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EDITOR'S NOTE: RESOLUTIONS
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Editor's Note: Resolutions
Victoria Prussen Spears 123

Cross-Border Resolution of Banking Groups: International Initiatives and U.S. Perspectives—Part VI
Paul L. Lee 125

Going Once, Going Twice: Avoiding a Prepetition Foreclosure Sale in Chapter 11
Jessica Liou and Alexander Condon 187

Disclosure & Finality—The Real Lessons Behind the Third Circuit's Affirmation of the Bankruptcy Court's Reconsideration and Denial of a $275 Million Termination Payment
Michael H. Torkin, Sandeep Qusba, Elisha D. Graff, and William T. Russell, Jr. 192

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Cross-Border Resolution of Banking Groups: International Initiatives and U.S. Perspectives—Part VI

By Paul L. Lee*

This multi-part article traces the development of new legal regimes for the cross-border resolution of banking groups since the time of the global financial crisis in 2007–2009. This part discusses changes to Title II of the Dodd-Frank Act recommended by the Treasury Department in a recent report, the implementation of the resolution plan requirement in Title I of the Dodd-Frank Act, and the development of a proposed subchapter V to Chapter 11 of the Bankruptcy Code for financial institutions.

The Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") contains two provisions of singular importance to the resolution of systemically important financial institutions.[1] The first is the Orderly Liquidation Authority in Title II of the Dodd-Frank Act discussed in detail in Part V of this article. The Orderly Liquidation Authority is intended to provide a mechanism for the orderly resolution of a failing financial institution whose resolution under the current Bankruptcy Code could adversely affect U.S. financial stability.[2] If invoked, the Orderly Liquidation Authority would be used in lieu of the Bankruptcy Code to resolve the failing financial institution.

The second is the resolution plan (or "living will") requirement in Title I of the Dodd-Frank Act. The resolution plan requirement provides that large bank holding companies and nonbank financial companies designated by the Financial Stability Oversight Council (the "FSOC") as systemically important must periodically file with the Board of Governors of the Federal Reserve System (the "Federal Reserve Board") and the Federal Deposit Insurance Corporation (the "FDIC") a plan for a "rapid and orderly resolution in the

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[1] Pub. L. No. 111-203, 124 Stat. 1376 (2010).

[2] 12 U.S.C. §§ 5381–5394.

event of material distress or failure."[3] The Federal Reserve Board and the FDIC are directed to determine whether the resolution plan as submitted is credible and would facilitate an orderly resolution of the company under the Bankruptcy Code.[4]

At the time of the passage of the Dodd-Frank Act, the provisions of Title II garnered greater attention than the resolution plan requirement in Title I. After a relatively slow start in providing guidance on the resolution planning process, the Federal Reserve Board and the FDIC implemented an increasingly robust guidance and review process, particularly for the resolution plans of the largest U.S. bank holding companies and the largest foreign banking organizations operating in the United States. As discussed in Part V of this article, a progression of robust resolution plans assisted by the development of the single-point-of-entry ("SPOE") strategy and the related requirement of total loss absorbing capacity ("TLAC") has provided encouragement that an orderly bankruptcy process might be possible even for some of the largest financial institutions.[5]

This part first discusses a report issued by the Treasury Department in February 2018, recommending changes to Title II to address perceived defects in its design. This part next discusses the implementation of the resolution plan requirement in Title I and its effects on the prospects for the use of Title II. Finally, this part discusses proposals to amend the Bankruptcy Code to add a new subchapter V to Chapter 11 for large financial institutions. The new subchapter is intended to facilitate an orderly resolution of a large financial institution under the Bankruptcy Code consistent with the purpose of the resolution plan requirement in Title I. The proposed subchapter V incorporates some of the special features contained in Title II that are thought by many observers to be better suited for handling the resolution of a large financial institution.

PRESIDENTIAL MEMORANDUM ON ORDERLY LIQUIDATION AUTHORITY

As noted in Part V of this article, in April 2017 President Trump issued a Presidential Memorandum directing the Secretary of the Treasury to conduct a thorough review of the Orderly Liquidation Authority in Title II.[6] As more of

[3] 12 U.S.C. § 5365(d)(1).

[4] 12 U.S.C. § 5365(d)(4).

[5] *See Part V*, 13 PRATT'S JOURNAL OF BANKRUPTCY LAW 395, 451–52 (2017).

[6] Administration of Donald J. Trump, *Memorandum on Orderly Liquidation Authority* (Apr.

a rhetorical flourish than an actual constraint, the Presidential Memorandum said that pending completion of the review and the submission of recommendations, the Secretary of the Treasury shall "to the extent consistent with law" refrain from invoking the Orderly Liquidation Authority unless the Secretary, in consultation with the President, determines that the criteria in Title II "require otherwise."[7] The Presidential Memorandum said that the existence of the Orderly Liquidation Authority might actually encourage excessive risk taking by creditors, counterparties, and shareholders of financial companies and that it was important to acknowledge the potentially adverse consequences of the availability and use of the Orderly Liquidation Authority.[8] The Presidential Memorandum also noted that it was important to evaluate whether other legislative changes, such as changes to the Bankruptcy Code, could fulfill the objectives of the Orderly Liquidation Authority "in a more effective manner."[9] The Presidential Memorandum directed the Secretary of the Treasury to consider whether a new chapter in the Bankruptcy Code for resolving a failing financial firm would be a superior method for resolving financial firms compared to Title II.[10]

A group of scholars at the Hoover Institution had suggested as early as 2009 that a new chapter be added to the Bankruptcy Code for financial institutions.[11] The approach of adding a new Chapter 14 to the Bankruptcy Code for financial institutions was adopted in a bill introduced in the Senate in 2013.[12] On the House side, legislators adopted the alternative approach of adding a new subchapter V to Chapter 11 for financial institutions. Bills providing for the addition of a new subchapter V to Chapter 11 of the Bankruptcy Code passed

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21, 2017) [hereinafter *Presidential Memorandum*], https://www.gpo.gov/fdsys/pkg/DCPD-201700266/pdf/DCPD-201700266.pdf.

[7] *Id.* § 2. *See Part V*, *supra* note 5, at 414-19 for a discussion of the mechanism in Title II for invoking the Orderly Liquidation Authority.

[8] *Presidential Memorandum*, *supra* note 6, at 1.

[9] *Id.*

[10] *Id.* at 2.

[11] *See* The Hoover Institution: The Resolution Project, http://www.hoover.org/research-teams/economic-policy-working-group/resolution-project; 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).

[12] Taxpayer Protection and Responsible Resolution Act, S. 1861, 113th Cong. (2013). *See also* Taxpayer Protection and Responsible Resolution Act, S. 1840,114th Cong. (2015). Besides adding a new Chapter 14 to the Bankruptcy Code, S. 1861 and S. 1840 also provided controversially for the repeal of Title II of the Dodd-Frank Act.

the House on a voice vote in 2014, 2016 and 2017.[13] These bills incorporated special features from Title II, such as a bridge company mechanism, an expedited process for transferring assets of the failing company to a bridge company over a "resolution weekend," and a temporary stay of acceleration and close-out rights on financial contracts of the failing company. In June 2017 the House passed a broad financial reform measure, the Financial CHOICE Act of 2017 (the "CHOICE Act"), which among its many provisions provided for the new subchapter V to Chapter 11 for financial institutions. Unlike the bankruptcy bills previously passed in the House in 2014, 2016 and 2017, the CHOICE Act also provided for a repeal of Title II.[14] Many observers were concerned that the report being prepared by the Secretary of the Treasury would endorse the approach taken in the CHOICE Act, *i.e.,* adding a new subchapter to the Bankruptcy Code for financial institutions, but at the same time repealing Title II.[15] These observers maintained that changes should be made to the Bankruptcy Code to facilitate its use for financial institutions, but that Title II should still be retained as a backstop to any enhanced Bankruptcy Code process.[16]

TREASURY DEPARTMENT REPORT

In February 2018, the U.S. Department of the Treasury issued a detailed report on Title II and the Orderly Liquidation Authority (the "Treasury Report") in response to the Presidential Memorandum.[17] The Treasury Report said that it shared many of the concerns that critics of Title II had raised in opposition to the original enactment of Title II (and, after its enactment, in

[13] Financial Institution Bankruptcy Act of 2014, H.R. 5421, 113th Cong. (2014); Financial Institution Bankruptcy Act of 2016, H.R. 2947, 114th Cong. (2016); and Financial Institution Bankruptcy Act of 2017, H.R. 1667, 115th Cong. (2017). None of these bills included a repeal of Title II.

[14] Financial CHOICE Act of 2017, H.R. 10 § 111, 115th Cong. (2017).

[15] *See, e.g.,* John Heltman, *The perils of repealing FDIC resolution powers*, AM. BANK., May 19, 2017, https://www.americanbanker.com/news/the-perils-jof-repealing-fdic-resolution-powers; Lalita Clozel, *Can FDIC resolution powers be reformed instead of axed?,* AM. BANK., June 6, 2017, https://www.americanbanker.com/news/can-fdic-resolution-powers-be-reformed-instead-of-axed.

[16] *See, e.g.*, Mark J. Roe, *Financial Scholars Oppose Eliminating "Orderly Liquidation Authority" As Crisis-Avoidance Restructuring Backstop* (May 26, 2017), https://corpgov.law.harvard.edu/wp-content/uploads/2017/05/Scholars-Letter-on-OLA-final-for-Congress.pdf.

[17] U.S. Department of Treasury, *Orderly Liquidation Authority and Bankruptcy Reform* (Feb. 21, 2018) [hereinafter *Treasury Report*], https://home.treasury.gov/sites/default/2018-02/OLA_REPORT.pdf.

favor of its repeal).[18] It said that Title II as enacted confers "far too much unchecked administrative discretion [on the FDIC], could be misused to bailout creditors, and runs the risk of weakening market discipline."[19] But to the surprise (and relief) of many observers, the Treasury Report did not recommend a repeal of Title II.[20] Instead the Treasury Report called for amendments to Title II to address certain identified concerns, but also for the retention of an amended Title II as an emergency tool for use under extraordinary circumstances.[21] The Treasury Report observed that while bankruptcy must be the presumptive option, "the bankruptcy of large, complex financial institutions may not be feasible in some circumstances, including when there is insufficient private financing."[22] It also recognized that without the assurance of Title II as a backstop emergency tool, foreign regulators would be more likely to impose *ex ante* "ring-fencing" requirements on the foreign affiliates of U.S. bank holding companies, a concern that the largest U.S. bank holding companies had prominently raised with the Treasury Department.[23]

The Treasury Report acknowledged that the current Bankruptcy Code is not designed to address financial distress of a debtor that engages in activities such as significant derivatives transactions and short-term borrowing.[24] As noted by the Treasury Report, these types of activities can make "solvent financial firms vulnerable to destabilizing run-like behavior that rapidly destroys value during times of market stress and can lead to financial contagion."[25] Accordingly, the Treasury Report called for reforms to the Bankruptcy Code to make it a "more

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[18] *Id.* at 1. Part V of this article discusses the arguments that the opponents originally made against the enactment of Title II and subsequently made in support of its repeal. *See Part V*, *supra* note 5, at 409-10 & 448-51.

[19] *Treasury Report*, *supra* note 17, at 1.

[20] *See, e.g.,* Aaron D. Klein, *Treasury gets it right: Bankruptcy Code, Dodd-Frank can work together*, Am. Bank., Feb. 28, 2018, https://www.americanbanker.com/opinion/treasury-gets-it-right-bankruptcy-code-dodd-frank-can-work-together; Rachel Witkowski, *Treasury endorses FDIC failure cleanup powers—with caveats*, Feb. 21, 2018, https://www.americanbanker.com/news/treasury-endorses-fdic-failure-cleanup-powers-with-caveats.

[21] *Treasury Report, supra* note 17, at 2.

[22] *Id*. Many commenters on the bankruptcy bills for financial institutions expressed doubts about whether there would be sufficient debtor-in-possession financing available to a large financial institution in bankruptcy. *See*, *e.g.*, Paul L. Lee, *Bankruptcy Alternatives to Title II of the Dodd-Frank Act—Part II*, 132 Banking L. J. 503, 550 (2015).

[23] *Treasury Report, supra* note 17, at 2.

[24] *Id.*

[25] *Id.* These same observations were among those made by the proponents of Title II in Congressional hearings in 2009–2010. *See Part V*, *supra* note 5, at 402–09.

effective" option for resolving financial firms and to make Title II "truly the option of last resort."[26] Perhaps unwittingly influenced by a prevailing political trope, the drafters of the Treasury Report proclaimed their approach "Bankruptcy First."[27]

Post-Crisis Developments in Resolution

The Treasury Report set the stage for its recommendations by first highlighting the significant post-crisis developments in the resolution field. The first development (as discussed in Part V of this article) is the conceptualization of the SPOE strategy for use under Title II and under the Bankruptcy Code.[28] The second development is the implementation of resolution planning under Title I. The Treasury Report noted that the Title I resolution plan process has led to significant advances in the resolvability of large financial institutions, many of these advances having been adopted in response to guidance from the Federal Reserve Board and the FDIC. One such advance is the rationalization of the legal entity structure of the large financial institutions, including a significant reduction in the number of legal entities in a company group and a better alignment of legal entity structures with distinct business lines.[29] Another advance is the ability of firms to assess and model potential capital and liquidity needs across key subsidiaries in the event of bankruptcy, to pre-position an appropriate amount of additional capital and liquidity at the key subsidiaries, and to establish contractually binding mechanisms to transfer additional capital and liquidity as and if needed.[30] The largest U.S. bank holding companies have executed secured support agreements that contractually require them to downstream capital and liquidity to their key operating subsidiaries in advance of the bankruptcy of the holding company.[31] These contractually binding agreements are intended to make these transfers less vulnerable to legal challenges in the event of the bankruptcy of the holding company. In addition, many of the largest U.S. bank holding companies have established intermediate holding companies (that issue no third-party debt of their own) to facilitate the use of their pre-funded financial resources to support their operating subsid-

[26] *Treasury Report, supra* note 17, at 3–4.

[27] *Id.* at 2.

[28] For a detailed discussion of the development of the SPOE strategy, see *Part V, supra* note 5, at 431–38.

[29] *Treasury Report*, *supra* note 5, at 13–14.

[30] *Id.* at 14.

