomm. on Regulatory Reform, Commercial and Antitrust Law of the H. Comm. on the Judiciary*, 113th Cong. (2014).

Systemic Resolution Advisory Committee.[104] This expert observed that the Dodd-Frank Act envisions bankruptcy as the preferred mechanism for resolution of systemically important financial institutions. Recognizing the advantages that the SPOE strategy provided in a Title II resolution, he was concerned that, by comparison, an SPOE strategy would be "very difficult to accomplish under the current Bankruptcy Code."[105] He outlined the changes to the Bankruptcy Code that he thought would be necessary to make an SPOE strategy in bankruptcy an effective alternative to an SPOE strategy under Title II. The successful use of an SPOE strategy requires that a bridge company be able to acquire all of the assets, contracts, permits and rights of the failed company while preserving the business of the transferred operating subsidiaries. Besides dealing with the termination rights in the financial contracts of the failed company and its operating subsidiaries, it would be necessary for amendments to the Bankruptcy Code to ensure that operating licenses and permits could be transferred to the bridge company or maintained at the operating companies notwithstanding the change of control of the operating subsidiaries.[106] He attached a proposal for adding a Subchapter V to Chapter 11 of the Bankruptcy Code that would implement the changes necessary to make the Bankruptcy Code a viable alternative for resolving a large financial institution. The proposal for Subchapter V paralleled the general approach in S. 1861 with two major differences.[107] The proposal did not include a repeal of Title II and it did not seek to restrict the ability of the Federal Reserve System to advance funds to a bridge company. To the contrary, the proposal included an amendment to Section 13 of the Federal Reserve Act to authorize advances to a bridge company as part of a bankruptcy reorganization process, provided that (i) the bridge company is solvent and (ii) the advance is secured to the satisfaction of the Federal Reserve Bank and bears a rate of interest above the market rate of interest at the time of the advance.[108]

A leading bankruptcy practitioner also testified at the hearing, but he directed his comments only to the proposals to revise the safe harbor provisions for financial contracts. He said that he believed that the safe harbor provisions

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[104] *Exploring Chapter 11 Reform: Corporate and Financial Institution Insolvencies; Treatment of Derivatives: Hearing Before the Subcomm. on Regulatory Reform, Commercial and Antitrust Law of the H. Comm. on the Judiciary*, 113th Cong. 96 (2014) (statement of Thomas H. Jackson, Professor & President Emeritus, University of Rochester).

[105] *Id.* at 104.

[106] *Id.* at 104–105.

[107] *Id.* at 117–128.

[108] *Id.* at 128.

played a vital role in promoting systemic stability and resilience.[109] Responding to criticism of the safe harbor provisions, which he described as "particularly prevalent in academic circles," he warned that repealing or substantially narrowing the safe harbor provisions would have significant negative effects on counterparties and the related markets.[110] He suggested that a more targeted approach, such as imposing a temporary stay on the close out of the financial contracts, would be a better approach.

Another commentator testifying on behalf of the NBC struck themes generally consistent with those mentioned by other commentators and those previously struck by the NBC in its comment letter of January 2014.[111] This commentator noted the importance of the SPOE strategy in insulating the operating subsidiaries of a large financial company from the shock created by the parent's bankruptcy filing. This commentator also emphasized the importance of a temporary stay from counterparty action on financial contracts at both the parent level and the subsidiary level. Finally, consistent with the point made in the NBC letter on S. 1861, the commentator reaffirmed that there must be a source for liquidity for a financial company in a bankruptcy process.[112]

The subcommittee subsequently produced a discussion draft of a bill, the "Financial Institution Bankruptcy Act of 2014," that incorporated many of the basic elements in S. 1861.[113] The discussion draft differed in form from the approach in S. 1861 by incorporating the provisions in a new Subchapter V of Chapter 11 rather than a separate chapter (as in the proposed Chapter 14 approach). It differed in substance from the approach in S. 1861 in not including a repeal of Title II or a restriction on Federal Reserve System lending. The draft bill included provisions similar to those in S. 1861 to facilitate an SPOE-like strategy, but with some procedural changes. For example, the draft

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[109] *Exploring Chapter 11 Reform: Corporate and Financial Institution Insolvencies; Treatment of Derivatives: Hearing Before the Subcomm. on Regulatory Reform, Commercial and Antitrust Law of the H. Comm. on the Judiciary*, 113th Cong. 33 (2014) (statement of Seth Grosshandler, Partner, Cleary Gottlieb Steen & Hamilton LLP).

[110] *Id.* at 45.

[111] *Exploring Chapter 11 Reform: Corporate and Financial Institution Insolvencies; Treatment of Derivatives: Hearing Before the Subcomm. on Regulatory Reform, Commercial and Antitrust Law of the H. Comm. on the Judiciary*, 113th Cong. 53 (2014) (statement of Jane Lee Vris, General Counsel, Millstein & Co.).

[112] *Id.* at 54–57.

[113] *See Hearing on the "Financial Institution Bankruptcy Act of 2014": Hearing Before the Subcomm. on Regulatory Reform, Commercial and Antitrust Law of the H. Comm. on the Judiciary*, 113th Cong. 100-128 (2014).

bill provided that (i) the bankruptcy court had to make a decision on a petition filing by the Federal Reserve Board within 14 hours of the filing; (ii) the company had to file any appeal from the bankruptcy court decision within 1 hour after the decision; and (iii) any appeal had to be heard within 12 hours of the bankruptcy court decision and the appeal decided not later than 14 hours after the appeal was filed. This tightly constrained schedule was designed to facilitate implementation of the quick sale strategy over a resolution weekend. Some commentators would find this schedule too constrained to constitute a meaningful review process.

The subcommittee held a hearing in July 2014 to take testimony on the discussion draft. Testifying again as he had in the March 2014 hearing was the principal architect of the Hoover Institution Chapter 14 proposal.[114] As might be expected, this commentator provided strong support for the objectives of the discussion draft. He asserted that the Bankruptcy Code would be a "wholly inadequate competitor" to an SPOE process under Title II unless a number of changes were made to the Bankruptcy Code as envisioned in the discussion draft.[115] Unless corrected by the amendments contained in the discussion draft, the problems in the Bankruptcy Code would in his view be "essentially, fatal to any effort to use the current Bankruptcy Code to recapitalize a [systemically important financial institution]."[116] This commentator concluded that the discussion draft effectively accomplished all the changes needed to make the Bankruptcy Code a viable alternative to the proposed SPOE procedure under Title II.[117] Indeed, he concluded that with the changes reflected in the draft bill, the Bankruptcy Code would be not just a parallel mechanism to accomplish an SPOE procedure outside of Title II, but a superior mechanism. In effect, however, he qualified this conclusion by declining to enter into the debate over whether the sources of market-based liquidity would be sufficient to permit an SPOE reorganization under the Bankruptcy Code.[118]

Another leading bankruptcy academician also testified in favor of the draft bill as an important and promising first step in meeting the Dodd-Frank Act

[114] *Hearing on the "Financial Institution Bankruptcy Act of 2014": Hearing Before the Subcomm. on Regulatory Reform, Commercial and Antitrust Law of the H. Comm. on the Judiciary*, 113th Cong. 39 (2014) (statement of Thomas H. Jackson, Professor & President Emeritus, University of Rochester).

[115] *Id.* at 47.

[116] *Id.* at 48.

[117] *Id.* at 54.

[118] *Id.* at 50 n.25.

preference for the use of the Bankruptcy Code over Title II.[119] He expressed doubts, however, about the utility of certain provisions in the draft bill, such as the provision requiring the appointment of a special trustee to administer a complex trust arrangement. He also suggested that the subcommittee should consider what might happen if a Subchapter V proceeding failed to halt a run on the operating subsidiaries.[120] Could the bridge company itself be put into a Title II proceeding? What could a bankruptcy court do if a state regulator or a foreign regulator took actions undermining the transfer of the operating subsidiaries to the bridge company?[121]

Two leading bankruptcy practitioners also testified in favor of amendments to the Bankruptcy Code. The first practitioner, who had also testified at the December 2013 and March 2014 hearings, reiterated his support of the changes to be made by the draft bill and offered suggestions for further enhancements to the discussion draft.[122] He made a number of important drafting comments on the bill. He also made several important policy comments. For example, he recommended that the bill should do everything it could to encourage voluntary rather than involuntary proceedings to facilitate a speedy resolution process. Thus, he recommended that the draft bill include a provision like that in Title II that would protect the directors of a financial company from liability for consenting to the filing of a voluntary petition (or presumably for not opposing an involuntary petition filed by the government authority).[123] Such a provision was subsequently added to the bill. He also supported the view expressed by the NBC in its earlier comment letter on S. 1861 about the desirability of a lender-of-last-resort facility to ensure the success of the SPOE recapitalization in bankruptcy.[124] He reaffirmed his previously expressed view of the need to retain Title II as a backup resolution option even if the proposed

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[119] *Hearing on the "Financial Institution Bankruptcy Act of 2014": Hearing Before the Subcomm. on Regulatory Reform, Commercial and Antitrust Law of the H. Comm. on the Judiciary*, 113th Cong. 83 (2014) (statement of Steven J. Lubben, Professor, Seton Hall University School of Law).

[120] *Id.* at 85–86.

[121] *Id.* at 86.

[122] *Hearing on the "Financial Institution Bankruptcy Act of 2014": Hearing Before the Subcomm. on Regulatory Reform, Commercial and Antitrust Law of the H. Comm. on the Judiciary*, 113th Cong. 12 (2014) (statement of Donald S. Bernstein, Partner, Davis Polk & Wardwell LLP).

[123] *Id.* at 23.

[124] *Id.* at 20–21.

changes were made to the Bankruptcy Code.[125]

The other practitioner likewise expressed support for efforts to amend the Bankruptcy Code to facilitate its use in the reorganization of systemically important financial institutions.[126] His views were animated by a strong aversion to the use of Title II, which he saw as lacking "clear and established rules, administered by an impartial tribunal."[127] Nonetheless, he expressed concerns about certain elements in the discussion draft. For example, while recognizing the need to subject qualified financial contracts to the automatic stay, at least on a temporary basis, he expressed concern about the feasibility of requiring the debtor to make a decision on the transfer of its entire derivatives portfolio within the 48-hour stay period.[128] He also expressed concerns about the abbreviated and constricted process for a challenge by the debtor to an involuntary petition filed by the government and for court approval of the transfer of assets of the financial company to the bridge company. He noted that the draft bill required a hearing on an involuntary petition within 12 hours of its filing without notice or attendance by creditors and with transcripts of the hearing to be kept under seal for at least three months after the hearing. As he noted, these provisions depart from standard Bankruptcy Code principles of due process and transparency.[129]

In September 2014, the Judiciary Committee approved H.R. 5421, the Financial Institution Bankruptcy Act of 2014, generally in the form of the discussion draft but with a number of changes made in response to comments received during the hearing process.[130] The full House approved H.R. 5421 by a voice vote in December 2014. H.R. 5421, as approved by the House, included provisions that were generally supported as far as they went by many of the practitioners and academicians who testified on the proposed legislation. Some observers, however, felt that the provisions did not go far enough. Although H.R. 5421 did not contain a prohibition on a government liquidity backstop as S.1861 did, H.R. 5421 did not make any provision for a government liquidity backstop to support the reorganization of a financial company in a bankruptcy proceeding. A number of individuals who testified on

[125] *Id.* at 34.

[126] *Hearing on the "Financial Institution Bankruptcy Act of 2014": Hearing Before the Subcomm. on Regulatory Reform, Commercial and Antitrust Law of the H. Comm. on the Judiciary*, 113th Cong. 60 (2014) (statement of Stephen E. Hessler, Partner, Kirkland & Ellis LLP).

[127] *Id.* at 68.

[128] *Id.* at 73.

[129] *Id.* at 79–80.

[130] *See* H.R. Rep. No. 113-630 (2014).

the discussion draft asserted that a bankruptcy reorganization of a large financial institution would likely not be feasible without such a government backstop at least on an interim basis.

Legislative Proposals in 114th Congress

H.R. 2947

In June 2015, H.R. 5421 with minor changes was re-introduced in the 114th Congress in the House as H.R. 2947.[131] In July 2015, the House subcommittee held a hearing on H.R. 2947.[132] Three bankruptcy practitioners testified at the hearing. A leading bankruptcy practitioner who had previously testified on H.R. 5421 testified as well on H.R. 2947.[133] In addition to reaffirming the views he had expressed earlier on H.R. 5421, he emphasized the progress that had been made in establishing the various predicates for the successful implementation of an SPOE strategy. He noted *inter alia* that the largest U.S. bank holding companies already had substantial amounts of long-term senior debt in advance of the anticipated promulgation of a long-term senior debt requirement by the Federal Reserve Board.[134] Similarly, he noted the implementation of the stay protocol by ISDA, which provides for a temporary stay of insolvency-related default and cross-default provisions in derivative contracts.[135] He noted as well that the largest U.S. firms were eliminating the issuance of short-term runnable debt from their holding companies and minimizing operating activities at the holding company level to facilitate the SPOE resolution approach.[136]

In addition to the specific comments he had made in his earlier testimony on H.R. 5421, he offered two specific observations on H.R. 2497. The first related to the provision allowing the Federal Reserve Board to file an involuntary petition and the debtor to contest the involuntary petition. He noted that any dispute over the filing of the involuntary petition had to be resolved in

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[131] Financial Institution Bankruptcy Act of 2015, H.R. 2947, 114th Cong. (2015).

[132] *See Financial Institution Bankruptcy Act of 2015: Hearing on H.R. 2947 Before the Subcomm. on Regulatory Reform, Commercial and Antitrust Law of the H. Comm. on the Judiciary*, 114th Cong. (2015).

[133] *Financial Institution Bankruptcy Act of 2015: Hearing on H.R. 2947 Before the Subcomm. on Regulatory Reform, Commercial and Antitrust Law of the H. Comm. on the Judiciary*, 114th Cong. 45 (2015) (statement of Donald S. Bernstein, Partner, Davis Polk & Wardwell LLP).

[134] *Id.* at 49.

[135] *Id.* at 49–50.

[136] *Id.* at 51.

sufficient time to allow a hearing on the transfer motion to the bridge company before the firm reopens for business on Monday morning (or even before the Asian markets reopen Sunday time in the United States).[137] Because of the criticality of this timing, the commentator suggested that the debtor's right to contest the involuntary petition could be eliminated or, alternatively, the ability of the Federal Reserve Board to file an involuntary petition could be eliminated. He concluded that even without the right to file an involuntary petition, the Federal Reserve Board would have sufficient supervisory authority, including the ability to commence proceedings under Title II, to assure that a financial firm took the steps necessary to protect the U.S. financial system.[138]

His second comment related to the temporary stay provisions in H.R. 2947. He noted that the absence of a temporary stay provision in the Bankruptcy Code was one of the reasons that the U.S. regulators had pressed for the adoption of a contractual work-around in the ISDA stay protocol. He emphasized that the approach taken in H.R. 2947 in providing for a temporary stay includes appropriate protections for the counterparties. The protections 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 motion to transfer these obligations to the bridge company, 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, and all claims against the debtor in respect of such contracts to be assumed by the bridge company; and
- 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.[139]

Finally, as he had in his earlier testimony on H.R. 5421, this bankruptcy practitioner strongly urged that even if changes were made to the Bankruptcy Code, Title II should be retained as a backup resolution tool.[140]

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[137] *Id.* at 55–56.