[31] *Id.* at 15.

iaries and to reduce the risk of legal challenge.[32]

Another important advance lies in the steps taken to prevent the disruption of critical services provided by affiliates and by third parties in the event of the bankruptcy of the parent holding company. Many of the critical services provided by affiliates of the largest bank holding companies are now housed in bankruptcy-remote entities. Contracts with third-party service providers have also been modified to provide that the services will continue to be provided even if the company declares bankruptcy.[33]

Another important advance as discussed in Part V of this article is the implementation of the TLAC and clean holding company requirements that are critical to the execution of the SPOE strategy under Title II or the Bankruptcy Code.[34] Still another advance as discussed in Part V of the article is the implementation of a protocol by the International Swaps and Derivatives Association (the "ISDA Universal Resolution Stay Protocol") providing for a temporary stay of acceleration and close-out rights on the "qualified financial contracts" ("QFCs") of a signatory based on the entry into bankruptcy or other resolution proceeding by an affiliate of the signatory.[35] In September 2017 the Federal Reserve Board issued a regulation requiring the global systemically important U.S. bank holding companies (and the U.S. operations of global systemically important foreign banking organizations) in effect to adhere to the ISDA Universal Resolution Stay Protocol (or similar provisions in the regulation) on their QFCs.[36] But even with these significant advances in resolution

[32] *Id*. These large U.S. bank holding companies have established intermediate holding companies not as a regulatory matter, but as a structural matter to better insulate their resolution plans from legal challenge. As discussed below, certain foreign banking organizations operating in the United States have been required as a regulatory matter to establish a U.S. intermediate holding company. *See* 12 C.F.R. § 252.153. The U.S. intermediate holding companies established by foreign banking organizations satisfy a regulatory and supervisory requirement, but they can also serve to facilitate an SPOE resolution strategy for the U.S. operations of the foreign banking organization. *See* Enhanced Prudential Standards for Bank Holding Companies and Foreign Banking Organizations, 79 Fed. Reg. 17,240, 17269 (Mar. 27, 2014) (discussing how a U.S. intermediate holding company of a foreign banking organization would facilitate an SPOE strategy in the United States).

[33] *Treasury Report*, *supra* note 17, at 15–16.

[34] *Id*. at 16–17. For a discussion of the TLAC and clean holding company requirements, see *Part V*, *supra* note 5, at 440–45.

[35] *Treasury Report*, *supra* note 17, at 17–18. For a discussion of the ISDA Universal Protocol, see *Part V*, *supra* note 5, at 445–47.

[36] *Treasury Report*, *supra* note 17, at 18–19. In response to the Federal Reserve Board stay regulation and the companion stay regulations issued by the other U.S. banking agencies, ISDA

planning, the Treasury Report concluded that additional changes should be made to the existing U.S. regimes for resolving financial institutions, both Title II and the Bankruptcy Code.

Recommended Changes to Title II

Citing serious problems in the original design of the Orderly Liquidation Authority in Title II, the Treasury Report recommended a number of changes to Title II. Certain of the recommended changes, such as strengthening the judicial review process in Title II and substituting a Bankruptcy Code claims process for the administrative claims process in Title II, can only be implemented by statutory amendments to Title II. Most of the other recommended changes can be implemented by amendments to existing FDIC regulations or by administrative practice. The principal recommended changes include the following:

- eliminate the FDIC's authority to treat similarly situated creditors differently "on an *ad hoc* basis"; only critical vendors needed for the continuation of vital services should be eligible for favored treatment, just as under the Bankruptcy Code;[37]
- provide greater clarity on the resolution strategy to be used by the FDIC under the Orderly Liquidation Authority by explicitly confirming its commitment to an SPOE strategy or identifying the circumstances, if any, in which the SPOE strategy would not be used;[38]
- if funding support for a bridge company under the Orderly Liquidation Authority is needed, loan guarantees for the bridge company should be used by the FDIC rather than direct loans to the bridge company and the FDIC should impose a significant premium fee on any guarantee (or premium interest rate on any loan);[39]

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in July 2018 adopted a further protocol, the 2018 US Resolution Stay Protocol, to assist market participants in complying with these regulations. *See* Press Release, ISDA, ISDA Publishes ISDA 2018 US Resolution Stay Protocol (July 31, 2018), https://www.isda.org/2018/07/31/isda-publishes-isda-2018-us-resolution-stay-protocol/.

[37] *See Part V*, *supra* note 5, at 428–30 for the discussion of the provisions in Title II and in FDIC rules that permit the FDIC as receiver under Title II to treat similarly situated creditors differently in certain cases.

[38] In December 2013, the FDIC issued a request for public comment on the proposed SPOE strategy. *See* Notice and Request for Comments, Resolution of Systemically Important Financial Institutions: The Single Point of Entry Strategy, 78 Fed. Reg. 76,614 (Dec. 18, 2013). The FDIC has not taken any formal action on the notice and request for comments. For a detailed discussion of the SPOE strategy, see *Part V*, *supra* note 5, at 431–47.

[39] *See Part V*, *supra* note 5, at 421–24 for a discussion of the special funding available from

- to the extent that the FDIC cannot limit its financial support to guarantees, it should make loans to the bridge company only on a secured basis with high-quality collateral; and the duration of any loan should be limited to a fixed term that is only as long as necessary to meet liquidity needs;[40]
- in the unlikely event that any FDIC funding is not fully repaid by the bridge company, the backstop assessment on the financial industry provided for in Title II should be imposed as soon as reasonably possible, well in advance of the five-year repayment deadline imposed by Title II;[41]
- provide for the adjudication of creditor claims by a bankruptcy court under the Bankruptcy Code rather than by the FDIC under an administrative claims process as provided in Title II and implementing FDIC regulations;[42] and
- strengthen the judicial review process provided in Title II by allowing the district court to review the entire seven-point basis for invoking the Orderly Liquidation Authority rather than the current provision which

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the FDIC and the Treasury to support the resolution of a covered financial company under Title II.

[40] The funding provisions in Title II do not expressly require that FDIC funding be done on a secured basis, but as discussed below, the FDIC has publicly stated that it would provide funding only on a secured basis and only for a brief transitional period.

[41] Title II contains a baroque mechanism for establishing a backstop assessment on large financial institutions to cover any shortfall in repaying the FDIC and the Treasury for financial assistance provided under Title II. 12 U.S.C. § 5390(o). The assessment, if needed, would be made on nonbank financial companies designated as systemically important by the FSOC under Title I, bank holding companies with consolidated assets of $50 billion or more, and other financial companies with consolidated assets of $50 billion or more. 12 U.S.C. § 5390(o)(1)(D)(ii). The FSOC is required to make a recommendation on a risk matrix to be used by the FDIC in establishing the assessment process. Both the FSOC and the FDIC are required to take into account a wide set of considerations relating to possible differences in the assets, activities and risks on the range of large financial institutions subject to the assessment. 12 U.S.C. § 5390(o)(4). The assessment, if needed, must be levied within 60 months from the date of issuance by the FDIC to its obligations to the Treasury. Title II provides that the FDIC shall prescribe regulations to carry out this assessment process. 12 U.S.C. § 5390(o)(6). The FDIC has not adopted any regulations to implement the assessment power provided for in Title II. For a discussion of the issues that are likely to be encountered in implementing this assessment mechanism, see Paul L. Lee, *The Dodd-Frank Act Orderly Liquidation Authority: A Preliminary Analysis and Critique—Part II*, 128 BANKING L.J. 867, 890–91 (2011).

[42] *See* 12 C.F.R. Part 380 for the FDIC rules implementing the Orderly Liquidation Authority, including the administrative claims process.

limits judicial review to only two points and by allowing *de novo* review of the district court decision by the appellate court (or alternatively, replacing the truncated pre-appointment review procedure with a more robust post-appointment petition to remove the FDIC as receiver).[43]

The Treasury Report was generally well received, except by those who had hoped to see the Treasury call for the outright repeal of Title II.[44] The changes to Title II recommended in the Treasury Report preserve the core provisions of the Orderly Liquidation Authority while modifying several provisions that have been the subject of repeated criticism, such as the perceived liberality of the funding terms available under Title II and the broad scope of discretion left to the FDIC under Title II. Some commentators have described the changes

[43] To invoke Title II, the Secretary of the Treasury in consultation with the President must make seven findings:

(i) the company is in default or in danger of default;

(ii) the failure of the company and its resolution under otherwise applicable federal or state law would have serious adverse effects on U.S. financial stability;

(iii) no viable private sector alternative is available to prevent the default of the company;

(iv) any effect on the claims or interests of creditors, counterparties, and shareholders of the company and other market participants as a result of actions to be taken under Title II is appropriate, given the impact that any action taken under Title II would have on U.S. financial stability;

(v) any action taken under Title II would avoid or mitigate such adverse effects, taking into consideration the cost to the general fund of the Treasury and the potential to increase excessive risk taking by creditors, counterparties and shareholders;

(vi) a federal regulatory agency has ordered the financial company to convert all of its convertible debt instruments that are subject to the regulatory order; and

(vii) the company satisfies the definition of "financial company" under Title II.

12 U.S.C. § 5383(b). Judicial review of the Secretary's findings is limited to only two of these findings, that the financial company is in default or in danger of default and that the company satisfies the definition of "financial company" in Title II. 12 U.S.C. § 5382(a)(1)(A)(iii). *See Part V*, *supra* note 5, at 418–21 for a further discussion of the judicial review process provided for in Title II.

[44] *See*, *e.g.*, Press Release, Hensarling: Treasury Report 'Inconsistent' With President's Core Principal on Dodd-Frank Bailout (Feb. 21, 2018), https://financial services.house.gov/news/documentprint.aspx?DocumentID=403087 (supporting the proposal for a new chapter to the Bankruptcy Code, but criticizing the failure of the Treasury Report to recommend repeal of the Orderly Liquidation Authority). There are equally zealous advocates on the other side of this argument. *See, e.g.*, Adam J. Levitin, *Bankruptcy's Lorelei: The Dangerous Allure of Financial Institution Bankruptcy*, 97 N.C. L. REV. (forthcoming 2019) (asserting that the Financial Institution Bankruptcy Act as contained in the CHOICE Act is an "ideological pipedream"); Stephen J. Lubben, *A Functional Analysis of SIFI Insolvency*, 96 TEX. L. REV. 1377, 1398 (2018) (asserting that the Financial Institution Bankruptcy Act provisions in the CHOICE ACT are "a pretend bankruptcy case" for financial institutions).

proposed by the Treasury Report as modest.[45] The proposed changes might also be described as incremental because in a number of instances they build on actions already taken by the FDIC.

With respect to the Title II authority to treat similarly situated creditors differently, the Treasury Report acknowledges that the FDIC has taken a step to circumscribe the potential breadth of the authority by providing through regulation that holders of unsecured senior debt with a term of more than 360 days would not be eligible to receive any "additional payments" from the FDIC as receiver and by providing the example of critical service providers as a category of creditors that might receive such "additional payments."[46] The Treasury Report does not mention how another development in resolution planning has also limited the potential scope of application of the Title II authority to treat similarly situated creditors differently. One of the objectives of the SPOE strategy is in fact to minimize the need to treat similarly situated creditors differently. This objective is addressed in the first instance through the structural subordination of the long-term debt holders at the top-tier holding company to the short-term debt holders and other general creditors at the operating subsidiary level.[47] The objective is further addressed by the "clean holding company" requirement in the TLAC rule, which restricts the kind (*e.g.*, no short-term debt or derivative contracts with third parties) and relative amount of other general creditor claims, (*i.e.*, not to exceed 5% of the total loss-absorbing capacity) that can be incurred at the top-tier holding company.[48]

Based on the discussion in the Treasury Report, it would appear that the

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[45] *See* Cleary Gottlieb, Treasury Recommends Retaining Orderly Liquidation Authority 1 (Feb. 28, 2018), https://www.clearygottlieb.com/news-and-insights/publication-listing/treasury-recommends-retaining-orderly-liquidation-authority.

[46] *Treasury Report*, *supra* note 17, at 33–34. *See* 12 C.F.R. § 380.27(b)(4) (providing that a general creditor, including one holding a debt instrument with a term of 360 days or less, would receive an "additional payment" only if a majority of the board of directors of the FDIC determines that the payment of the "additional payment" is necessary to meet the objectives of Title II). *See also* 76 Fed. Reg. 4,207, 4212 (Jan. 25, 2011) (stating in the preamble to the FDIC regulation that "'additional payments' to any creditor will be very rare" and providing the example of "essential and necessary service providers" such as utility providers and payment processors that might receive "additional payments" for services rendered prior to the appointment of the FDIC as receiver).

[47] *See* Total Loss-Absorbing Capacity, Long-Term Debt, and Clean Holding Company Requirements for Systemically Important U.S. Bank Holding Companies and Intermediate Holding Companies of Systemically Important Foreign Banking Organizations, 80 Fed. Reg. 74,926, 74,928 (Nov. 30, 2015).

[48] *See* 80 Fed. Reg. at 74,930. For a further discussion of the relevance of the SPOE strategy to the question of the treatment of similarly situated creditors under Title II, see Paul L. Lee,

Treasury Department expects the FDIC to revise its regulation to restrict the FDIC authority to treat certain creditors more favorably than other creditors to limit it to critical service providers. Alternatively, the Treasury Report suggests that the standards set forth in Title II for the treatment of similarly situated creditors could be replaced in their entirety by regulation with a single standard that "articulates the judicially-established bankruptcy standard."[49] Articulating the "judicially-established bankruptcy standard" may be more difficult a task than the Treasury Report envisions. There is a continuing debate among bankruptcy experts about the appropriate scope of the exceptions to the absolute priority rule.[50] In any event, the Treasury Report suggests that the need to treat critical service providers differently than other general creditors under the Title II authority has been reduced by the actions taken by the large financial firms to modify their contracts with critical service providers to better ensure the continuity of services during a resolution.

With respect to the Title II resolution strategy, the Treasury Report acknowledges that the FDIC has said that it expects to use an SPOE strategy where feasible because of the significant advantages it has over other resolution strategies.[51] The Treasury Report might also have noted that the FDIC and the Federal Reserve Board have specifically incorporated the predicates for an SPOE strategy in their resolution plan guidance to the largest U.S. bank holding companies and foreign banking organizations with the largest U.S. operations, providing further practical confirmation of their commitment to the strategy.[52] In proposing the TLAC requirement, the Federal Reserve Board has likewise said that the TLAC requirement is "primarily focused on implementing the SPOE strategy," because the SPOE strategy offers substantial advantages over

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Bankruptcy Alternatives to Title II of the Dodd-Frank Act—Part II, 132 BANKING L.J. 503, 541–42 (2015).

[49] *Treasury Report*, *supra* note 17, at 34.

[50] *See*, *e.g.*, Stephen J. Lubben, *The Overstated Absolute Priority Rule*, 21 FORDHAM J. CORP. & FIN. L. 581 (2016); Levitin, *supra* note 44.

[51] *Treasury Report*, *supra* note 17, at 10–12 (citing the FDIC notice and request for comment on the SPOE strategy).

[52] *See* Federal Deposit Insurance Corporation & Board of Governors of the Federal Reserve System, *Guidance for 2017 § 165(d) Annual Resolution Plan Submissions by Domestic Covered Companies that Submitted Resolution Plans in July 2015*, https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20160413a1.pdf. Seven of the eight largest U.S. bank holding companies have expressly adopted an SPOE strategy in their most recent resolution plan filings. The guidance document does not prescribe an SPOE strategy, but it provides guidance specifically designed to assist in the implementation of an SPOE strategy.

other resolution strategies.[53] The Treasury Report recommends that the FDIC finalize its December 2013 notice and explicitly confirm its general commitment to the SPOE strategy. In light of public statements in support of an SPOE strategy already made by the FDIC and the Federal Reserve Board, this would be a useful step although the agencies will probably want to be cautious in providing any flat commitment to use an SPOE strategy. One large institution, Wells Fargo, has adopted a multiple-point-of-entry strategy in its resolution plan filings.