[138] *Id.* at 56.

[139] *Id.* at 57.

[140] *Id.* at 47.

Another bankruptcy practitioner who had testified on H.R. 5421 also returned to testify again on H.R. 2947.[141] He expanded on his earlier testimony in several respects. First, he observed that while the implementation of an SPOE strategy in bankruptcy required deviation from traditional Bankruptcy Code notions of due process, transparency and inclusiveness, the unique characteristics of a large financial firm bankruptcy required such deviations. He regarded the deviations in H.R. 2947 to facilitate an SPOE strategy in bankruptcy as being within well-established Chapter 11 principles and existing practices for quick sales under Section 363.[142]

Second, he revisited the concern he had expressed in his 2014 testimony that it might not be feasible to require the debtor or the Federal Reserve Board to make transfer decisions about the entire book of qualified financial contracts within the 48 hours of the bankruptcy filing. He was now persuaded that the 48-hour stay and related provisions were a workable solution to the issue of transferring the entire derivatives book over a resolution weekend.[143]

Third, he revisited his concern about the compressed time frame and limit of judicial review under which the debtor could challenge the filing of an involuntary petition by the regulators. He reaffirmed his view that these provisions depart "meaningfully" from standard Bankruptcy Code principles of due process and transparency, even taking into account the special circumstances surrounding a financial institution failure.[144] He recommended that the involuntary petition provision be removed entirely. His recommendation rested in part on his observation that the regulators already have "myriad" methods of effectively requiring a financial company to commence a voluntary case under the Bankruptcy Code.[145]

Another bankruptcy practitioner testified at the hearing on behalf of the NBC.[146] The views of the NBC were presented principally in the form of a letter of June 18, 2015 from the NBC to the Chairman and Ranking Member of the Senate Judiciary Committee and the Chairman and Ranking Member of

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[141] *Financial Institution Bankruptcy Act of 2015: Hearing on H.R. 2947 Before the Subcomm. on Regulatory Reform, Commercial and Antitrust Law of the H. Comm. on the Judiciary*, 114th Cong. 61 (2015) (statement of Stephen E. Hessler, Partner, Kirkland & Ellis LLP).

[142] *Id.* at 73–75.

[143] *Id.* at 77–78.

[144] *Id.* at 79.

[145] *Id.*

[146] *Financial Institution Bankruptcy Act of 2015: Hearing on H.R. 2947 Before the Subcomm. on Regulatory Reform, Commercial and Antitrust Law of the H. Comm. on the Judiciary*, 114th Cong. 87 (2015) (statement of Richard Levin, Partner, Jenner & Block LLP).

the regulatory reform subcommittee of the House Judiciary Committee.[147] The thrust of the letter was established in one of its initial paragraphs:

> While [S. 1861] and [H.R. 5421] offered tools to address some of [the] problems [of resolving a SIFI] (for example, by facilitating the use by SIFIs of single point of entry recapitalization and by limiting early termination rights on 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.[148]

The comment letter identified several points of concern with the legislative proposals being considered. The first point was perhaps the most significant because it suggested an underlying concern with the use of the bankruptcy process itself. The comment letter said:

> 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.[149]

In form, this statement is intended to support the proposition that Title II should be retained even if changes are made to the Bankruptcy Code. (In its January 2014 letter, the NBC had refrained from taking a position on whether Title II should be repealed). In substance, however, this statement appears to support the proposition that Title II should actually be preferred over the Bankruptcy Code for the resolution of a systemically important financial institution. This acknowledgment that a bankruptcy process might not be the best process for resolving a systemically important financial institution is all the

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[147] Letter from the National Bankruptcy Conference to Hon. Tom Marino, Hon. Hank Johnson, Hon. Chuck Grassley & Hon. Patrick J. Leahy (June 18, 2015), *available at* http://www.nationalbankruptcyconference.org/images/NBC_Ltr_to_Cong_re_SIFI_Bills.pdf [hereinafter National Bankruptcy Conference 2015 Letter].

[148] *Id.* at 2.

[149] *Id.* (emphasis added). Observers from the banking sector have reached a similar conclusion. *See, e.g.,* Michael S. Helfer, *We Need Chapter 14 — And We Need Title II*, *in* Across The Great Divide: New Perspectives On The Financial Crisis 335, 337 (Martin N. Baily & John B. Taylor eds., Hoover Institution Press 2014) ("In fact, for various reasons, Title II is likely to work better than bankruptcy in certain circumstances.")

more remarkable because it comes from a distinguished group of bankruptcy professionals and bankruptcy judges. This acknowledgement displays none of the agnosticism of the GAO reports and none of the boosterism of the AOUSC reports. It also runs counter to the recent expressions of opinion by various public and private commentators that resolution under this Bankruptcy Code should be preferred over resolutions under Title II for the largest financial institutions.

The analysis in the letter is instructive in this respect. The letter notes that in virtually all countries, regulators have historically controlled the process for resolving banks.[150] It further notes that since the financial crisis in 2008, many countries, including the United States, have enacted special resolution regimes, giving regulators greater control over the resolution of other financial firms, including broker-dealers.[151] This is a significant departure from the state of affairs that existed at the time of the Lehman bankruptcy when the local broker-dealer affiliates of Lehman were placed into ordinary insolvency proceedings supervised by a host of local administrators or liquidators. The letter attributes important consequences to this development:

> 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

[150] *Id.* at 3.

[151] *Id.* at 3–4. The Financial Stability Board (the "FSB") has spearheaded efforts to achieve national resolution regimes that are better suited for dealing with large financial firms in distress. When it initiated this effort, FSB concluded that corporate insolvency procedures were not well suited to deal with the failure of major banks and other financial institutions and that there should be special resolution regimes for large financial firms. *See* FSB, *Consultative Document, Effective Resolution of Systemically Important Financial Institutions* 8 (July 19, 2011), *available at* http://www.financialstabilityboard.org/wp-content/uploads/r_110719.pdf?page_moved=1. In subsequently promulgating its Key Attributes of Effective Resolution Regimes for Financial Institutions, the FSB specifically concluded that each jurisdiction should have a designated administrative authority responsible for exercising resolution powers over financial firms and that the designated administrative authority should have the expertise, resources and operational capacity necessary to implement resolution measures for large complex financial firms. FSB, *The Key Attributes of Effective Resolution Regimes for Financial Institutions* (October 15, 2014), *available at* http://www.financialstabilityboard.org/wp-content/uploads/r_141015.pdf. For a further discussion of the approach to resolution taken by the FSB, see Paul L. Lee, *Cross-Border Resolution of Banking Groups: International Initiatives and U.S. Perspectives-Part I*, 9 Pratt's J. of Bankr. L. 391 (2013).