With respect to the use of the Title II funding authority, the Treasury Report acknowledges that the FDIC has stated that it intends to maximize the use of private funding in a resolution by providing guarantees of private-sector funding to the bridge company where possible, rather than providing direct loans to the bridge company.[54] The FDIC has similarly stated that if it were to provide direct loans to a bridge company, it would do so on a fully secured basis and only on a brief transitional basis.[55] The FDIC's previous statements on these points are consistent with the Treasury Report recommendations. In two respects, however, the Treasury Report appears to go beyond what the FDIC has previously stated as its position on funding under Title II. First, the Treasury Report states that the FDIC should lend only on a premium interest rate to incentivize the use of private funding markets by the bridge company and should provide a guarantee of private sector funding only at a premium fee.[56] This recommendation responds to concerns expressed by certain commentators that loans made by the FDIC to a bridge company might not accurately reflect a market rate and could constitute a subsidy to the bridge company.[57] Under the funding provision in Title II, the Treasury is already subject to a directive

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[53] *See* Total Loss-Absorbing Capacity, Long-Term Debt, and Clean Holding Company Requirements for Systemically Important U.S. Bank Holding Companies and Intermediate Holding Companies of Systemically Important Foreign Banking Organizations, 80 Fed. Reg. 74,926, 74,928 (Nov. 30, 2015).

[54] *Treasury Report*, *supra* note 17, at 11 (citing the FDIC notice and request for comment on the SPOE strategy).

[55] *Id.* The Treasury Report suggests that the FDIC should accept only high-quality assets as collateral and should publish a list of the types of collateral that it would deem acceptable such as the collateral deemed acceptable by a Federal Reserve Bank for discount window lending. *Id.* at 39. If the FDIC were to propose to accept collateral that had not been previously identified as being eligible, the Treasury Report states that the proposed collateral should be approved by the Secretary of the Treasury on a case-by-case basis. *Id.*

[56] *Id.* at 37–38.

[57] *See*, *e.g.*, *Who is Too Big to Fail: Does Title II of the Dodd-Frank Act Enshrine Taxpayer-Funded Bailouts?: Hearing Before the Subcomm. on Oversight and Investigations of the H. Comm. on Financial Services*, 113th Cong. 14 (2013) [hereinafter *Too Big to Fail Hearing*]

to impose a surcharge on its loans to the FDIC and in effect require the FDIC to impose a surcharge on any loans it makes to a bridge company.[58] It is not clear whether the Treasury Report is calling for anything more than what is already contained in Title II in this regard.[59]

Second, the Treasury Report also states that FDIC guarantees should presumptively be treated the same as direct loans made by the FDIC for purposes of calculating compliance with the maximum obligation limitation in Title II. The maximum obligation limitation in Title II limits the aggregate amount of obligations, both direct obligations resulting from FDIC borrowings from the Treasury and contingent obligations such as FDIC guarantees of private-sector loans, that the FDIC may incur in connection with the orderly liquidation of a covered financial company.[60] The Treasury Report says that the

(statement of Joshua Rosner) ("[T]here is no obligation or mechanism within Title II to price the credit risk that is being taken on, and I think that is an important part of the subsidy as well."); *id.* at 22 (statement of David Skeel) ("The FDIC can essentially cherry pick the rate it wants by picking obligations of the maturity that has an attractive interest rate. So there is very, very little limitation on them."); *id.* at 29 (statement of David Skeel) ("Taxpayers are paying if the interest rate on loans that the bridge institution has is a below-market interest rate.") *See also 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, 113th Cong. 76 (July 2014) (indicating that the moral hazard created by Title II is "exacerbated by the substantial discretion that Title II affords the government to determine the appropriate rate at which to lend to the bridge company") (footnote omitted).

[58] The funding provision in § 210(n)(5)(C) of Title II provides that the purchase of obligations by the Secretary of the Treasury from the FDIC shall be on such terms and conditions "as to yield a return at a rate determined by the Secretary, taking into consideration the current average yield on outstanding marketable obligations of the United States of comparable maturity, plus an interest rate surcharge." The interest rate surcharge "shall be greater than the difference between (i) the current average rate on an index of corporate obligations of comparable maturity; and (ii) the current average rate on outstanding marketable obligations of the United States of comparable maturity." 12 U.S.C. § 5390 (n)(5)(C). This provision is intended to set a floor on the interest rate surcharge that the Treasury must impose. Some observers have criticized even this funding provision as being too imprecise. *See, e.g.*, *Too Big to Fail Hearing*, *supra* note 57, at 63 (statement of Joshua Rosner) ("Nowhere in Dodd-Frank does it state which index should be used for determining these bond yield (sic). As a result, if the FDIC chooses to index to a 'AAA' corporate average, funding may be at rates that the market confers on only the healthiest institutions.").

[59] The Treasury Report identifies one other benefit provided to a bridge company under Title II that it regards as an inappropriate subsidy, *i.e.*, the provision in § 210(h)(10) of Title II that exempts a bridge company from all federal, state and local taxes. *Treasury Report*, *supra* note 17, at 36. *See* 12 U.S.C. § 5390(h)(10). The Treasury Report calls for the repeal of this provision.

[60] 12 U.S.C. § 5390(n)(6); 12 C.F.R. § 380.10. *See Part V*, *supra* note 5, at 422–23 for a discussion of the maximum obligation limitation in Title II.

Treasury does not expect to approve an FDIC orderly liquidation repayment plan unless the plan provides that any amounts guaranteed by the FDIC will count on a dollar-for-dollar basis against the maximum obligation limitation.[61] This approach would be significantly more stringent than the approach that the FDIC has taken in calculating exposure on guarantees under the Federal Deposit Insurance Act (the "FDIA") and presumably the practice that the FDIC had previously assumed it would use under Title II.[62]

With respect to expediting any backstop assessment, the Treasury Report notes that the other reforms it proposes will minimize the "already low risk" that a bridge company would be unable to repay any funding support that it gets from the FDIC.[63] The Treasury Report nonetheless recommends that in the "unlikely event" that the FDIC funding is not fully repaid by the bridge company, an assessment against the large financial companies should be made as soon as reasonably possible well in advance of the five-year repayment deadline set in Title II.[64] The ability of the FDIC to impose any such assessment on an expedited basis, however, will be a function of a future rulemaking process by the FDIC. As noted above, Title II directs the FDIC in consultation with the FSOC to adopt regulations to establish the mechanism for the assessment process. The FDIC has not proposed any regulations in this respect and it is not clear that the Treasury expects the FDIC to begin such a rulemaking process. Given the supposition that it is unlikely that an assessment would actually be needed in the case of any future resolution and the fact that an assessment methodology would likely be highly dependent upon the overall financial situation prevailing at the time of any future resolution, it is unlikely that the FDIC would find it desirable or even feasible to begin the rulemaking

[61] *Treasury Report*, *supra* 17, at 38 n.117. The Treasury must approve a repayment plan submitted by the FDIC in order to continue to provide funding to the FDIC after the first 30 days of the receivership. 12 U.S.C. § 5390 (n)(9)(B).

[62] The maximum obligation limitation in Title II is modeled on a similar provision in section 15(c) of the FDIA. Like section 15(c) in the FDIA, the maximum obligation limitation provision in Title II provides that the FDIC "shall value any contingent liability at its expected cost to the [FDIC]." 12 U.S.C. § 5390 (n)(8)(B). *See* 76 Fed. Reg. 72,645, 72,647 (Nov. 25, 2011) (discussing the "expected cost" treatment of contingent liabilities under the maximum obligation limitation in Title II). The Treasury Report position appears to be in conflict with this statutory language.

[63] *Treasury Report*, *supra* note 17, at 6.

[64] *Id*. Title II permits the FDIC with the approval of the Secretary of the Treasury to extend the five-year repayment deadline if the FDIC determines that an extension is necessary to avoid a serious adverse effect on the U.S. financial system. 12 U.S.C. § 5309 (o)(1)(c). The thrust of the Treasury Report is not simply to avoid any such extension, but to accelerate the five-year repayment deadline.

process until an event compels the use of Title II.[65]

At least two of the changes recommended by the Treasury Report will require statutory amendments to Title II. The first such change is to provide for a bankruptcy court process to adjudicate the claims of creditors of the covered financial company in substitution for the FDIC administrative claims process provided in Title II.[66] The Treasury Report favors a bankruptcy court process because it would be more transparent than the FDIC receivership process.[67] The likely use of an SPOE resolution strategy in a Title II resolution may make the bifurcation of the weekend resolution activity by the FDIC as receiver and the post-weekend adjudication of creditor claims by a bankruptcy court somewhat more feasible. The application of the clean holding company requirement (which limits the amount of general creditor claims other than loss-absorbing long-term debt claims at the systematically important bank holding company level) may also simplify the claims process. Nonetheless, the recommendation to split authority between the FDIC and a bankruptcy court will present challenges in coordinating the FDIC role in overseeing the operation and rehabilitation of the bridge company with the bankruptcy court interest in maximizing the value of the bridge company for creditors of the estate.

The second change requiring an amendment to Title II is the proposal to strengthen the judicial review process for the decision to invoke Title II.[68] Under the current provisions in Title II, the judicial review process is truncated in time and scope. As discussed above, the Secretary of Treasury in consultation with the President must make seven determinations to authorize the appointment of the FDIC as receiver for a company under Title II. Upon making these determinations, the Secretary must notify the covered financial company. If the board of directors of the covered financial company acquiesces to the

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[65] The assessment provision in Title II requires that the assessment process take into account a significant number of factors, including the risk profile of the covered financial company, how that risk profile may be paralleled by other financial companies and how particular financial companies benefited or would benefit from the orderly liquidation of the particular covered financial company. Certain of the considerations listed in the assessment provision will be more readily applied after the orderly liquidation of a particular covered financial company has been initiated. *See* 12 U.S.C. § 5390(o)(4)(A) & (C).

[66] *Treasury Report*, *supra* note 17, at 34–35.

[67] 12 U.S.C. § 5390(b)(1). The Treasury Report proposes that the priority of claims provision in Title II (which deviates from the Bankruptcy Code priority of claims provision in respect of an elevated priority for amounts owed to the United States and a lower priority for salary claims of senior executives and board members) would be retained.

[68] *Treasury Report*, *supra* note 17, at 39–41.

appointment of the FDIC as receiver, the Secretary can immediately appoint the FDIC as receiver.[69] If the board of directors does not acquiesce to the appointment of the FDIC as receiver, the Secretary must petition the U.S. District Court for the District of Columbia for an order authorizing the Secretary to appoint the FDIC as receiver. In reviewing the request for the order to appoint the FDIC as receiver, the district court is directed to review (under an arbitrary and capricious standard) only two of the seven statutory determinations, namely, that the covered financial company is in default or in danger of default and that the covered financial company meets the definition of "financial company" under Title II.[70] If the district court does not make its determination within 24 hours of receipt of the petition, the petition from the Secretary is deemed granted by operation of law.[71]

In response to criticisms that the current review process in Title II is deficient perhaps to the point of being unconstitutional, the Treasury Report recommends that the judicial process in Title II be expanded to allow the district court to review all seven of the Secretary's determinations, including most importantly that the company's failure and resolution under the Bankruptcy Code would have serious adverse effects on U.S. financial stability.[72] The Treasury Report suggests that the deferential "arbitrary and capricious" standard already provided for in Title II will protect against the district court substituting its judgment on these determinations for that of the government.

Recommended Changes to the Bankruptcy Code

The Treasury Report strongly endorses the adoption of bankruptcy reform (which the Treasury Report refers to as a "Chapter 14" bankruptcy approach after the version of a bankruptcy reform bill introduced in the Senate in 2013).[73] As noted above, the House has passed a bankruptcy bill for financial

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[69] 12 U.S.C. § 5382(a)(l)(A)(i). *See Part V*, *supra* note 5, at 419–20 for a discussion of the appointment and review process.

[70] 12 U.S.C. § 5382(a)(1)(A)(iii). For a list of the other statutory determinations, see *supra* note 43.

[71] 12 U.S.C. § 5382(a)(l)(A)(v).

[72] *Treasury Report, supra* note 17, at 40–41. For a detailed discussion of the constitutional issues that may be presented by Title II, see Thomas W. Merrill & Margaret L. Merrill, *Dodd-Frank Orderly Liquidation Authority: Too Big for the Constitution?* 163 U. Pa. L. Rev. 165 (2014); *Examining Constitutional Difficulties and Legal Uncertainties in the Dodd-Frank Act: Hearing Before the Subcomm. on Oversight and Investigations of the H. Comm. on Financial Services*, 113th Cong. (2013).

[73] *See* Taxpayer Protection and Responsible Resolution Act, S. 1861, 113th Cong. (2013). S. 1861 followed the lead of the Hoover Institution which pioneered the effort to create a new

institutions in the form of a new subchapter V to Chapter 11 in 2014, 2016 and 2017. The Treasury Report supports the proposed reform to the Bankruptcy Code because it "would bolster bankruptcy as the presumptive approach for all failed financial corporations, making it less likely that [the Orderly Liquidity Authority] will be needed."[74]

The Treasury Report nonetheless acknowledges that any bankruptcy reform proposal designed for large financial institutions will face some challenges. It identifies liquidity as one of the most significant challenges to the resolution of a financial institution under the Bankruptcy Code, but cites three factors that may mitigate the challenge.[75] The first factor is the development of the SPOE strategy, which the Treasury believes will help conserve liquidity and assist the bridge company in accessing private sector funding. Similarly, the Treasury Report cites the development in resolution plans of measures to stockpile liquidity to meet "peak" liquidity needs during the early stages of a resolution as helpful in addressing the liquidity concern. The second factor is the provision in the bankruptcy bills that stays counterparty close-out and liquidation rights on derivatives and other financial contracts for a 48-hour period pending the potential transfer of assets and certain liabilities to a bridge company.[76] The 48-hour stay is designed among other things to prevent counterparties from draining liquidity from the failing company. The third factor is the availability of Title II itself with its Treasury funding source as a backstop and last resort.[77]

Chapter 14 in the Bankruptcy Code for financial institutions. *See* 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). The version of bankruptcy reform passed in the House takes the form of a new subchapter V to Chapter 11 rather than a new Chapter 14, but the substance of the bills is essentially the same with the principal exception that S. 1861 also provided for the repeal of Title II.

[74] *Treasury Report*, *supra* note 17, at 25.

[75] *Id*. at 27.

[76] *Id.* at 28.

[77] *Id.* Title II provides for the possibility that the FDIC could be appointed as a receiver for a covered financial company under Title II after a case or proceeding for the company had already been commenced under the Bankruptcy Code or the Securities Investor Protection Act ("SIPA"). In the event that the FDIC is appointed as a receiver under Title II, any case or proceeding under the Bankruptcy Code or SIPA would be dismissed. 12 U.S.C. § 5388(a). Although Title II envisions the possibility of an FDIC receivership under Title II superseding a prior Bankruptcy Code or SIPA filing, it would be a most undesirable turn of events, creating even greater confusion and disruption in the markets. Thus, the Treasury and the federal regulators would have to have a high level of confidence that a bankruptcy filing by the company would provide a successful path to an orderly resolution. If not, they would likely be forced to invoke Title II and forestall the company from filing for bankruptcy. In this sense, Title II might better be

Another challenge identified by the Treasury Report is ensuring that the primary regulators have an appropriate role in the bankruptcy process. The Treasury Report endorses the provisions in the bankruptcy bills that give the federal regulatory agencies and the Treasury Department standing to raise issues in the bankruptcy process and suggests that foreign regulators should also be given standing in a bankruptcy case if the financial institution has significant cross-border operations.[78] The Hoover Institution proposal as well as an early Senate and House version of a bankruptcy bill for financial institutions would have provided a more robust role for the Federal Reserve Board. These proposals would have allowed the Federal Reserve Board to initiate the bankruptcy case upon its certification that immediate commencement of the case was necessary to avoid serious adverse effects on U.S. financial stability. The most recent House-passed versions of a bankruptcy bill do not provide the Federal Reserve Board with such authority. Only the financial institution itself can initiate a bankruptcy case under the recent House-passed versions of the bankruptcy bill.[79] Some commentators have continued to suggest that a bankruptcy bill for large financial institutions should provide authority for the Federal Reserve Board to initiate an involuntary bankruptcy case against a large financial institution. The Treasury Report suggests a middle ground for Congress to consider. The Treasury Report notes that the current versions of a bankruptcy bill would require the bankruptcy court to make a number of findings (on a preponderance-of-the-evidence standard) before the court could authorize a transfer of assets to a bridge company, including a finding that the transfer is necessary to prevent serious adverse effects on U.S. financial stability. The Treasury Report observes that a bankruptcy judge might find it difficult to make this factual finding, particularly within the short time frame envisioned in the bankruptcy bill.[80] The Treasury Report suggests that as a compromise the bankruptcy bill might explicitly provide for judicial deference to a Federal Reserve Board determination on this key point.[81] This would allow the transfer petition to be acted upon by the court more quickly. The Treasury Report also suggests that the Federal Reserve Board, the FDIC and other U.S. financial regulatory agencies coordinate with their foreign counterparts in advance of any

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thought of as a frontstop, rather than a backstop, to bankruptcy.

[78] *Treasury Report*, *supra* note 17, at 28.

[79] *See, e.g.,* H.R. 1667 § 3 (proposed 11 U.S.C. § 1183).

[80] *Treasury Report*, *supra* note 17, at 29.

[81] *Id.* To the extent that the proponents of a Bankruptcy Code approach to resolution of large financial institutions cite an independent judicial process as one of its benefits, express reliance by the court on a key determination by the Federal Reserve Board appears to come closer to reliance on the regulators' process reflected in Title II.

filing and "redouble their efforts to establish protocols for cooperation with their foreign counterparts."[82] In a self hortatory gesture, the Treasury Report recommends that the Treasury should deepen its own participation in international crisis management groups. Globalists will perhaps be encouraged by this gesture.

Finally, the Treasury Report recognizes that another challenge for any bankruptcy reform measure is to ensure that the judges presiding over the bankruptcy cases have sufficient expertise with respect to the operation of the U.S. financial system.[83] The bankruptcy bills provide as a first step that the Chief Justice of the United States will designate not fewer than 10 bankruptcy judges to be available to hear bankruptcy cases for financial institutions.[84] The Treasury Report suggests that the designated judges could engage in planning and coordination exercises with the regulators, including cross-border exercises such as the crisis management groups that the U.S. regulators and their foreign counterparts have established for the large internationally active banking groups. To the *bien pensant*, this recommendation may seem sensible. However, it would represent a significant expansion of (and departure from) the role customarily assumed by a judge. It might also present significant issues under the rules that restrict the ability of U.S. bank regulators and foreign regulators to share confidential supervisory information relating to a regulated entity with third parties. It might also appear to compromise the independence of a designated judge who is subsequently called upon to preside over the bankruptcy case of one of these large banking institutions.

The Treasury Report reflects in the main a balanced approach to the issues surrounding Title II. It is not clear, however, whether the Treasury Department will place a high priority on promoting the proposed legislative changes to Title II. As a practical matter, the recommended administrative changes to the Title II process can more easily be achieved with the assistance of the FDIC under its new leadership. Similarly, it is not clear whether the Treasury Department will place a high priority on promoting changes to a Bankruptcy Code measure that has in its current form already passed the House three times in the last several years. At least from a legislative perspective, the Treasury Report may prove to be more of a reference item than an action item.

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[82] *Id.*

[83] *Id.*

[84] *Id.* at 30. The Treasury Report recommends that consideration also be given to the alternative of designating district court judges rather than bankruptcy judges for the new Chapter 14 Bankruptcy Code process. *Id.*

TITLE I RESOLUTION PLAN REQUIREMENT

Statutory Provisions

Title I of the Dodd-Frank Act as originally enacted directed the Federal Reserve Board to impose heightened prudential standards on bank holding companies with total consolidated assets of $50 billion or more and on nonbank financial companies designated by the FSOC for supervision by the Federal Reserve Board.[85] In May 2018, a significant revision to Title I of the Dodd-Frank Act was made with the enactment of the Economic Growth, Regulatory Relief, and Consumer Protection Act (the "EGRRCPA").[86] The EGRRCPA raised the $50 billion asset thresholds in Title I to $100 billion upon its enactment and to $250 billion effective as of November 2019.[87] Among the provisions affected by the asset threshold change in Title I is the resolution plan requirement contained in section 165(d) of Title I. Section 165(d) of Title I as originally enacted required bank holding companies with total consolidated assets of $50 billion or more as well as nonbank financial companies designated by the FSOC to present periodically to the Federal Reserve Board and the FDIC a plan "for rapid and orderly resolution in the event of material financial distress or failure."[88]

The resolution plan requirement initially proved to be one of the most fraught exercises under the Dodd-Frank Act. Under the terms of the resolution plan requirement, the Federal Reserve Board and the FDIC must assess whether the plan is credible and would facilitate an orderly resolution of the company under the Bankruptcy Code.[89] If the Federal Reserve Board and the FDIC jointly determine that the resolution plan of a company is not credible or would

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[85] 12 U.S.C. § 5365(a).

[86] Pub. L. No. 115-174 (2018).

[87] *Id.* at § 401. The EGRRCPA provides that a bank holding company regardless of size that has been identified as a global systemically important bank holding company under the Federal Reserve Board capital rule (12 C.F.R. § 217.402) will be treated as a bank holding company with total consolidated assets equal to or greater than $250 billion for purposes of the heightened prudential standards in Title I. The EGRRCPA also provides that the Federal Reserve Board may, by order or rule, impose any prudential standard, including a resolution plan requirement, on any bank holding company with total consolidated assets equal to or greater than $100 billion if the Federal Reserve Board determines that it is appropriate to prevent or mitigate risks to the financial stability of the United States or to promote the safety and soundness of the bank holding company.

[88] 12 U.S.C. § 5365(d)(1). Currently, there are no nonbank financial companies designated by the FSOC under Title I.

[89] 12 U.S.C. § 5365(d)(4).

not facilitate an orderly resolution, the company is required to resubmit the resolution plan with revisions, demonstrating that the plan is credible and would result in an orderly resolution under the Bankruptcy Code. If the company fails to submit a satisfactory revised plan, the Federal Reserve Board and the FDIC may jointly impose more stringent capital or liquidity requirements or restrictions on the growth, activities or operations of the company and its subsidiaries. If a company fails to submit a satisfactory revised plan within two years from the date of the imposition of such requirements or other restrictions, the Federal Reserve Board and the FDIC, in consultation with the FSOC, may order the company to divest assets or operations.[90] Like the prospect of a hanging, the prospect of a major divestiture order is intended to concentrate the mind of senior management of the institution on their resolution planning process. In fact, the resolution plan requirement is designed to encourage the largest and most complex financial institutions to change their structures and operations on their own to facilitate their hypothetical resolution path under the Bankruptcy Code.

The statutory language for the resolution plan requirement in Title I provides only a few indications of what must be included in a resolution plan, such as a description of the ownership structure, assets, liabilities, and contractual obligations of the company; an identification of the cross-guarantees tied to different securities; an identification of major counterparties; and a process for determining to whom the collateral of the company is pledged.[91] In addition, the statutory language requires information regarding the manner and extent to which any insured depository subsidiary of the company is adequately protected from risks arising from the activities of any nonbank subsidiaries of the company. The Federal Reserve Board and the FDIC have provided greater specificity on the informational content of a resolution plan in a joint rule.[92] Subsequently, as part of a self-styled iterative process in reviewing resolution plans, the Federal Reserve Board and the FDIC have issued additional detailed guidance on the requirements to be met in resolution plans.

Regulatory Provisions

One of the challenges in crafting regulations applicable to the resolution plan requirement was the range of bank holding companies covered by the original $50 billion asset threshold in Title I. The $50 billion threshold clearly encompassed many U.S. banking institutions that individually were not

[90] 12 U.S.C. § 5365(d)(5)(B).

[91] 12 U.S.C. § 5365(d)(1).

[92] 12 C.F.R. Part 243 (Federal Reserve Board); 12 C.F.R. Part 381 (FDIC).

systemically important.[93] When the Federal Reserve Board and the FDIC initially proposed their joint rule to implement the resolution plan requirement, they drew no distinction among the institutions captured by the $50 billion threshold.[94] One of the criticisms of the proposed rule by industry commentators was that it made no allowance for the differences among the bank holding companies and foreign banking organizations, ranging from very large, complex organizations that have substantial nonbank operations to smaller, less complex organizations that are composed predominantly of one or more insured depository subsidiaries.[95] The commenters suggested that the final rule should provide for a tailored resolution plan regime for smaller, less complex companies.[96] In response to this criticism, the Federal Reserve Board and the FDIC provided in their final regulation for a tailored resolution plan approach. The tailored resolution plan was available to a company that (i) has less than $100 billion in total nonbank assets (or in the case of a foreign banking organization, in total U.S. nonbank assets) and (ii) the total insured depository institution assets of which comprise 85% or more of the company's total consolidated assets (or in the case of a foreign banking organization, the assets of any insured depository institution and branches and agencies comprise 85% or more of the company's U.S. total assets).[97] The tailored resolution plan

[93] The problem with the original $50 billion asset threshold was compounded by an interpretation that the Federal Reserve Board imposed on the statutory language in Title I. The Federal Reserve Board concluded that with respect to a foreign banking organization with U.S. operations, the $50 billion test would be applied on the foreign banking organization's worldwide assets, not its U.S. assets. This interpretation as applied to the resolution plan requirement in Title I meant that a foreign bank with a branch in the United States would be required to file a U.S. resolution plan simply because its worldwide assets were $50 billion or more. The Federal Reserve Board and the FDIC originally estimated that 124 organizations would be required to file resolution plans. 76 Fed. Reg. 22,648, 22,654 (April 22, 2011) (proposed rule). A trade group for foreign banking organizations estimated that foreign banking organizations represented 98 of the 124 organizations. *See* Letter from the Institute of International Bankers to the FDIC 5 (June 10, 2011), https://www.iib.org/page/CommentLetters2011.

[94] 76 Fed. Reg. 22,648 (Apr. 22, 2011) (proposed rule).

[95] *See* 76 Fed. Reg. 67,323, 67,324 (Nov. 1, 2011) (final rule).

[96] *Id.*

[97] *Id* at 67,330. The Federal Reserve Board and the FDIC were facilitated in their adoption of the tailored resolution plan by the promulgation by the FDIC of its own resolution plan rule for insured depository institutions with $50 billion or more in total assets. *See* Resolution Plan Required for Insured Depository Institutions With $50 Billion or More in Total Assets, 76 Fed. Reg. 58379 (Sept. 21, 2011) (interim final rule). The FDIC rule imposes on these insured depository institutions a resolution plan requirement comparable to that in Title I. The principal difference between the plans is that the Title I resolution plan is done with the Bankruptcy Code

provides for a more limited set of information relating principally to the nonbank subsidiaries of the company, and the interconnectedness of such subsidiaries to the insured depository subsidiaries of the company.[98]

In their final regulation, the Federal Reserve Board and the FDIC introduced another segmentation in the resolution plan process. They provided for a staggered filing process for the first resolution plan based on the size of the filing company. Companies with $250 billion or more in total nonbank assets (or for foreign based companies, total U.S. nonbank assets) were required to file their first plan by July 1, 2012 ("first-wave" filers).[99] Companies with $100 billion or more in total nonbank assets (or for foreign based companies, total U.S. nonbank assets) were required to file their first plan by July 1, 2013 ("second-wave" filers). The remaining companies covered by the resolution plan rule were required to file their first plan by December 31, 2013 ("third-wave" filers). The resolution plan regulation provided that the plans would be filed on an annual basis. Each resolution plan was to be divided into a public section, which included general information about the filing firm and a high-level discussion of the firm's resolution strategy, and a confidential section. Most of the filing in fact would be in the confidential section that would for the largest firms run thousands of pages in length.

The resolution plan regulation provided a relatively detailed listing of the subjects to be covered and the information to be provided in a resolution plan.[100] Additional guidance from the Federal Reserve Board and the FDIC, however, would still prove essential to making the resolution planning process a robust exercise. That guidance would come after the Federal Reserve Board and the FDIC had an opportunity to review the initial resolution plans as filed. As the Federal Reserve Board and the FDIC gained more experience in

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as the applicable law and the resolution plan for an insured depository institution is done with the FDIA as the applicable law.

[98] The Federal Reserve Board and the FDIC estimated that 104 of the 124 organizations originally identified as being subject to the Title I resolution plan rule would be eligible to file a tailored plan. 76 Fed. Reg. at 67,333. The tailored plan provision eased the burden on many foreign bank organizations with limited nonbank operations in the United States.

[99] The "first-wave" filers were Bank of America, Bank of New York Mellon, Barclays, Citigroup, Credit Suisse, Deutsche Bank, Goldman Sachs, JPMorgan Chase, Morgan Stanley, State Street Corp., and UBS.

[100] *See* 12 C.F.R. § 243.4 & 12 C.F.R. § 381.4 (describing the informational content of a resolution plan). The regulation expressly provided that a covered company could not rely on the provision of extraordinary support by the United States or any other government to it or its subsidiaries to prevent the failure of the covered company. 12 C.F.R. § 243.4(a)(4)(ii) & 12 C.F.R. § 381.4(a)(4)(ii).

reviewing the resolution plans, particularly those filed by the largest U.S. banking institutions and large foreign banking institutions, they commenced a process of articulating through private meetings, individual "feedback" letters and public guidance documents their expanding expectations for the scope and content of the resolution plans.[101] The Federal Reserve Board and the FDIC also acquired insights from the FDIC's own planning process for the potential use of the new resolution authority in Title II. These insights, particularly as to the advantages of an SPOE strategy, informed the approach that the Federal Reserve Board and the FDIC would take to their assessment of the viability of the Title I resolution plans.

Guidance Documents

April 2013 Guidance

In April 2013, the Federal Reserve Board and the FDIC issued their first set of detailed guidance on resolution plans to the 11 "first-wave" filers, based on the resolution plans that they had filed in July 2012.[102] The 2013 guidance called for detailed analysis of a set of "significant obstacles" to a rapid and orderly resolution that the Federal Reserve Board and the FDIC had identified in their review of the 2012 resolution plans. These obstacles summarized at a high level were:

- *Multiple Competing Insolvencies:* The risk of discontinuity of critical operations, systemic consequences and/or uncertainty of outcome that could be created by multiple, competing insolvency proceedings under

[101] For a detailed description and critique of the initial implementation process of the resolution plan requirement by the agencies, see United States Gov't Accountability Office, GAO 16 341, Resolution Plans: Regulators Have Refined Their Review Processes but Could Improve Transparency and Timeliness (2016).