> 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.[152]

The letter distills the essence of the problem for the resolution of a global financial institution:

> 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.[153]

The NBC also reiterated (but this time with even greater force) the point it made in its January 2014 letter on the need for a backup liquidity source for a bridge company. The NBC noted that if a financial firm is to be reorganized, it needs to be recapitalized virtually overnight (or over a resolution weekend) and the recapitalized firm needs to reopen the next business day with sufficient liquidity to meet withdrawals until the "run" subsides and confidence in the firm is restored. The conclusion of the NBC in its letter was emphatic:

> The [NBC] 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 [NBC] opposes provisions (like those in [S. 1861]) 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.[154]

The view of the NBC on the need for a non-market backstop liquidity source

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[152] *Id.* at 4.

[153] *Id.* at 5.

[154] *Id.* at 7.

is clear. The prospect of adding a provision for a non-market backstop liquidity source to any bankruptcy bill is far less clear.

S. 1840

In July 2015, Senators Cornyn and Toomey introduced S. 1840 as a successor to their earlier bill, S. 1861.[155] S. 1840 was revised from S. 1861, paralleling many of the provisions in H.R. 2947. S. 1840, however, differs from H.R. 2947 in two significant respects. First, like S. 1861, S. 1840 includes a repeal of Title II. In a measure directed perhaps at readers suffering from an attention deficit, the sponsors of S. 1840 moved the provision repealing Title II from the beginning of the bill to the end of the bill.[156] Second, like S. 1861, S. 1840 includes a prohibition on a Federal Reserve Bank providing advances to a company in a bankruptcy proceeding or to a bridge company.[157]

S. 1840 differs from H.R. 2947 in form because it continues to provide for a separate Chapter 14 rather than a Subchapter V. S. 1840 also differs from H.R. 2947 substantively in several other respects. Unlike H.R. 2947, it does not provide authority for the Federal Reserve Board to initiate a bankruptcy proceeding. Unlike H.R. 2947, it also does not provide authority for the Federal Reserve Board to initiate a so-called "quick sale" of the assets of the debtor to a bridge company.

In July 2015, a subcommittee of the Senate Banking Committee held a hearing on S. 1840.[158] A leading academician, who serves on the FDIC's Systemic Resolution Advisory Committee, testified that in his view the largest financial companies currently could not be resolved either under Title II or the Bankruptcy Code even if changes were made to the Code.[159] He expressed a strong preference for the use of a bankruptcy resolution process rather than

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[155] Taxpayer Protection and Responsible Resolution Act, S. 1840, 114th Cong. (2015).

[156] S. 1840, § 5.

[157] S. 1840, § 6.

[158] *See The Role of Bankruptcy Reform in Addressing Too-Big-to-Fail: Hearing Before the Subcomm. on Financial Institutions and Consumer Protection of the Sen. Comm. on Banking, Housing, and Urban Affairs*, 114th Cong. (2015), *available at* http://www.banking.senate.gov/public/index.cfm?FuseAction=Hearings.Hearing&Hearing_ID=383d37ed-252d-4167-9b29-d2a669c41440.

[159] *The Role of Bankruptcy Reform in Addressing Too-Big-to-Fail: Hearing Before the Subcomm. on Financial Institutions and Consumer Protection of the Sen. Comm. on Banking, Housing, and Urban Affairs*, 114th Cong. (2015) (statement of Simon Johnson, Professor, MIT Sloan School of Management), *available at* http://www.banking.senate.gov/public/index.cfm?FuseAction=Hearings.Testimony&Hearing_ID=383d37ed-252d-4167-9b29-d2a669c41440&Witness_ID=1004fadd-c9b0-4e26-881e-e165375899cd.

Title II, but concluded that the largest U.S. financial companies would have to reduce their size and complexity to make a bankruptcy process feasible.[160] He said that in any event Title II should not be repealed.[161] Another academician testified in favor of the bankruptcy reform provisions in S. 1840.[162] He said that the changes reflected in S. 1840 should be made to the Bankruptcy Code to assure that a viable bankruptcy process exists to avoid recourse to Title II or a bailout.[163] With the changes to the Bankruptcy Code contained in S. 1840, he saw bankruptcy as presenting a more viable alternative to a Title II process.

A leading banking lawyer, who has been involved in resolution planning under Title I and Title II, also testified on S. 1840.[164] He detailed in his testimony the multiple steps that large banking institutions have taken since the time of the financial crisis to make themselves more readily resolvable under the Bankruptcy Code or Title II. These steps included, for example, significant increases in equity capital, loss-absorbing long-term debt, and liquidity reserves.[165] He supported the general thrust of the changes made in S. 1840 with two principal exceptions. He indicated that the provision prohibiting a Federal Reserve Bank from providing liquidity to a bridge company should be deleted for the same reasons as the NBC had stated in its letter, including the concern that the absence of a government liquidity facility in a bankruptcy proceeding would increase the range of circumstances under which Title II could be lawfully invoked.[166] He also indicated that it was inadvisable to repeal Title II. He cited three reasons why there would be value in preserving Title II. The first was the possible need for a government source of backup liquidity in

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[160] *Id.* at 5.

[161] *Id.* at 3.

[162] *The Role of Bankruptcy Reform in Addressing Too-Big-to-Fail: Hearing Before the Subcomm. on Financial Institutions and Consumer Protection of the Sen. Comm. on Banking, Housing, and Urban Affairs*, 114th Cong. (2015) (statement of John B. Taylor, Professor, Stanford University), *available at* http://www.banking.senate.gov/public/index.cfm?FuseAction=Hearings.Testimony&Hearing_ID=383d37ed-252d-4167-9b29-d2a669c41440&Witness_ID=9bee4015-c269-4153-8578-1dfb7daf50e5.

[163] *Id.* at 8.

[164] *The Role of Bankruptcy Reform in Addressing Too-Big-to-Fail: Hearing Before the Subcomm. on Financial Institutions and Consumer Protection of the Sen. Comm. on Banking, Housing, and Urban Affairs*, 114th Cong. (2015) (statement of Randall D. Guynn, Partner, Davis Polk & Wardwell LLP), *available at* http://www.banking.senate.gov/public/index.cfm?FuseAction=Hearings.Testimony&Hearing=383d37ed-252d-4167-9b29-d2a669c41440&Witness_ID=b58cf4e6-9612-478e-bdaf-cd3da329107a.

[165] *Id.* at 15–19.

[166] *Id.* at 21.

the event of a "liquidity famine" in the market at the time of a financial crisis. The second was unforeseeable emergency circumstances that would justify a compromise with the rule of law in favor of allowing the FDIC to exercise the broad range of discretion granted to it under Title II and not available to a bankruptcy court. The third was the "almost impossible time" that many foreign regulators would have in accepting that an SPOE strategy can be effectively executed under the Bankruptcy Code (rather than under a regulator-supervised process as in Title II).[167]

Finally, the architect of the Hoover Institution's proposal for a Chapter 14 2.0 again testified in favor of S. 1840.[168] As he had done in his testimony on H.R. 5421 in 2014, he outlined the reasons why changes needed to be made to the Bankruptcy Code to make it an effective alternative to a Title II resolution, particularly with respect to an SPOE strategy. The Chapter 14 approach in S. 1840 incorporates many of the features that are incorporated into the Hoover Institution proposal for a Chapter 14. The architect of the Hoover Institution proposal for Chapter 14 2.0 avoided a direct criticism of the provision in S. 1840 that would prohibit a Federal Reserve Bank from providing backup liquidity support to a bridge company, suggesting that the discussion of the "contentious" issue of the need for a backup facility "can be held separately."[169] As noted above, the Hoover Institution proposal for Chapter 14 2.0 itself makes provision for the possibility of government financing to a bridge company. Other commentators, including the NBC, have been prepared to take a stronger stand on the need for a government backup facility in the bankruptcy of a systemically important financial institution.

With the exception of the repeal of Title II and the prohibition on Federal Reserve Bank funding, the substantive approaches in S. 1840 and H.R. 2947 are very similar.

WEIGHING THE ADVANTAGES AND DISADVANTAGES OF A BANKRUPTCY APPROACH

The proponents of a bankruptcy approach to the resolution of systemically

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[167] *Id.* at 22–23.

[168] *The Role of Bankruptcy Reform in Addressing Too-Big-to-Fail: Hearing Before the Subcomm. on Financial Institutions and Consumer Protection of the Sen. Comm. on Banking, Housing and Urban Affairs,* 114th Cong. (2015) (statement of Thomas H. Jackson, President Emeritus, University of Rochester), *available at* http://www.banking.senate.gov/public/index.cfm?FuseAction=Hearings.Testimony&Hearing_ID=383d37ed-252d-4167-9b29-d2a669c41440&Witness_ID=9aee634c-67d7-4c74-896b-c876c6263337.

[169] *Id.* at 14 n.31.

important financial institutions offer an array of arguments in favor of the use of bankruptcy over Title II. Some of the arguments emphasize the strengths of a bankruptcy approach. Other arguments emphasize the weaknesses of a Title II approach. These arguments can be readily synthesized. One of the early arguments in favor of a bankruptcy approach was that the use of Chapter 11 would allow a reorganization of the firm to preserve its going concern value, whereas Title II called for a liquidation of the firm with the attendant loss of going concern value.[170] A liquidation under Title II would needlessly deprive creditors of the firm of a higher recovery that might be possible in a Chapter 11 reorganization. As some of the early critics of Title II acknowledged, the FDIC might be able to achieve a *de facto* reorganization under Title II through the use of a bridge company structure, which is expressly authorized in Title II.[171] Building upon the bridge company construct in Title II, the FDIC has developed the proposed SPOE approach, which is specifically designed to preserve the ongoing operation (and value) of the principal subsidiaries of a firm in Title II resolution. As various proponents of a bankruptcy approach acknowledge, an SPOE strategy under Title II would make a reorganization under Title II a more attractive option than a reorganization under Chapter 11 for a large complex financial institution.[172]

Another early argument in favor of a bankruptcy approach over Title II was that the Bankruptcy Code provided clear rules on creditor rights, including most importantly the absolute priority rule. Critics of Title II cited the provisions in Title II that allow the FDIC to make "additional payments" to "selected" categories of creditors as antithetical to basic bankruptcy principles.[173] As discussed in Part I of this article, the FDIC has tried to mitigate the concern with its authority to make "additional payments" by circumscribing that authority in the regulations that it has adopted under Title II.[174] But

[170] *See, e.g.*, Wallison, *supra* note 1, at 17–18; DAVID SKEEL, THE NEW FINANCIAL DEAL: UNDERSTANDING THE DODD-FRANK ACT AND ITS (UNINTENDED) CONSEQUENCES 148–149 (2011).

[171] *See, e.g.*, Skeel, *supra* note 170, at 149.

[172] *See, e.g.*, Jackson, *supra* notes 114–118. *But see* Paul H. Kupiec & Peter J. Wallison, *Can the "single point of entry" strategy be used to recapitalize a failing bank?* (American Enterprise Institute Economic Working Paper 2014-08, Nov. 4, 2014) (arguing that an SPOE approach is not permitted under Title II).

[173] *See* Statement of Republican Policy on H.R. 4173, the "Dodd-Frank Wall Street Reform and Consumer Protection Act" (June 30, 2010), http://repcloakroom.house.gov/news/documentsingle.aspx?Document ID=193034; Skeel, *supra* note 69, at 9 & 148. *See also* James H.M. Sprayregen & Stephen E. Hessler, *Too Much Discretion To Succeed: Why A Modified Bankruptcy Code Is Preferable To Title II Of The Dodd-Frank Act* (2011).

[174] *See* Part I, 131 BANKING L.J. 437, 462–463 (2015).

perhaps the best answer to the concern that the FDIC would have the authority to draw distinctions between categories of creditors under Title II is the FDIC's development of the SPOE strategy. Under that strategy, the loss-absorbing capacity for a firm in Title II would reside in the equity, subordinated debt and long-term senior debt at the top-tier company. To the greatest extent possible, the general creditor class at the top-tier company will be limited to long-term senior debt, which will be structurally subordinated to the creditors of the operating subsidiaries. Short-term debt at the top-tier company would be discouraged through other supervisory measures so as to avoid the need to use the authority in Title II to treat similarly situated creditors differently.[175] Thus, the need for the FDIC as receiver to draw distinctions between categories of debt holders in the general creditor class would be minimized.[176] The same approach would presumably be used in a bankruptcy process if the Bankruptcy Code were to be amended to facilitate an SPOE approach.

One of the other abiding arguments made by proponents of a bankruptcy approach is that the Bankruptcy Code provides a transparent process subject to judicial review and the rule of law.[177] Title II on the other hand is an administrative process with limited transparency. It involves the exercise of broad powers by the FDIC with only limited judicial review.[178] In this view,

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[175] *See* Jackson, *supra* note 114, at 45–46 (noting that the SPOE approach allows the FDIC to leave long-term debt behind in the receivership consistent with the pre-established creditor priorities). *See also* Guynn, *supra* note 164, at 9 n.30 (noting that the SPOE strategy for structural subordination of long-term senior debtholders was designed to address the criticism of the FDIC's discretion to discriminate among similarly situated creditors). To the extent that critical vendor claims are booked at the top-tier company, these claims would presumably be transferred to the bridge company. This treatment would be consistent with the general approach that has been taken in Chapter 11 cases in handling vendor claims that are critical to the reorganization. For a discussion of the development of the critical vendor doctrine under Chapter 11 of the Bankruptcy Code, *see* COLLIER GUIDE TO CHAPTER 11: KEY TOPICS AND SELECTED INDUSTRIES, Chapter 20: Chapter 11 Cases Involving Retail Businesses ¶ 20.03[3] (2014).

[176] *See* David A. Skeel, Jr., *Single Point of Entry and the Bankruptcy Alternative, in* ACROSS THE GREAT DIVIDE: NEW PERSPECTIVES ON THE FINANCIAL CRISIS 313, 322 (Martin N. Baily & John B. Taylor eds., 2014) (noting that the SPOE approach could couple a "relatively clear set of rules" with the speed of an administrative process).

[177] *See, e.g.*, Jackson, *supra* note 104, at 100 (noting that a key difference between bankruptcy and Title II is that a Title II resolution is "handled by the FDIC, as receiver, retaining significant discretion, as compared to a bankruptcy court, subject to statutory rules that can and will be enforced by appellate review through Article III jurisdiction"). *See also* Skeel, *supra* note 170, at 122 (comparing the "secret, opaque, highly discretionary administrative process" of the FDIC as receiver with the "clear rules and opportunities for judicial review throughout the [bankruptcy] process").