[102] *See* Joint Press Release, Board of Governors of the Federal Reserve System & Federal Deposit Insurance Corporation, Agencies provide additional instructions for submission of some resolution plans (Apr. 15, 2013), https://www.federalreserve.gov/newsevents/pressreleases/bcreg20130415c.htm. The agencies issued separate guidance documents for the seven domestic banking institutions with $250 billion or more in nonbank assets and the four foreign banking institutions with $250 billion or more in U.S. nonbank assets. The guidance in the two documents was substantially the same. *See* Federal Deposit Insurance Corporation & Board of Governors of the Federal Reserve System, *Guidance for 2013 § 165(d) Annual Resolution Plan Submissions by Domestic Covered Companies that Submitted Initial Resolution Plans in 2012* (Apr. 15, 2013), https://www.fdic.gov/regulations/reform/domesticguidance.pdf; Federal Deposit Insurance Corporation & Board of Governors of the Federal Reserve System, *Guidance for 2013 § 165(d) Annual Resolution Plan Submissions by Foreign-Based Covered Companies that Submitted Initial Resolution Plans in 2012* (Apr. 15, 2013), https://www.fdic.gov/regulations/reform/foreignguidance.pdf.

different insolvency frameworks and/or administered in multiple jurisdictions;

- *Global Cooperation:* The risk that actions (or non-actions) of a covered company could incent host supervisors or resolution authorities or third parties to take actions (or abstain from actions) that could result in ring-fencing of assets or lead to other outcomes that could exacerbate financial instability in the United States and/or loss of franchise value;
- *Operations and Interconnectedness:* The risk that services provided by an affiliate or third party might be interrupted, or financial market utility ("FMU") access and/or payment and clearing capabilities might be lost; an affiliate or third party might fail to perform service level agreements; the covered company might experience interruption or loss of data and IT services; a counterparty might exercise contract rejection powers or might be excused from the continued provision of rights which are available to a counterparty under applicable law or by contract;
- *Counterparty Actions:* The risk of counterparty actions, including derivative and repurchase agreement unwinds, of a volume sufficient to create operational challenges for the covered company or its FMUs and/or systemic market disruption or financial instability in the United States; and
- *Funding and Liquidity:* The risk of insufficient liquidity at one or more material entities or in one or more jurisdictions, to maintain critical operations, including increased margin requirements, acceleration, termination, or inability to roll over short-term borrowings.

The guidance called for detailed informational responses on each of these obstacles describing the actions to be taken to remediate or mitigate each obstacle, including a timeline for the remedial or mitigating action, to be included in the next resolution plans to be filed by the "first-wave" firms by October 1, 2013. The guidance also called for a detailed set of information on the substantive and procedural steps that would be taken in a bankruptcy filing and in a 30-day "runway" period preceding a bankruptcy filing.[103] This information would also include how the firm expects its material subsidiaries to be placed into resolution and the firm's ability to control that sequence. The guidance called for a significant expansion of the information and analysis in the resolution plans filed by the 11 "first-wave" filers.

August 2014 Determinations

In August 2014, the Federal Reserve Board and the FDIC issued a joint press

[103] *Id.* at 6–7.

release announcing their "feedback" to the 11 "first-wave" filers on the second round of resolution plans that they had filed in October 2013. Significantly, the press release indicated that the FDIC had determined that the second-round resolution plans submitted in October 2013 by the 11 "first-wave" filers were not credible and would not facilitate an orderly resolution under the Bankruptcy Code.[104] The press release indicated that the Federal Reserve Board had taken the less drastic step of determining that the 11 "first-wave" filers needed to take immediate steps to improve their resolvability and reflect those improvements in their 2015 resolution plans.[105] As discussed above, section 165(d)(4) requires a joint determination by the FDIC and the Board of Governors that a resolution plan is not credible or would not facilitate an orderly resolution of the company under the Bankruptcy Code before action can be taken by the agencies under section 165(d)(5).[106] The Federal Reserve Board did not join the FDIC in making such a determination based on the 2013 resolution plans before them. The FDIC and the Federal Reserve Board, however, did say in their joint press release that if the companies did not submit changes responsive to the identified shortcomings in their next plans to be filed by July 1, 2015, the agencies expected to use their authority under section 165(d) to determine jointly that a resolution plan did not meet the requirements of the Dodd-Frank Act.[107]

In their joint press release, the FDIC and the Federal Reserve Board noted some common failures in the 2013 plans, such as (i) unrealistic assumptions about the likely behavior of customers, counterparties, investors, central clearing facilities, and regulators, and (ii) the failure to make or even to identify the kinds of changes in firm structure or practice necessary to enhance the prospects of an orderly resolution. In a separate statement, Vice Chairman Thomas Hoenig of the FDIC identified other failures in the plans, such as the failure to address continued reliance on wholesale funding and the failure to demonstrate how a large financial company could access private debtor-in-

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[104] *See* Joint Press Release, Board of Governors of the Federal Reserve System & Federal Deposit Insurance Corporation, Agencies Provide Feedback on Second Round Resolution Plans of "First-Wave" Filers (Aug. 5, 2014), https://www.federalreserve.gov/newsevents/pressreleases/bcreg20140805a.htm.

[105] *Id. See also* Statement of the Board of Governors of the Federal Reserve System regarding the 2013 resolution plans filed by 11 large banking organizations (Aug. 5, 2014), https://www.federalreserve.gov/newsevents/press/bcreg/bcreg20140805-statement.htm.

[106] 12 U.S.C. § 5365(d)(4) & (5)(B).

[107] *See* Joint Press Release, *supra* note 104.

possession financing.[108]

In separate (nonpublic) letters to each of the 11 companies, the agencies detailed individual shortcomings in their 2013 plans and expectations for the 2015 plans. The agencies' press release indicated that among the actions that the agencies expected the companies to take was establishing a "rational and less complex" legal structure to improve resolvability, developing a holding company structure that supports resolvability, ensuring the continuity of shared services for critical operations during resolution, and demonstrating operational capabilities, such as the ability to produce reliable information in a timely manner, to facilitate the resolution process.[109] In addition to these structural and operational action points, the agencies also called upon the firms to take action on an industry-wide and individual-firm basis to amend their derivative and other financial contracts to provide for a stay of early termination rights triggered by insolvency proceedings.[110] This action item was in response to the widely perceived problems arising from the prospect of the immediate close-out and sale of collateral underlying financial contracts in the event of the initiation of a resolution proceeding.[111]

The individual "feedback" letters were much appreciated by the 11 companies. They would have been more appreciated, however, if they had been received sooner. By the time the letters were received, the 11 "first-wave" filers had already filed their third round of resolution plans in July 2014. With the FDIC at least having determined that the 2013 resolution plans for the "first-wave" filers were not credible and would not facilitate an orderly resolution under the Bankruptcy Code, much was now riding on the next submission of resolution plans in July 2015. Pressure on the Federal Reserve Board and the FDIC was increasing from certain Congressional quarters for a joint determination of non-credibility in the resolution plan exercise.

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[108] *See* Statement of Thomas M. Hoenig, Vice Chairman, FDIC, on the Credibility of the 2013 Living Wills Submitted by First Wave Filers (Aug. 5, 2014), https://www.fdic.gov/news/news/speeches/spaug0514a.html.

[109] *See* Joint Press Release, *supra* note 104.

[110] *Id.*

[111] As discussed in Part V of this article, in response to pressure from the Federal Reserve Board, the FDIC, and the Financial Stability Board, the International Swaps and Derivatives Association ("ISDA") announced in October 2014 that 18 of its major global bank members had agreed to enter into a resolution stay protocol for derivative transactions. Subsequently, in November 2015, ISDA announced an expansion of the 2014 stay protocol to cover securities financing transactions. The ISDA protocol provides for a temporary stay of certain early termination rights that would otherwise be triggered by insolvency or resolution events. For a discussion of the ISDA protocols, see *Part V*, *supra* note 5, at 445–48.

April 2016 Guidance and Determination Letters

A critical juncture in the resolution plan process was reached in April 2016 when the Federal Reserve Board and the FDIC announced their determinations on the resolution plans filed by the eight systemically important domestic banking institutions in July 2015.[112] The Federal Reserve Board and the FDIC jointly determined that the 2015 resolution plans of Bank of America, Bank of New York Mellon, JPMorgan Chase, State Street Corp., and Wells Fargo were not credible or would not facilitate an orderly resolution under the Bankruptcy Code.[113] Each of these firms was directed to provide a written submission by October 1, 2016 explaining how it would remediate the deficiencies identified in its individual "feedback" letter. In an added step for transparency, the Federal Reserve Board and the FDIC publicly released the "feedback" letters to the institutions detailing the deficiencies or shortcomings in the plans.

In addition to the individual "feedback" letters, the agencies also issued a detailed guidance document for these firms in preparing their 2017 resolution plans, with a particular eye on the likelihood that an SPOE strategy would be the preferred resolution strategy.[114] The guidance identified six key vulnerabilities that apply across resolution plans: capital; liquidity; governance mechanisms; operational; legal entity rationalization and separability; and derivative and trading activities.[115] The following discussion outlines the guidance on several of these key vulnerabilities.

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[112] *See* Joint Press Release, Board of Governors of the Federal Reserve System & Federal Deposit Insurance Corporation, Agencies announce determinations and provide feedback on resolution plans of eight systemically important, domestic banking institutions (Apr. 13, 2016), https://www.federalreserve.gov/newsevents/pressreleases/bcreg20160413a.htm. The eight domestic institutions are Bank of America, Bank of New York Mellon, Citicorp, Goldman Sachs, JPMorgan Chase, Morgan Stanley, State Street Corp., and Wells Fargo.

[113] The agencies identified weaknesses in the 2015 resolution plans of Goldman Sachs and Morgan Stanley, but did not make joint determinations regarding the plans and their deficiencies. Neither agency found that Citicorp's 2015 resolution plan was not credible or would not facilitate an orderly resolution. *Id*.

[114] *See* PWC, Regulatory brief: Single point of entry strategy ascends (July 2015), http://www.pwc.com/en-US/us/financial-services/regulatory-services/publications/assets/resolution-planning-2015-wave-1.pdf (noting that six of the eight systemically important domestic banks had adopted an SPOE strategy in their 2015 resolution plans).

[115] *See* Federal Deposit Insurance Corporation & Board of Governors of the Federal Reserve System, *Guidance for 2017 § 165(d) Annual Resolution Plan Submissions by Domestic Covered Companies that Submitted Resolution Plans in July 2015* (Apr. 2016), https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20160413a1.pdf [hereinafter *Guidance for 2017 Submissions*]. In 2017, the FDIC and the Federal Reserve Board issued a comparable guidance document for the four large foreign banking organizations that were "first-wave" filers. *See Guidance for 2018 § 165(d) Annual Resolution Plan Submissions by Foreign-based Covered Companies that Submitted*

Capital

The 2016 guidance document indicated that to help ensure that a firm's material subsidiaries can operate while the parent company is in bankruptcy, the firm should have an adequate amount of "loss-absorbing capacity." A firm would have to hold a minimum amount of total loss-absorbing capital, as well as a minimum amount of long-term debt, to help ensure that the firm has the capacity to recapitalize itself and its material subsidiaries on a consolidated basis (external TLAC).[116]

The guidance document further indicated that a firm's external TLAC should be complemented by appropriate positioning of additional loss-absorbing capacity within the corporate family (internal TLAC). The positioning of a firm's internal TLAC should seek to balance the certainty associated with pre-positioning internal TLAC directly at material subsidiaries with the flexibility provided by holding recapitalization resources at the parent level to meet unanticipated losses at material subsidiaries. That balance should take account of both pre-positioning at material subsidiaries and holding resources

Resolution Plans in July 2015 (Mar. 2017), https://www.federalreserve.gov/newsevents/press releases/files/bcreg20170324a21.pdf. The four large foreign banking organizations have each adopted a global SPOE strategy. They have also established a U.S. intermediate holding company as required by the Federal Reserve Board's prudential regulation implementing the Title I heightened prudential requirements. *See* 12 C.R.R. § 252.153. Although the Federal Reserve Board imposed the intermediate holding company requirement on foreign banks with large operations in the United States for prudential and supervisory reasons, the Federal Reserve Board recognized that an intermediate holding company would be relevant for resolution purposes and could be used to effect an SPOE strategy in the United States. The guidance document for the four large foreign banking organizations indicates that the U.S. resolution plan should address a scenario where the U.S. operations experienced material financial distress and the foreign parent is unable or unwilling to provide sufficient financial support for the continuation of the U.S. operations and as a result at least the U.S. intermediate holding company files for Chapter 11 bankruptcy.

[116] *See Guidance for 2017 Submissions*, *supra* note 115, at 4. The TLAC requirement was under active discussion by the Federal Reserve Board and the FDIC as early as 2013. *See, e.g.,* Governor Daniel K. Tarullo, *Toward Building a More Effective Resolution Regime: Progress and Challenges* 3 (Oct. 18, 2013) http://www.federalreserve.gov/newsevents/speech/-tarullo20131018a.htm (stating that the Federal Reserve Board would be issuing a proposal that would require the largest, most complex banking firms to hold a minimum amount of long-term, unsecured debt at the holding company level that could be converted into equity). The 2016 guidance itself refers to the TLAC proposal that the Federal Reserve Board published for comment in November 2015. *See* Total Loss-Absorbing Capacity, Long-Term Debt, and Clean Holding Company Requirements for Systemically Important U.S. Bank Holding Companies and Intermediate Holding Companies of Systemically Important Foreign Banking Organizations, 80 Fed. Reg. 74,926 (Nov. 30, 2015) (proposed rule). The Federal Reserve Board finalized the TLAC rule in December 2016. *See* 82 Fed Reg. 8,266 (Jan. 24, 2017) (final rule).

at the parent and the obstacles associated with each. Accordingly, the firm should not rely exclusively on either full pre-positioning or parent contributable resources to recapitalize any material subsidiary.[117]

To support the execution of the firm's resolution strategy, material subsidiaries would need to be recapitalized to a level that allows them to operate or be wound down in an orderly manner following the parent company's bankruptcy filing. The guidance document refers to this as the resolution capital execution need ("RCEN").[118] The firm should have a methodology for periodically estimating the amount of capital that may be needed to support each material subsidiary after the bankruptcy filing. The firm's positioning of internal TLAC should be able to support the RCEN estimates. In addition, the RCEN estimates should be incorporated into the firm's governance framework to ensure that the parent company files for bankruptcy at a time that enables execution of the preferred strategy.