[178] For a criticism of the limited judicial review process provided in Title II, s*ee, e.g.*, Kenneth

even the initial determination whether a company should be resolved under Title II or under the Bankruptcy Code is essentially at the discretion of the Secretary of the Treasury.[179]

While a Bankruptcy Code approach is intended to provide greater transparency, inclusiveness, and judicial oversight than the Title II approach, these objectives face a challenge at the very outset of the proposed Bankruptcy Code process. H.R. 2947 provides that if the Federal Reserve Board files the petition to commence a case (and the company does not consent), a court must hold a confidential hearing to review the petition not later than 16 hours after the petition is filed and must decide (applying a preponderance of the evidence standard) within two hours whether to approve the petition or dismiss it.[180] This truncated time frame for a decision on the petition (and a similar truncated time frame on any appeal) is necessary to permit a court hearing and decision on the motion for a transfer of the assets of the debtor to a bridge company within 48 hours of the filing of the initial petition.[181] In the view of various commentators, the process in H.R. 2947 is not realistic and does not provide for a meaningful judicial review.[182] Moreover, the use of this process seems to be at odds with the concern previously expressed by many commentators about the highly compressed and confidential provisions for judicial

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E. Scott, *The Context of Bankruptcy Resolution* 1, 9, *in* Making Failure Feasible: How Bankruptcy Reform Can End "Too Big to Fail" (Kenneth E. Scott et al. eds., Hoover Institution Press 2015) (asserting that the pre-seizure judicial hearing provided for in Title II is an "empty formality"); Wallison, *supra* note 1, at 14 (criticizing the fact that under Title II a court would have only 24 hours to decide a challenge by the company to the use of Title II); Skeel, *supra* note 170, at 131 (criticizing the fact that the standard of review for a filing of a petition under Title II is "arbitrary and capricious" and that the court is given only 24 hours to make a decision).

[179] *See* Sprayregen & Hessler, *supra* note 173, at 9 (arguing that the threshold determination whether a distressed financial company will be resolved under Title II or the Bankruptcy Code is subject to the discretion of the Secretary of the Treasury in consultation with the President, the FDIC and the Federal Reserve Board).

[180] H.R. 2947, § 1183.

[181] The initial review process in H.R. 2947 is actually more truncated than the initial review process in Title II. Title II requires the initial court review and decision to be completed within 24 hours of the initial filing; otherwise, the petition is deemed granted. 12 U.S. C. § 5382(a)(a)(A)(v). H.R. 2947 requires the initial court review and decision to be completed within 18 hours of the initial filing.

[182] *See, e.g.*, National Bankruptcy Conference 2015 Letter, *supra* note 147, at 6 (stating that the truncated process in H.R. 2947 is "unrealistically short" and does not provide "any real opportunity" to make an informed and reasoned decision on the merits); Hessler, *supra* note 141, at 79 (stating that the review process in H.R. 2947 departs "meaningfully" from standard Bankruptcy Code principles of due process and transparency).

review in Title II.[183]

One possible solution to this dilemma is to remove the right of the Federal Reserve Board to initiate an involuntary bankruptcy case. This is the approach taken in S. 1840.[184] Several bankruptcy practitioners proposed this approach because they believe that the regulators have "myriad" ways to induce a company to file "voluntarily," including through the threat of the use of a Title II process.[185] Ironically, this approach appears to rely on the type of non-transparent regulatory practice that the proponents of bankruptcy criticized in formulating their original arguments for a bankruptcy approach.

Another solution suggested by several commentators would be to allow the Federal Reserve Board to file a petition, but not allow the company to contest the filing.[186] This is the approach suggested by the Hoover Institution in its Chapter 14 2.0.[187] This approach reflects a concession to practicality, *i.e.*, that the tight time frame for a hearing and an order on the transfer of assets to the bridge company does not permit an extended judicial process for the initial filing.[188] It should be noted that this practicality concern also requires that the hearing process for the transfer to the bridge company also be relatively truncated in terms of time and notice. This approach likewise represents a compromise of the principles that are supposed to animate the Bankruptcy Code reform effort.[189] In fact, under any of the approaches outlined above, the proponents are obliged to compromise one or more of the principles that they have said they are championing by advocating a bankruptcy approach over a Title II approach. It seems particularly anomalous that to achieve the cited advantages of the bankruptcy process, the proponents must in effect dispense with many of the cited advantages of the bankruptcy process during the early

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[183] *See, e.g.,* Scott, *supra* note 178, at 9; Wallison, *supra* note 1, at 14.

[184] S. 1840, § 1403.

[185] *See, e.g.*, Hessler, *supra* note 141, at 79. *See also* Bernstein, *supra* note 133, at 56.

[186] *See, e.g.*, National Bankruptcy Conference 2015 Letter, *supra* note 147, at 6; Bernstein, *supra* note 133, at 55.

[187] *See* Jackson, *supra* note 58, at 35–36.

[188] *Id.*

[189] *See, e.g.*, Hessler, *supra* note 141, at 73 (noting that the relatively limited review and notice to a relatively limited number of secured and unsecured creditors provided for in the transfer motion in H.R. 2947 is generally contrary to prevailing Bankruptcy Code norms of due process, transparency and inclusiveness). Another proponent of a bankruptcy approach acknowledged in his testimony in support of S. 1840 that under the provisions of S. 1840 the bankruptcy court "need only make cursory findings" based on the Federal Reserve Board's certifications to approve the transfer motion. *See* Taylor, *supra* note 162, at 12.

critical days of the bankruptcy case—the days when many of the most important decisions relating to the estate of the company will be made.

A resolution weekend (if the firm can make it to the weekend) will in all events be a challenging one for the bankruptcy court under either H.R. 2947 or S. 1840. As noted above, H.R. 2947 provides for the possibility of an involuntary filing by the Federal Reserve Board, which would require a court hearing and determination (and possible appeal) unless the debtor consents to the order of relief. S. 1840, which as noted above provides only for a voluntary filing by the debtor (and thereby eliminates the need for a hearing on the filing), nonetheless requires speedy determinations by the court on a number of other critical matters. H.R. 2947 requires the same. First, the court will be called upon to review and approve, approve with modifications, or disapprove a motion to transfer substantially all of assets of the estate to a bridge company. The court is required to make a number of significant determinations (based on a preponderance of the evidence test) to approve the motion.[190] Under S. 1840 this motion can only be filed by a trustee. This presupposes that the court has already appointed a trustee pursuant to Section 1104 of the Bankruptcy Code, which itself requires notice and a hearing. H.R. 2947 likewise requires that a trustee be appointed by the court.

Second, as part of any order approving a transfer to the bridge company, the court must also approve a special trustee who is to hold in trust for the sole benefit of the estate all of the equity securities in the bridge company. The court must also approve the trust agreement pursuant to which the special trustee would act. The trust agreement would govern the (essentially consultative) relationship that would exist between the special trustee and the bridge company with respect to such matters as changes in directors or senior officers or material corporate actions by the bridge company. Additionally, if particularly fortunate, the court might also be called upon to approve a request for debtor-in-possession financing over the resolution weekend.[191] If debtor-in-

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[190] Some of the required determinations to be made by the court are relatively fact specific, such as that the transfer does not provide for the transfer of equity of the debtor or for the assumption of any "capital structure debt" by the bridge company. Other required determinations are less fact specific, such as that the transfer is necessary to prevent serious adverse effects on financial stability in the U.S., that the bridge company is not likely to fail to meet its obligations on any debt, executory contract or qualified financial contract to be assumed by it, and that the bridge company has governing documents and initial directors and senior officers that are in the best interests of the creditors and the estate. The latter provision appears to envision that the governing documents will be presented to the court as well as the identity of the initial directors and senior officers as part of the transfer motion. *See* H.R. 2947, §1185.

[191] S. 1840 prohibits any federal funding to the debtor or bridge company in a proposed

possession financing is to be had, to reassure the markets it must be committed to and approved by the opening of business on the Monday morning following the resolution weekend. Decisions on these complex matters will have to be made by the court with no prior exposure to the facts during the course of the weekend.

In addition to these formal decision making processes, there would be extensive informal processes that would also have to occur over the resolution weekend as well. For example, both S. 1840 and H.R. 2947 require notice to the primary U.S. financial regulatory agency for any affiliate of the debtor that is proposed to be transferred to the bridge company. Neither S. 1840 nor H.R. 2947 requires notice to any primary foreign regulator for any affiliate proposed to be transferred to the bridge company. Informal coordination with the foreign regulators of the most significant foreign subsidiaries of the debtor will nonetheless be absolutely essential if there is to be any hope that adverse action by the foreign regulators with respect to those foreign subsidiaries can be avoided.

Accepting that some compromise on principles must be made to accommodate the timing exigencies of a resolution of a systemically important financial institution, the proponents of a bankruptcy approach would still argue that the compromises in the initial stages of the bankruptcy process are worth the advantages that accrue in the subsequent stages of the process. Proponents of a bankruptcy approach see distinct advantages in a bankruptcy approach over a Title II approach in handling the process after a resolution weekend. One perceived advantage is that the bridge company would not be subject to the control of a government agency such as the FDIC, whereas a bridge company used in a Title II process would be effectively run for an indeterminate period by the FDIC. The bridge company in the bankruptcy model would also arguably have the advantage of facing market discipline "first and foremost."[192] Second, the market would determine the equity value of the bridge company

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Chapter 14 case. H.R. 2947 does not contain such a prohibition, but neither H.R. 2947 nor S. 1840 addresses how § 364 would apply in a proposed Subchapter V or Chapter 14 case. Since under S. 1840 or H.R. 2947 the bridge company would not be in a bankruptcy case, § 364 of the Bankruptcy Code would not apply to financing provided to the bridge company. It will be the bridge company and not the debtor that will require "debtor-in-possession" financing in a SPOE structure. *See* Scott, *supra* note 178, at 8. The Hoover Institution Chapter 14 2.0 proposal deals with this problem by expressly providing for the possibility of "debtor-in-possession" financing being provided to the bridge company upon an order of the bankruptcy court. *See* Jackson, *supra* note 58, at 28.

[192] *See* Jackson, *supra* note 114, at 55.

whereas the FDIC's approach would be to rely on expert valuations.[193] Third, the management officers of the bridge company would be identified both by the company's primary regulator and by the creditors of the debtor as the beneficial owners of the equity in the bridge company and as the parties with the most direct interest in how the bridge company will be managed.[194] Fourth, the bridge company in a bankruptcy process would be an ordinary corporation whereas the bridge company in Title II is treated as a government-owned entity as least in so far as it is exempt from federal, state or local taxes.[195]

Some proponents of a bankruptcy approach appear to assume that detaching the bridge company from the "control" of the FDIC or its primary regulator is a significant advantage in the proposed bankruptcy approach.[196] Other bankruptcy professionals have concluded that to benefit from the prior supervisory work done to coordinate the resolution of large financial firms in multiple countries, it will be important to ensure that the U.S. regulators continue to play a "very significant" role in the ongoing restructuring of the bridge company.[197] These commentators see such involvement as essential to eliciting cooperation from foreign regulators for the operation of the bridge company. The difference in the role that the primary regulator of the bridge company would be envisioned to play in the operation of the bridge company under a bankruptcy approach and the role that the FDIC as receiver and the other primary regulator of a bridge company would be envisioned to play under Title II is not altogether clear.[198] The proponents of a bankruptcy approach

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[193] *Id.*

[194] *Id.* at 55–56.

[195] *Id.* at 56.

[196] Some of the concern among proponents of detaching the bridge company from government control undoubtedly arises from the experience of government interference in bankruptcy processes during the last financial crisis. *See, e.g.*, Mark J. Roe & David Skeel, *Assessing the Chrysler Bankruptcy*, 108 MICH. L. REV. 727 (2010).

[197] National Bankruptcy Conference 2015 Letter, *supra* note 147, at 5.

[198] In its request for comments on the SPOE strategy, the FDIC discussed how it would oversee the operations of a bridge company as part of a Title II process. *See* 78 Fed. Reg. 76,614, 76,616–76,617 (2013). The oversight function by the FDIC would presumably be in addition to the oversight by the primary regulator (such as the Federal Reserve Board) of the bridge company. The FDIC indicates that it would require the bridge company to enter into an initial operating agreement, requiring *inter alia* the preparation of (i) a business plan for the bridge company, (ii) a capital, liquidity and funding plan, and (iii) a restructuring plan, including divestitures of assets, businesses and subsidiaries. *Id.* at 76,617. These are the same types of plans that the primary regulator of the bridge company would presumably require for its own oversight. The FDIC further indicates that it would retain control over certain key matters relating to the governance of the bridge company, including approval rights for any issuance of stock,

appear to assume that the role to be played by the primary regulator of the bridge company in a bankruptcy approach would be substantially less intrusive than the role that the FDIC would play in a Title II approach.

Although the FDIC has stated that it would seek to return a bridge company to private hands as soon as practicable, it is not possible to predict how long the transition process would take.[199] The FDIC has suggested that it might take six to nine months before control of the bridge company would be turned over to the creditors and other claimants who are the beneficial owners of the equity in the bridge company.[200] During this period, the FDIC expects to make decisions on many issues that will affect the ultimate disposition and value of the bridge company. For example, the FDIC has indicated that during this period plans would be adopted to shrink businesses, break businesses into smaller units, or liquidate certain subsidiaries or business lines of the bridge company.[201] The FDIC would require the board of directors and management of the bridge company to stipulate that they would complete the plans for restructuring and reorganizing the company after control is returned to the beneficial owners.[202] The purpose of these restructuring requirements is to ensure that the bridge company is reorganizing itself in a way that will make it resolvable under the Bankruptcy Code. The purpose of the related governance requirements is to ensure that decisions made during the period of direct FDIC oversight continue to control the ambit of decision making for the bridge company after it returns to private hands.[203] Under S.1840 and H.R. 2947, the board of directors and senior management of the bridge company would not be constrained by such restructuring directives set by the FDIC. The outcomes under a Title II process and a revised bankruptcy process relating to the size or shape of the bridge company or its successor could be very different. In this respect the proponents of a bankruptcy approach may be correct that the process and the outcomes under a bankruptcy approach would be more responsive to creditor interests than a Title II approach.

In addition to weighing the potential advantages of a revised Bankruptcy

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amendments to the articles of incorporation or bylaws, capital transactions or asset sales in excess of established thresholds, changes in directors, distribution of dividends, establishment of equity based compensation plans, and the replacement of the company's independent accounting firm. *Id.*

[199] 78 Fed Reg. at 76,620.

[200] *Id.*

[201] *Id.* at 76,617.

[202] *Id.* at 76,620.