The firm's RCEN methodology should use conservative forecasts for losses and incorporate estimates of potential additional capital needs through the resolution period, consistent with the firm's resolution strategy. The RCEN methodology should be calibrated so that recapitalized subsidiaries have sufficient capital to maintain market confidence as required under the preferred resolution strategy. Capital levels should meet or exceed all applicable regulatory capital requirements for well-capitalized status and meet estimated additional capital needs throughout the resolution period.[119]

Liquidity

The 2016 guidance document also stated that a firm should have the liquidity capabilities necessary to execute its preferred resolution strategy. For resolution purposes, these capabilities would include having an appropriate model and process for estimating and maintaining sufficient liquidity at or readily available to material entities and a methodology for estimating the liquidity needed to successfully execute the resolution strategy.[120]

The firm should be able to measure the stand-alone liquidity position of each material entity—*i.e.*, the high-quality liquid assets ("HQLA") at the material entity less net outflows to third parties and affiliates—and ensure that liquidity is readily available to meet any deficits. The model to measure this needs to

[117] *Guidance for 2017 Submissions*, *supra* note 115, at 4 5.

[118] *Id.* at 5.

[119] *Id.* at 6.

[120] *Id.*

cover a period of at least 30 days and reflect the idiosyncratic liquidity profile and risk of the firm. The model should ensure that the parent holding company holds sufficient HQLA (inclusive of its deposits at the U.S. branch of the lead bank subsidiary) to cover the sum of all stand-alone material entity net liquidity deficits. The stand-alone net liquidity position of each material entity (HQLA less net outflows) should be measured using the firm's internal liquidity stress test assumptions and should treat inter-affiliate exposures in the same manner as third-party exposures. For example, an overnight unsecured exposure to an affiliate should be assumed to mature. Finally, the firm should not assume that a net liquidity surplus at one material entity could be moved to meet net liquidity deficits at other material entities or to augment parent resources.[121]

The firm should also have a methodology for estimating the liquidity needed after the parent's bankruptcy filing to stabilize the surviving material subsidiaries and to allow those entities to operate post-filing, which the guidance refers to as resolution liquidity execution need ("RLEN").[122] The RLEN estimate should be incorporated into the firm's governance framework to ensure that the firm files for bankruptcy in a timely way, *i.e.*, prior to the firm's HQLA falling below the RLEN estimate. The firm's RLEN methodology should:

(i) estimate the minimum operating liquidity ("MOL") needed at each material entity to ensure those entities could continue to operate post-parent's bankruptcy filing and/or to support a wind-down strategy;

(ii) provide daily cash flow forecasts by material entity to support estimation of peak funding needs to stabilize each entity under resolution;

(iii) provide a comprehensive breakout of all inter-affiliate transactions and arrangements that could impact the MOL or peak funding need estimates; and

(iv) estimate the minimum amount of liquidity required at each material entity to meet the MOL and peak needs noted above, which would inform the firm's board of directors of when they need to take resolution-related actions.[123]

The peak funding need estimates should be projected for each material entity and cover the length of time the firm expects it would take to stabilize that

[121] *Id.* at 7.

[122] *Id.*

[123] *Id.* at 8.

material entity. The firm's forecasts of MOL and peak funding needs should ensure that material entities could operate post-filing consistent with regulatory requirements, market expectations, and the firm's post-failure strategy. These forecasts should inform the RLEN estimate, *i.e.*, the minimum amount of HQLA required to facilitate the execution of the firm's strategy. The RLEN estimate should be tied to the firm's governance mechanisms to assist the board of directors in taking timely resolution-related actions.[124]

Governance Mechanisms

The guidance also directs the firms to develop governance playbooks designed to ensure that the board of directors take timely action to facilitate the preferred strategy for resolution, including identified triggers for specific actions, such as the recapitalization of subsidiaries prior to the parent company's bankruptcy filing and the execution of a bankruptcy filing, first-day orders and emergency relief motions such as those relating to the implementation of the ISDA Universal Resolution Stay Protocol.[125]

The guidance focuses particular attention on the legal considerations that will underlie the orderly resolution process, such as pre-bankruptcy parent support to its material subsidiaries. The 2016 guidance also indicates that the resolution plan should include a detailed legal analysis of the potential state law and bankruptcy law challenges and mitigants to the planned provision of capital and liquidity to the subsidiaries prior to the parent holding company's bankruptcy filing.[126] The guidance document focuses on the key issues to the success of an SPOE strategy which is largely dependent upon the provision of capital and liquidity support by the parent company to its operating subsidiaries. The analysis should identify potential legal obstacles and explain how the firm would seek to ensure that capital and liquidity support would be provided as planned. Legal obstacles would include claims of fraudulent transfer, preference, breach of fiduciary duty, and any other applicable legal theory identified by the firm. The analysis also should include related claims that may prevent or delay an effective recapitalization, such as equitable claims to enjoin the transfer (*e.g.*, imposition of a constructive trust by the court). The analysis should apply the actions contemplated in the plan regarding each element of the claim, the anticipated timing for commencement and resolution of the claims, and the extent to which adjudication of such claim could affect execution of the firm's preferred resolution strategy.

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[124] *Id.*

[125] *Id.* 9–10 & 15.

[126] *Id.* at 10–11.

The analysis should also include mitigants to the potential legal challenges to the planned capital or liquidity support. In identifying appropriate mitigants, the firm should consider the effectiveness of a contractually binding mechanism ("CBM"), pre-positioning of financial resources in material entities, and the creation of an intermediate holding company. Moreover, if the plan includes a CBM, the firm should consider whether it is appropriate that the CBM should have the following: (i) clearly defined triggers; (ii) triggers that are synchronized to the firm's liquidity and capital methodologies; (iii) perfected security interests in specified collateral sufficient to fully secure all support obligations on a continuous basis (including mechanisms for adjusting the amount of collateral as the value of obligations under the agreement or collateral assets fluctuate); and (iv) liquidated damages provisions or other features designed to make the CBM more enforceable.[127]

The 2016 guidance marked a critical juncture in the Title I resolution plan process because it reflected an expanded focus on the predicates for a successful SPOE strategy, such as the financial and legal ability of a holding company to provide capital and liquidity support to its material operating subsidiaries. Some of these predicates were being implemented through regulatory requirements such as the TLAC and clean holding company rules and the QFC stay rule promulgated by the Federal Reserve Board. Some of the predicates were also being implemented in response to the 2016 guidance, such as the CBM approach or the intermediate holding company approach. These particular predicates were necessary to insulate the capital and liquidity support for the operating subsidiaries from legal challenges in a Bankruptcy Code process.

Operational and Other Continuity Issues

The 2016 guidance also describes a range of operational matters that must be addressed, such as arrangements to facilitate continued access to financial market utilities, to track collateral sources and uses, and to ensure continuity of shared and outsourced services.[128] It also outlines the requirements for a dealer firm's plan to stabilize, wind-down or novate its derivatives portfolios.

Expanded Public Sections

The guidance directed the companies to expand the public section of their resolution plan filing in the interest of providing more information and greater transparency to the public at large. The guidance indicated that in their public section the companies should broadly explain how they addressed any deficiencies, shortcomings and other vulnerabilities identified by the agencies.

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[127] *Id.* at 11.

[128] *Id.* at 12–17.

The companies should also provide a high-level discussion of their liquidity resources and loss-absorbing capacity. This was a further step in the efforts of the agencies to increase the transparency of the resolution planning process. The agencies recognized that the markets were interested in better understanding the status of actions taken by the largest companies in making themselves more resilient to financial stress.

December 2016 Determinations

In December 2016, the FDIC and the Federal Reserve Board announced that Bank of America, Bank of New York Mellon, JPMorgan Chase and State Street had adequately remedied the deficiencies in their 2015 resolution plans identified in the separate feedback letters that each had received in April 2016.[129] Consistent with their practice of increasing the public transparency of the resolution planning process, the agencies also publicly released their feedback letters to each of the firms, which discussed at a high level the corrective actions taken by the firms.

The FDIC and the Federal Reserve Board also announced that Wells Fargo had not adequately remedied certain of the deficiencies in its 2015 resolution plan identified in its April 2016 feedback letter. The FDIC and the Federal Reserve Board determined pursuant to the resolution plan rule to impose two restrictions on Wells Fargo pending the adequate remediation of the deficiencies in its 2015 resolution plan: neither Wells Fargo nor any subsidiary would be permitted to establish a foreign bank or a foreign branch, and neither Wells Fargo nor any subsidiary would be permitted to acquire any nonbank subsidiary.[130] This was a significant step and the first time that the FDIC and the Federal Reserve Board used their joint authority under the resolution plan rule to impose restrictions on an institution for its failure to remediate a deficiency. Wells Fargo was directed to file a revised submission addressing the remaining deficiencies in its resolution plan by March 31, 2017.[131] On April 24, 2017, the FDIC and the Federal Reserve Board announced that the March 31, 2017 resubmission by Wells Fargo adequately remedied the remaining deficiencies in its 2015 resolution plan and that Wells Fargo was therefore relieved of the restrictions imposed in the agencies' December 2016 letter.[132]

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[129] *See* Joint Press Release, Board of Governors of the Federal Reserve System & Federal Deposit Insurance Corporation, Agencies announce determinations on October resolution plan submissions of five systemically important domestic banking institutions (Dec. 13, 2016), https://www.federalreserve.gov/newsevents/pressreleases/bcreg20161213a.htm.

[130] *Id.*

[131] *Id.*

[132] *See* Joint Press Release, Board of Governors of the Federal Reserve System & Federal

December 2017 Determinations

In December 2017, the FDIC and the Federal Reserve Board announced their determinations on the resolution plans filed by the eight systemically important U.S. bank holding companies in July 2017.[133] Citing the "significant progress" made by these institutions in recent years, the agencies announced that they had not found any "deficiencies," *i.e.*, weaknesses severe enough to trigger a resubmission process, in any of the eight submissions. The agencies did jointly determine that the submissions from four firms (Bank of America, Goldman Sachs, Morgan Stanley and Wells Fargo) had some "shortcomings" (which are less severe weaknesses than "deficiencies") that would require further work in the next round of plan submissions in July 2019.[134] The agencies also announced that they were exploring ways to improve the resolution process such as extending the cycle for filing from annual to once every two years.

January 2018 Feedback to Foreign Banks

In January 2018, the Federal Reserve Board and the FDIC released feedback letters to 19 foreign banks with respect to their resolution plans submitted in December 2015.[135] The feedback letters reflected a significant easing of the requirements for the plans that these banks were scheduled to file in December 2018. Eleven of the foreign bank organizations with total U.S. non-branch assets of less than $50 billion were permitted to file "reduced" plans.[136] The

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Deposit Insurance Corporation, Agencies announce Wells Fargo has remediated resolution plan deficiencies (April 24, 2017), https://www.federalreserve.gov/newsevents/pressreleases/bcreg20170424a.htm.

[133] *See* Joint Press Release, Board of Governors of the Federal Reserve System & Federal Deposit Insurance Corporation, Agencies announce joint determinations for living wills (Dec. 19, 2017), https://www.federalreserve.gov/newsevents/pressreleases/bcreg20171219a.htm.

[134] *Id*.

[135] Press Release, Board of Governors of the Federal Reserve System, Agencies complete assessment of resolution plans of 19 foreign-based banks (Jan. 29, 2018), https://www.federalreserve.gov/newsevents/pressreleases/bereg20180129a.htm. In December 2018, the Federal Reserve Board and the FDIC released feedback letters to the four large foreign banking organizations (with $250 billion or more in U.S nonbank assets) based on the resolution plans that they had filed in July 2018. The agencies noted meaningful improvements over the resolution plans filed by these foreign banking organizations in July 2015. *See* Joint Press Release, Federal Reserve and FDIC announce resolution plan determinations for four foreign-based banks and finalize guidance for eight domestic banks (Dec. 20, 2018), https://www.federalreserve.gov/newsevents/pressreleases/bcreg20181220c.htm.

[136] In 2016 the Federal Reserve Board and the FDIC had allowed foreign banking organizations with less than $50 billion in total U.S. assets to file "reduced" plans. *See* Joint Press Release, Agencies permit reduced content resolution plan submissions for firms with limited U.S. operations (June 10, 2016), https://www.federalreserve.gov/newsevents/pressreleases/bcreg20160610a.

other eight were permitted to file "limited" plans, which required more information than a "reduced" plan, but significantly less than the requirements previously applicable to them. The trend line from the Federal Reserve Board and the FDIC was now firmly established in the direction of easing the filing requirements for institutions other than the eight systemically important U.S. banking organizations and the four foreign banking organizations with the largest U.S. operations.

June 2018 Agency Request for Comments

In June 2018 the Federal Reserve Board and the FDIC released for public comment proposed guidance for the resolution plans to be filed by the eight systemically important U.S. bank holding companies in 2019.[137] The proposed guidance is based in large part on the prior guidance document issued in 2016 by the agencies, but with greater specificity provided in the areas of derivatives and trading activities and payment, clearing and settlement activities. This was the first time that the agencies asked for public comment before issuing guidance on the resolution plan process.[138] The public comment process was undertaken in response to a recommendation that the Treasury Department made in a general report on bank regulatory policies and practices issued in June 2017.[139] That report made several recommendations for improving the resolution plan process. One recommendation was that the agencies should improve the guidance process itself. The principal criticism of the guidance process in the Treasury Report was the following:

> The slow accretion of guidance for living wills without the benefit of public notice and comment has imposed an undue burden on participating institutions. Living wills' thresholds of participation should be more appropriately tailored to the size and complexity of banks' business models and not serve as supplemental capital and liquidity regulatory guidance requirements. Current guidance has

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htm. The January 2018 action extended the benefit of a reduced plan to a foreign banking organization with less than $50 billion in total U.S. non-branch assets as distinguished from total U.S. assets.

[137] *See* Resolution Planning Guidance for Eight Large, Complex U.S. Banking Organizations, 83 Fed. Reg. 32,856 (July 16, 2018).

[138] Industry groups took the opportunity to file extensive comments on the proposed guidance. *See*, *e.g.*, Letter from the Bank Policy Institute and the Securities Industry and Financial Markets Association to the Federal Reserve Board and FDIC (Sept. 14, 2018).

[139] *See* Department of the Treasury, *A Financial System That Creates Economic Opportunities: Banks and Credit Unions* (2017) at 66–68, https://www.treasury.gov/press-center/press-releases/Documents/A%20Financial%20System.pdf.

> required the pre-positioning of excess amounts of liquidity and capital by requiring banks to pre-fund a bankruptcy through the Resolution Liquidity Execution Need (RLEN) and Resolution Adequacy and Positioning (RLAP) standards.[140]

The Treasury said that, going forward, resolution guidance should only be issued after notice and public comment. In perhaps a more controversial vein, the Treasury also recommended that Title I of the Dodd-Frank Act be amended to remove the FDIC from the resolution plan process entirely.[141] Such a change in the Dodd-Frank Act is now most unlikely because of the control that the Democrats gained in the House of Representatives after the November 2017 election. The Treasury also recommended that the $50 billion asset threshold in the resolution plan requirement be adjusted.[142] That result was subsequently achieved with the enactment of the EGRRCPA. The Treasury report also recommended that the agencies formalize the existing practice of requiring resolution plans on a two-year cycle rather than the one-year cycle provided in the regulation.[143]

Prospective Changes

Further changes to the resolution plan process are in the offing. In remarks addressed to an industry conference in November 2018, the newly appointed Chairman of the FDIC discussed the progress made in resolution planning under the Title I resolution plan rule and under the separate FDIC resolution plan rule for insured depository institutions with total assets of $50 billion or more.[144] She confirmed that the Federal Reserve Board and the FDIC are reviewing the Title I resolution plan rule and expect to publish for public comment a proposal to amend the rule. She also indicated that the FDIC is planning to issue an advance notice of proposed rulemaking with respect to its

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[140] *Id*. at 68 (footnote omitted).

[141] *Id*.

[142] *Id*. at 67.

[143] *Id*. In December 2018, the Federal Reserve Board and the FDIC finalized the resolution plan guidance that they had published for comment in June 2018. *See* Joint Press Release, Federal Reserve and FDIC announce resolution plan determinations for four foreign- based banks and finalize guidance for eight domestic banks (Dec. 20, 2018), https://www.federalreserve.gov/newsevents/pressreleases/bcreg20181220c.htm. The final guidance was generally similar to the proposed guidance issued in June 2018 with the indication that further guidance in the areas of resolution liquidity and internal loss absorbing capacity would be issued in the future.

[144] Jelena McWilliams, Chairman, FDIC, Keynote Remarks at the 2018 Annual Conference of the Clearing House (TCH) and Bank Policy Institute (BPI) (Nov. 28, 2018), https://www.fdic.gov/news/news/speeches/spnov2818.html.

separate resolution plan rule for insured depository institutions, including revisiting the $50 billion asset threshold in that rule.[145] The proposed changes will also be designed to tailor the rule more appropriately to reflect differences in the size, complexity, and risk of the insured depository institution.

The Federal Reserve Board in October 2018 published a proposed rule to implement the changes made by the EGRRCPA to the $50 billion asset threshold in Title I.[146] The proposed rule does not address the change in the $50 billion asset threshold in section 165(d) of Title I. The notice of proposed rulemaking indicates that the Federal Reserve Board intends to seek public comment on a proposal to address the applicability of the resolution plan requirement to firms with total consolidated assets in the range of $100 billion to $250 billion.[147] The notice of proposed rulemaking indicates that the Federal Reserve Board is working with the FDIC to amend the Title I resolution plan rule to adjust the scope and applicability of the resolution plan requirements for companies that remain subject to the resolution plan requirement. There have been indications that the agencies are considering implementing the provisions of the EGRRCPA by removing most firms with assets between $100 billion and $250 billion entirely from the resolution plan regime.[148] This would mean that perhaps as few as 13 domestic bank holding companies would remain subject to the Title I resolution plan requirement. It is currently unclear how the Federal Reserve Board and the FDIC might modify the resolution plan requirements applicable to foreign banking organizations.

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[145] *Id*. *See supra* note 97 for background on the FDIC resolution plan rule for insured depository institutions. The focus of the resolution plan requirement for insured depository institutions with $50 billion or more in total assets differs to some extent from the focus of the Title I resolution plan requirement. The principal focus of the Title I resolution plan is addressing the systemic risk presented by the failure of a large bank holding company and its subsidiaries (or a designated nonbank financial company and its subsidiaries). The principal focus of the insured depository institution resolution plan is limiting the risk to the Deposit Insurance Fund in the event of a failure of a large insured depository institution. Accordingly, the asset threshold considerations for resolution plans may differ between Title I resolution plans and FDIA resolution plans.

[146] *See* Prudential Standards for Large Bank Holding Companies and Savings and Loan Holding Companies, 83 Fed. Reg. 61,408 (Nov. 29, 2018) (proposed rule).

[147] 83 Fed. Reg. at 61,410.

[148] *See*, *e.g.*, Randal K. Quarles, Vice Chairman for Supervision, Federal Reserve Board, Getting It Right: Factors for Tailoring Supervision and Regulation of Large Financial Institutions (July 18, 2018). https://www.federalreserve.gov/newsevents/speech/quarles20180718a.htm.

BANKRUPTCY REFORM PROPOSALS

Background

The requirement in Title I that large bank holding companies produce a credible plan for an orderly resolution under the Bankruptcy Code has had important consequences. As noted above, it has resulted in significant changes in the structure and operations of U.S. bank holding companies, particularly the eight systemically important bank holding companies. It has also produced pressure for changes to the Bankruptcy Code to facilitate its use in an orderly resolution of a large U.S. bank holding company, including changes to support an SPOE approach in bankruptcy. Although some commentators have argued that Title II is unnecessary and perhaps even pernicious, other commentators have argued that the Bankruptcy Code is not well suited to resolving a large financial institution in an orderly fashion.[149] Many bankruptcy scholars and practitioners have concluded that amendments to the Bankruptcy Code are needed to make it more "competitive" with the Title II SPOE strategy for use in resolving a large complex financial institution.[150]

A resolution working group at the Hoover Institution spearheaded an effort in 2009 to develop a new chapter to the Bankruptcy Code for financial institutions in the hope of heading off the enactment of a special resolution regime like that in Title II.[151] After Title II was enacted, the working group continued to promote amendments to the Bankruptcy Code in the hope of avoiding the use of Title II through the availability of an enhanced Bankruptcy Code alternative. In 2010 the Hoover Institution working group released a bankruptcy proposal for financial institutions described as "Chapter 11F".[152] The Hoover Institution working group continued to refine its proposal and released a revised proposal for a new Chapter 14 in 2012.[153] Even as the Hoover

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[149] *See Part V*, *supra* note 5, at 409–13 for a discussion of the contrasting views on the need for Title II and the problems with a bankruptcy process for large financial companies.

[150] *See*, *e.g.*, 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" 22 (Kenneth F. Scott et al. eds., Hoover Institution Press 2015).

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

[152] *See* 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).

[153] *See* Thomas H. Jackson, *Bankruptcy Code Chapter 14: A Proposal*, *in* BANKRUPTCY NOT

Institution working group was refining its proposal for a new Chapter 14, the FDIC itself was breaking new ground in the development of the SPOE strategy. In 2015 the Hoover Institution working group released a further revision of its Chapter 14 proposal, which was expanded to reflect an SPOE strategy.[154] The Hoover Institution working group was worried that without a clear mechanism for an SPOE approach 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."[155]

A bankruptcy bill for financial institutions introduced in the Senate in 2013 and again in 2015 included provisions to reflect the core elements of an SPOE strategy as a proposed Chapter 14 to the Bankruptcy Code.[156] The core elements of an SPOE strategy have also been included in the House versions of a bankruptcy bill for financial institutions as a new subchapter V to Chapter 11.[157] These provisions for a new subchapter V passed the House on a voice vote as H.R. 5421 in 2014, H.R. 2947 in 2016, and H.R. 1667 in 2017.[158] The House Report accompanying H.R. 1667 describes its intended purpose as follows:

> H.R. 1667 allows the debtor holding company that sits atop the financial firm's corporate structure to transfer its assets, including the equity in all of its operating subsidiaries, to a newly-formed bridge company over a single weekend.. . . Furthermore, the subchapter V "single point of entry" approach allows all of the financial institution's operating subsidiaries to remain out of the bankruptcy process.[159]

Bailout: A Special Chapter 14 (Kenneth E. Scott & John B. Taylor eds., Hoover Institution Press 2012).

[154] *See* Jackson, *supra* note 150.

[155] *Id.* at 22.

[156] S. 1861, 113th Cong. (2013); S. 1840, 114th Cong. (2015). As noted above, S. 1861 and S. 1840 besides incorporating an SPOE provision also included a repeal of Title II of the Dodd-Frank Act.

[157] The House Report accompanying H.R. 1667 explains that the advantage of adding a subchapter V to Chapter 11, instead of a new Chapter 14, is that it ensures that other provisions of Chapter 11 remain fully applicable, together with all existing case law. H.R. Rep. No. 115-80, at 3–4 (2017).

[158] *See supra* note 13. For a detailed discussion of the efforts to develop a new chapter or subchapter of the Bankruptcy Code for financial institutions, see Paul L. Lee, *Bankruptcy Alternatives to Title II of the Dodd-Frank Act—Part I*, 132 Banking L. J. 437 (2015) & *Part II*, 132 Banking L. J. 503 (2015).

[159] H.R. Rep. No. 115-80, at 4–5 (2017) (footnote omitted).

Summary of the Proposed Subchapter V to Chapter 11 in H.R. 1667

Availability

The proposed subchapter V to Chapter 11, as reflected in H.R. 1667, is specifically designed for handling the bankruptcy of financial companies. Subchapter V of Chapter 11 would be available only to a "covered financial corporation," which is defined to mean a corporation organized under federal or state law that is

(i) a bank holding company as defined in the Bank Holding Company Act of 1956 (the "BHCA"); or

(ii) a corporation that exists for the primary purpose of owning, controlling and financing its subsidiaries, that has total consolidated assets of $50 billion or more, and that has

(a) annual gross revenues from activities that are financial in nature (as defined in the BHCA), and if applicable, from the ownership or control of one or more insured depository institutions, representing 85 percent or more of its consolidated annual gross revenues; or

(b) consolidated assets related to activities that are financial in nature and, if applicable, from the ownership or control of one or more insured depository institutions, representing 85 percent or more of its consolidated assets.[160]

The significance of this definition is that it includes all bank holding companies, while it covers a nonbank financial company (otherwise meeting the financial activity test based on gross revenues or assets) only if the company also has $50 billion or more in assets. The Treasury Report notes that even as to bank holding companies, the reason for commencing a Chapter 14 case (rather than a standard Chapter 11 case) would be to use the expedited provision for the transfer of property of the estate to a bridge company.[161] The test in Chapter 14 (as well as in H.R. 1667) for the approval of a transfer to a bridge company is that the transfer is necessary to "prevent serious adverse effects on financial stability in the United States." As the Treasury Report indicates, the incorporation of a systemic risk test in the transfer provision of Chapter 14 means that most bank holding companies with assets of less than $50 billion (and many with assets of more than $50 billion) probably would not qualify for

[160] H.R. 1667 § 2(a) (proposed 11 U.S.C. § 101(9A)).

[161] *Treasury Report*, *supra* note 17, at 52.

a successful use of Chapter 14 because they do not present systemic risk.[162] As a matter of consistency, however, the Treasury Report suggests that the $50 billion asset threshold for nonbank financial companies be eliminated.[163]

Commencement of the Case

A case under subchapter V may be commenced under section 1183(a) of H.R. 1667 only by a filing of a petition by a covered financial corporation.[164] The filing of the petition by the covered financial corporation constitutes an order for relief under the subchapter, similar to filing a voluntary petition under other chapters of the Bankruptcy Code. Earlier versions of the bankruptcy bill provided that the Federal Reserve Board could also commence a case against a covered financial corporation under subchapter V.[165] That provision has been dropped from the more recent House versions of the bankruptcy bill such as H.R. 1667.

Section 1183(c) includes a special exculpation provision for the filing of a petition. It provides that the members of the board of directors of a covered financial corporation would have no liability to shareholders, creditors, or other parties in interest, for a good faith filing of a petition to commence a case under subchapter V or for any reasonable action taken in good faith contemplation of such a petition or a transfer under section 1185 or section 1186, whether prior to or after commencement of the case. This provision has been the source of some controversy.[166] The provision has a partial antecedent in section 207 of Title II, which exculpates the members of a board for acquiescing in or consenting in good faith to the appointment of the FDIC by the Secretary of the Treasury as receiver for a company.[167] A proponent for this exculpation

[162] *Id*. Similarly, many bank holding companies will not have established the structural and financial prerequisites such as TLAC that would enable them to use an SPOE strategy in a bankruptcy case. The regulatory TLAC requirement is applicable only to the eight systemically important U.S. bank holding companies and to the U.S. intermediate holding companies of certain systemically important foreign banking organizations.

[163] *Id*.

[164] H.R. 1667 § 3 (proposed 11 U.S.C. § 1183(a)).

[165] *See* H.R. 5421 § 3 (proposed 11 U.S.C. § 1183(a)(2)). *See also* S. 1861 § 4 (proposed 11 U.S.C. § 1403).

[166] *See, e.g.*, Mark J. Roe & David A. Skeel, Jr., *Bankruptcy for Banks: A Sound Concept That Needs Fine-Tuning*, N.Y. Times (Aug. 16, 2016), https://www.nytimes.com/2016/08/17/business/dealbook/bankruptcy-for-banks-a-sound-concept-that-needs-fine-tuning.html (criticizing the breadth of the exculpation provision).

[167] 12 U.S.C. § 5387. Title II can only be invoked by the Secretary of the Treasury, but the company can challenge the appointment of the FDIC as receiver by the Secretary in court. 12

provision in H.R. 1667 might suggest that the exculpation for a filing by the debtor is appropriate in the bankruptcy case because of the specter that the board might be forced into a subchapter V filing by a threat from regulatory authorities that they would otherwise invoke Title II. An opponent of this provision would argue that for its own reasons a board would find a bankruptcy proceeding under subchapter V to be far preferable to a Title II proceeding.[168] The idea for an exculpation provision in the bankruptcy bill seems to have originated with the National Bankruptcy Conference. In a comment letter on S. 1861, the National Bankruptcy Conference recommended that a "narrowly crafted" exculpation of the board and management be provided in light of the "extraordinary" transfer provision in the bill that would allow a wholesale transfer of assets to a bridge company "without legally required approvals under constituent documents, exchange rules and state laws requiring shareholder approval and the like."[169] The scope of exculpation in 1183(c) may nonetheless be broader than the "narrowly crafted" relief contemplated by the National Bankruptcy Conference.

Section 1183(d) requires the debtor's counsel to provide as much advance confidential notice as practicable (but without disclosing the identity of the potential debtor) to the chief judge of the court of appeals for the circuit embracing the district in which the counsel intends to file a petition to commence a case under subchapter V. The chief judge of the circuit will then randomly assign a bankruptcy judge from among a group of bankruptcy judges previously designated by the Chief Justice of the United States. The House Report on H.R. 1667 explains optimistically that this advance notice will allow the designated bankruptcy judge "time to prepare for the weekend bankruptcy proceedings."[170]

Standing for Regulators

Section 1184 provides that the Federal Reserve Board, the Securities and

U.S.C. § 5382. To incentivize the members of the board not to mount such a challenge, Title II exculpates the directors for acquiescing or consenting in good faith to the appointment of the FDIC by the Secretary.

[168] *See H.R. 1667, The Financial Institution Bankruptcy Act of 2017: Hearing Before the Subcomm. on Regulatory Reform, Commercial and Antitrust Law of the House Comm. on the Judiciary*, 115th Cong. 10 (2017) (statement of Stephen E. Hessler supporting the exculpation provision) & 12 (statement of Bruce Grohsgal opposing the exculpation provision).

[169] Letter from the National Bankruptcy Conference to Senator John Cornyn & Senator Pat Toomey (Jan. 29, 2014), *in Exploring Chapter 11 Reform: Corporate and Financial Institution Insolvencies; Treatment of Derivatives: Hearing Before the Subcomm. on Regulatory Reform, Commercial & Antitrust Law of the House Comm. on the Judiciary*, 113th Cong. 60, 64 (2014).

[170] H.R. Rep. No. 115-80, at 16 (2017).

Exchange Commission (the "SEC"), the Office of the Comptroller of the Currency (the "OCC"), the Commodity Futures Trading Commission (the "CTFC"), the FDIC and the Treasury Department have standing to appear and be heard on any issue in a subchapter V bankruptcy case.