[203] *Id.*

Code approach over a Title II approach, it is also necessary to weigh the potential disadvantages of such an approach over a Title II approach. There are two widely cited disadvantages to a revised Bankruptcy Code approach. The first is that a bankruptcy approach by its nature will not enjoy the benefit of international coordination and cooperation to the extent that supporters of Title II believe a Title II approach would.[204] The second is that there is no provision for a backup liquidity source for a large complex financial company in bankruptcy.[205]

As to the first disadvantage, there is general skepticism that foreign regulators and resolution authorities would show the same confidence and understanding of a bankruptcy process as they would for a regulator initiated, controlled, and coordinated resolution process. There is of course no assurance that foreign authorities would cooperate and refrain from ring fencing the foreign operations of a U.S. company even in a Title II SPOE resolution. But the objective of an SPOE strategy (which immediately recapitalizes the U.S. and foreign operating subsidiaries of the failed firm) and the joint resolution planning process by U.S. and foreign regulators is precisely to raise the level of confidence and understanding among those regulators. The international efforts aimed at establishing uniform standards for TLAC and most importantly internal TLAC are likewise designed to "hard wire" mechanisms into regulatory regimes that will induce cooperative actions by home and host jurisdictions.[206] There is no mechanism for advance consultation and coordination and much less for advance planning among judicial authorities in a court-administered resolution process.[207] Even supporters of a revised Bankruptcy Code approach think that

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[204] *See, e.g.*, Michael S. Helfer, *We Need Chapter 14 - And We Need Title II, in* Across The Great Divide: New Perspectives On The Financial Crisis (Martin N. Bailey & John B. Taylor eds., Hoover Institution Press 2014); National Bankruptcy Conference 2015 letter, *supra* note 147, at 5; Johnson, *supra* note 159, at 56. *See also* Paul Tucker, *The Resolution of Financial Institutions Without Taxpayer Solvency Support: Seven Retrospective Clarifications and Elaborations*, Remarks at European Summer Symposium in Economic Theory, Gerzensee, Switzerland (July 3, 2014), at 4-5. *But see* Simon Gleeson, *The Consequences of Chapter 14 for International Recognition of US Bank Resolution Action, in* Making Failure Feasible: How Bankruptcy Reform Can End "Too Big To Fail" 111 (Kenneth E. Scott et al. eds., Hoover Institution Press 2015) (suggesting that foreign courts are more likely to provide recognition to a Chapter 14 case as a court administered process than to Title II as an administrative process).

[205] *See, e.g.*, National Bankruptcy Conference 2015 Letter, *supra* note 147, at 7; Bernstein, *supra* note 122, at 32-33; and sources cited *supra* note 83. *See also* John F. Bovenzi, Randall D. Guynn & Thomas H. Jackson, *Too Big to Fail: The Path to a Solution* 71-72 (Bipartisan Policy Center May 2013).

[206] *See* Tucker, *supra* note 204, at 5.

[207] *See*, e.g., Helfer, *supra* note 204, at 337-338; Tucker, *supra* note 204, at 4-5.

foreign regulatory authorities will have an "almost" impossible time in accepting the idea that a large complex financial institution can be effectively resolved under the Bankruptcy Code.[208]

This concern among foreign authorities will be compounded if there is no government liquidity backstop for the bridge company in a bankruptcy process (as there would be in a Title II process). This is the second major disadvantage of a bankruptcy approach. The need for some kind of backup liquidity facility in the bankruptcy of any large complex financial institution appears to have been accepted by most of the commentators who testified on the proposed Chapter 14 and proposed Subchapter V approach. The NBC has been particularly forceful in its comments on the need for a lender-of-last-resort facility for systemically important financial institutions.[209] Other bankruptcy experts have taken the same position.[210] Even a commentator who has suggested that the need for a backup liquidity source in bankruptcy may be overstated has nonetheless suggested as a cautionary matter that such a backup source should be made available in the bankruptcy process.[211] Because there appears to be no political appetite to provide such a backup facility as part of the process to amend the Bankruptcy Code or otherwise, this significant disadvantage will continue to afflict any bankruptcy approach under Chapter 14 or Subchapter V. Without some provision for government backup liquidity support in a bankruptcy process, a bankruptcy process will not appear credible

[208] *See* Guynn, *supra* note 164, at 22-23.

[209] *See* National Bankruptcy Conference 2015 Letter, *supra* note 147, at 7.

[210] *See* Bernstein, *supra* note 122, at 32-33; Bovenzi, Guynn & Jackson, *supra* note 205, at 71-72; and sources cited *supra* note 83. Among the challenges that the bridge company and its operating subsidiaries will face on the Monday after a resolution weekend is the lack of a credit rating for the bridge company and the risk of a downgrade for those operating subsidiaries with their own credit ratings. The credit rating agencies will play a critical role in the transition of the bridge company to the private funding markets and the ability of the operating subsidiaries to continue to fund themselves in the private markets. This critical factor has received relatively scant attention in the literature on resolution.

[211] *See* David A. Skeel, Jr., *Financing Systemically Important Financial Institutions in Bankruptcy*, in MAKING FAILURE FEASIBLE: HOW BANKRUPTCY REFORM CAN END "TOO BIG TO FAIL" 59 (Kenneth E. Scott et al. eds, Hoover Institution Press 2015). This commentator believes that the "widespread" pessimism about the ability of a large financial company to borrow sufficient funds in a bankruptcy process is "substantially" overstated. *Id.* at 63. This commentator suggests, for example, that a quick sale resolution of a large institution would require less new liquidity than a traditional bankruptcy process. *Id.* at 63-64. However, because of a "residuum of uncertainty" about the ability of a large financial company to obtain adequate liquidity, he recommends that § 13(3) of the Federal Reserve Act be amended to provide express authority for emergency funding in a bankruptcy case. *Id.* at 65. Other commentators have made a similar recommendation. *See, e.g.,* Bovenzi, Guynn & Jackson, *supra* note 205, at 71-72.

to important constituencies, including foreign authorities.

CONCLUSION

Because Title II is intended as an exception to the otherwise preferred use of the Bankruptcy Code to resolve financial companies, revisions to the Bankruptcy Code to facilitate its use to resolve such companies should have wide support. Indeed, virtually all the parties who have testified on the Bankruptcy Code reform proposals have supported the idea of making changes to the Bankruptcy Code to facilitate and promote its use in resolving large financial companies. Some observers, however, have cautioned that without significant changes in size and structure, various large financial companies will still not be readily resolvable under Title II or under a revised Bankruptcy Code. Many observers have also suggested that in the event of a systemic crisis, neither Title II nor a revised Bankruptcy Act would be able to handle the multiple failures that might ensue.

The enhancement of potential options for the resolution of large financial firms should nonetheless be promoted. In a sense, this is what the FDIC has done with its development of the SPOE strategy. Many observers were originally skeptical whether a large complex financial firm could be resolved in an orderly fashion even under Title II. The SPOE strategy has offered renewed hope that an orderly (or at least less disorderly) resolution may now be possible under Title II.[212]

For the same reasons, the Bankruptcy Code should be revised to make it a better potential option for the orderly resolution of a large complex financial firm, using an SPOE strategy.[213] Caution, however, should be exercised to avoid over-weighing a revised bankruptcy option. If a revised bankruptcy approach cannot at least initially be validated through acceptance by the relevant foreign regulators and inclusion in the joint resolution planning processes among the U.S. regulators and the relevant foreign regulators, the U.S. regulators should be wary of attaching much weight to the bankruptcy option.

In the end, one overriding conclusion emerges from an analysis of the

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[212] *See,* e.g., Skeel, *supra* note 176, at 333.

[213] An SPOE strategy featured prominently in most of the living wills filed in July 2015 by the twelve largest banking institutions. Six of the eight domestic banking institutions relied on an SPOE strategy. The four foreign banking institutions relied on a global SPOE approach. *See* PwC, Regulatory brief, *Resolution: Single Point of Entry Strategy Ascents* (July 2015), *available at* http://www.pwc.com/en-US/us/financial-services/regulatory-services/publications/assets/resolution-planning-2015-wave-1.pdf.

proposed bankruptcy option. That overriding conclusion is that Title II must be retained even if the Bankruptcy Code is revised as proposed in Chapter 14 or Subchapter V. Meanwhile, heightened efforts must be made to address – outside the scope of the Bankruptcy Code itself – the prospects for acceptance of a bankruptcy approach by foreign regulators and resolution authorities and the prospects for a private solution to the need for a backup funding source for a large financial company in bankruptcy.