Transfer to a Bridge Company

The objective of the bankruptcy measure for financial companies is to replicate the speed and efficiency that are thought to characterize the Title II SPOE resolution mechanism. This objective requires several core provisions to accommodate the special circumstances of a failing financial company. The first such provision is for a "quick sale" mechanism to allow the transfer of assets and certain liabilities of the failing company to a new bridge company over a "resolution weekend." Section 1185(a) provides an expedited process for the transfer of property of the estate as a modification to the standard provisions in section 363 of the Bankruptcy Code.[171] Section 1185(a) provides that upon the request of the trustee and after notice and a hearing that may occur not less than 24 hours after the order for relief, the court may order a transfer of property of the estate and the assignment of executory contracts, unexpired leases, and QFCs of the debtor to a bridge company. This transfer is expected to occur within 48 hours of the time of the filing of the case to obtain the benefit of another provision in the bill that provides for a 48-hour stay against the acceleration and close-out of the QFCs of the debtor and its affiliates. Unless otherwise ordered by the court, electronic or telephonic notice of the request to make a transfer must be given at least 24 hours before the hearing to the holders of the 20 largest secured claims against the debtor, the holders of the 20 largest unsecured claims against the debtor, and the counterparties to any debt, executory contract, unexpired lease, and QFC proposed to be transferred.[172] Notice must also be provided to (i) the Federal Reserve Board, the FDIC, the

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[171] The provisions of section 363 would apply to a transfer and assignment made under section 1185 except as otherwise modified by the provisions of section 1185. H.R. 1667 § 3 (proposed 11 U.S.C. § 1185(a)). Section 365 on the other hand would not apply to a transfer made under section 1185, 1187 or 1188. H.R. 1667 § 3 (proposed 11 U.S.C. § 1181).

[172] H.R. 1667 § 3 (proposed 11 U.S.C. § 1185(b)(2) (4)). The challenge of providing on such a short timetable notice to every counterparty to any debt, executory contract, unexpired lease, and QFC proposed to be transferred to the bridge company may be made more practicable by the TLAC and clean holding company requirements applicable to the eight systemically important U.S. bank holding companies. These requirements generally prevent the top-tier holding companies from issuing any short-term debt or QFCs to third parties and restrict the amount of other general creditor claims that the top-tier holding company may incur. *See Part V, supra* note 5, at 440–47 for a discussion of the TLAC and clean holding company requirements.

OCC, the CFTC, the SEC, the Secretary of the Treasury, and the United States trustee or bankruptcy administrator, and (ii) the primary financial regulatory agency for any affiliate the equity securities of which are to be transferred to the bridge company.[173] Such expedited relief is significantly faster than what is otherwise available under section 363 of the Bankruptcy Code, permitting a sale to be consummated over a resolution weekend before the financial markets reopen.[174]

Under section 1185(c) the court may order the transfer only if it makes a number of specified findings (on the basis of a preponderance of the evidence),[175] the principal of which are that (i) the transfer is necessary to prevent serious adverse effects on U.S. financial stability; (ii) the transfer does not provide for the assumption of any "capital structure debt" by the bridge company;[176] (iii) the trustee has demonstrated that the bridge company is not likely to fail to meet its obligations on any debt, executory contract, QFC or unexpired lease assumed by the bridge company; and (iv) the bridge company will have governing documents and initial directors and senior officers that are in the best interest of the creditors and the estate. Certain of these required determinations, particularly the first and the third, call for the exercise not simply of factual determination but also of financial judgment. The Treasury Report itself recognizes the difficulty facing a bankruptcy judge in making the first determination, *i.e.*, that the transfer is necessary to prevent serious adverse effects on U.S. financial stability, and recommends that the judge be permitted simply to rely on a determination by the Federal Reserve Board on this

[173] H.R. 1667 § 3 (proposed 11 U.S.C. § 1185(b)(5) (11)).

[174] While the Lehman Brothers bankruptcy sale was approved a mere five days after the petition date, the bankruptcy judge specifically noted that Lehman "could never be deemed a precedent for future cases . . . ." *See* Sept. 19, 2008, Hr'g Tr. at 251:25, *In re Lehman Brothers Holdings, Inc.*, No. 08-13555 (Bankr. S.D.N.Y.) [Dkt. No. 6715].

[175] By way of contrast, section 363 of the Bankruptcy Code requires a debtor to demonstrate an "articulated business justification" for approving a sale outside of the ordinary course of business based on a variety of factors, but there are no specific findings required. *See In re Lionel Corp.*, 722 F.2d 1063 (2d Cir. 1983).

[176] The term "capital structure debt" is defined in H.R. 1667 to mean any unsecured debt of the debtor for borrowed money to which the debtor is the primary obligor other than a QFC and other debt secured by a lien on property of the estate that is to be transferred to the bridge company pursuant to the court order. H.R. 1667 § 3 (proposed 11 U.S.C. § 1182(3)). The term is intended to encompass the long-term debt issued by systemically important bank holding companies pursuant to the Federal Reserve Board TLAC rule. The exclusion of any "capital structure debt" from the transfer of the assets and certain other liabilities of the debtor to the bridge company is what makes that debt "loss absorbing" and what allows the bridge company to the capitalized.

point.[177] One can foresee that the third determination, *i.e.*, that the bridge company is not likely to fail to meet its obligations on any debts or contracts assumed by the bridge company, might also present a challenge for a judge to make on an expedited basis.[178] This determination, however, may be made somewhat more manageable by the TLAC and clean holding requirements applicable to the eight systemically important U.S. bank holding companies. As noted above, these requirements generally prevent those eight entities from issuing any short-term debt or entering into any QFCs with third parties and restrict the amount of other general creditor claims that the top-tier holding company may incur.

Section 1185 specifically provides that upon the entry of an order approving the transfer, any property transferred and any contracts, leases, and QFCs assigned to the bridge company will no longer be property of the estate.[179] This is an important provision because, when read in conjunction with section 1186 discussed below, it appears to exclude from bankruptcy court jurisdiction much of what happens after the actions of the resolution weekend.

Appointment of the Special Trustee

One of the other determinations that must be made under section 1185(c) is that the transfer order provides for the appointment of a special trustee and for a transfer to a special trustee of all the equity securities of the bridge company.[180] These mechanics are provided in section 1186. Section 1186(a)(1) provides that the court must appoint a qualified and independent special trustee to hold in trust for the sole benefit of the estate all the equity securities of the bridge company.[181] Pursuant to section 1186(a)(1) the court must also approve a trust agreement to govern the newly formed trust which is to exist for the sole purpose of holding, administering and ultimately disposing of the equity securities of the bridge company. In connection with the hearing to approve a

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[177] The National Bankruptcy Conference made a comparable recommendation in its comment letter on S. 1861. *See supra* note 169.

[178] The Hoover Institution working group suggested that the test should be whether the bridge company provides adequate assurance of future performance of the contracts, the test in section 365(f)(2) of the Bankruptcy Code. *See* Jackson, *Building on Bankruptcy*, *supra* note 150, at 52. The drafters of H.R. 1667 have chosen what appears to be a milder formulation than an "adequate assurance" test. As discussed below, section 1187(c) does incorporate an adequate assurance test for the assignment to the bridge company of any contract of the debtor that is in default (other than a default under an ipso facto clause).

[179] H.R. 1667 § 3 (proposed 11 U.S.C. § 1185(a)).

[180] H.R. 1667 § 3 (proposed 11 U.S.C. § 1185(c)(7)).

[181] H.R. 1667 § 3 (proposed 11 U.S.C. § 1186(a)(1)).

transfer under section 1185, the trustee must confirm to the court that the Federal Reserve Board has been consulted regarding the identity of the proposed special trustee and advise the court of the results of the consultation.

Section 1186(b) provides certain basic requirements for the trust agreement. These requirements include quarterly reporting by the special trustee to the court, as well as a notice filing with the court by the special trustee of:

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

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

(iii) any material corporate action of the bridge company, including recapitalization, material borrowing, termination of an intercompany debt or guarantee, transfer of a substantial portion of the assets of the bridge company, or issuance or sale of any securities of the bridge company.[182]

The trust agreement must also provide that a sale of any equity securities of the bridge company may not be consummated until the special trustee consults with the FDIC and the Federal Reserve Board regarding the sale and discloses the results of the consultation to the court.[183]

Although the trust agreement must provide for notice on these matters to the court, section 1186 does not assign any specific role to the court relating to the notice or consultation. Under section 1186(c), the special trustee is required to distribute the assets held in trust, if the court confirms a plan in the case, in accordance with the plan, or if the case is converted to a case under Chapter 7, as ordered by the court. Section 1186(d) states that after the transfer to the special trustee of all the equity securities of the bridge company, the special trustee shall be subject only to applicable nonbankruptcy law and that the actions and conduct of the special trustee shall no longer be subject to approval by the bankruptcy court.[184] The special trustee will presumably exercise control and oversight of the operations of the bridge company pending distribution of the equity securities of the bridge company in accordance with the provisions of section 1186(c).

Stay of Executory Contracts

The Lehman Brothers bankruptcy highlighted the prospects for a massive acceleration and close-out of financial contracts when a large financial

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[182] H.R. 1667 § 3 (proposed 11 U.S.C. § 1186(b)(2)–(3)).

[183] H.R. 1667 § 3 (proposed 11 U.S.C. § 1186(b)(4)).

[184] H.R. 1667 § 3 (proposed 11 U.S.C. § 1186(d)).

institution files for bankruptcy protection. The Bankruptcy Code's automatic stay and other protections are not applicable to a broad set of financial contracts, including derivatives and repurchase agreements. As discussed in Part V of this article, in response to the Lehman Brothers experience in bankruptcy, special provisions were included in Title II to address QFCs.[185] Title II provides that a counterparty on a QFC is stayed for one business day from exercising any termination, liquidation or netting right arising solely by reason of or incidental to the appointment of the FDIC as receiver for the failed company or the insolvency or financial condition of the company.[186] This one-business-day stay is intended to facilitate the transfer of the QFC book of business over a "resolution weekend" to a bridge financial company or theoretically even to a third-party acquirer if such an acquirer could be found.

Title II also contains another special provision that authorizes the FDIC as receiver to enforce certain contracts of subsidiaries or affiliates of a covered financial company notwithstanding cross-default clauses in the contracts. Title II provides that the FDIC as receiver has the power to enforce contracts of subsidiaries or affiliates of the covered financial company, the obligations of which are guaranteed, supported by or "linked" to the covered financial company, notwithstanding any contractual right to terminate, liquidate or accelerate such contracts based solely on the insolvency, financial condition or receivership of the covered financial company, (i) if the guaranty or other support and related assets and liabilities are transferred to and assumed by a bridge financial company or other third party within the same period of time covered by the stay on the close-out rights on the QFCs of the covered financial company, or (ii) if the FDIC as receiver otherwise provides adequate protection with respect to the obligations.[187] This provision is designed to address the concern with cross-default and acceleration rights that would otherwise permit the close-out and liquidation of these contracts against the subsidiary or affiliate. The exercise of such cross-default rights against subsidiaries and affiliates of the covered financial company is perceived to be disruptive to an orderly resolution process of the covered financial company and to present

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[185] *Part V*, *supra* note 5, at 410–13, 425-26, & 430–31.

[186] 12 U.S.C. § 5390(c)(10)(B). The one-business-day stay included in Title II is based on a similar one-business-day stay contained in the FDIA for the receivership of insured depository institutions. 12 U.S.C. § 1821(e)(10)(B). The FDIA also originated the term "qualified financial contract." *See* 12 U.S.C. § 1821(e)(8)(D)(i).

[187] 12 U.S.C. § 5390(c)(16). The FDIC has broadly construed this statutory provision in its regulations implementing Title II. *See* 12 U.S.C. § 380.12. *See also* Enforcement of Subsidiary and Affiliate Contracts by the FDIC as Receiver of a Covered Financial Company, 77 Fed. Reg. 63,205 (Oct. 16, 2012).

potential systemic risk through a fire sale of collateral by counterparties of the subsidiaries and affiliates. It would also be inconsistent with the theory of an SPOE resolution which is intended to preserve and protect the continuing operations of the subsidiaries and affiliates of the holding company from the effects of the resolution of the holding company.

H.R. 1667 deals with the issues presented by existing exceptions from the automatic stay in section 362 of the Bankruptcy Code in two sections: section 1187 relating to contracts other than QFCs and section 1188 relating to QFCs. Section 1187(a) provides a 48-hour stay of termination, acceleration or modification rights under any debt, executory contract or unexpired lease of the debtor or any affiliate, based solely on a default by the debtor or a provision in the debt, contract, lease, or agreement that is conditioned on:

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

(ii) the commencement of a case under title 11 concerning the debtor;

(iii) the appointment of or taking possession by a trustee in a case under title 11 concerning the debtor; or

(iv) a credit rating agency rating or absence or withdrawal of a credit rating agency rating of the debtor, an affiliate for 48 hours after commencement of the case, the bridge company while the special trustee is the direct or indirect beneficial owner of more than 50 percent of the equity securities of the bridge company, or an affiliate while the special trustee is the direct or indirect beneficial owner of more than 50 percent of the equity securities of the bridge company.[188]

The temporary stay provision in section 1187 differs from the stay in Title II in at least two respects. First, the section 1187 temporary stay applies to a contract right that arises from any default by the debtor, presumably including a payment default. In contrast, the temporary stay in Title II applies to a contract right that arises solely by reason of or incidental to the appointment of the FDIC as receiver or the insolvency or financial condition of the company. Second, the section 1187 temporary stay treats a credit agency rating or absence or withdrawal of a credit rating in the same manner as other ipso facto events listed in section 365(e)(1).[189]

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[188] H.R. 1667 § 3 (proposed 11 U.S.C. § 1187(a)(1)).

[189] Section 365(e)(1) does not expressly include credit agency ratings in its list of ipso facto events. 11 U.S.C. § 365(b)(2). In adopting its rule to implement the stay provision contained in Title II, the FDIC staff indicated that a change in a credit rating of a covered financial company

Under section 1187 the stay for the benefit of the debtor terminates upon the earliest of:

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

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

(iii) a final order denying a request for a transfer under section 1185; or

(iv) the time the case is dismissed.[190]

Under section 1187, the stay for the benefit of an affiliate terminates upon the earliest of:

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

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

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

(iv) the time the case is dismissed.[191]

The applicability of sections 1187 and 1188 to affiliates of the debtor is noteworthy, because the Bankruptcy Code generally only protects debtors and not their affiliates. In this respect, sections 1187 and 1188 follow the precedent set in Title II, which as noted above extends protections to certain affiliate contracts.[192]

Section 1187(b) provides that a debt, executory contract (other than a QFC), unexpired lease, or agreement under which the debtor has issued or is obligated for any debt may be assumed by a bridge company in a transfer under section 1185 notwithstanding any provision in the agreement or in applicable nonbankruptcy law that (i) prohibits, restricts, or conditions the assignment; or (ii) accelerates, terminates or modifies the debt, contract, lease, or agreement on

would be encompassed within the meaning of the term "financial condition" for purposes of the Title II stay provision. *See* 77 Fed. Reg. 63,205, 63,207 (Oct. 16, 2012). Under this reading by the FDIC staff, the stay provision in Title II would be consistent with the approach taken in section 1187.

[190] H.R. 1667 § 3 (proposed 11 U.S.C. § 1187(a)(3)(A)).

[191] H.R. 1667 § 3 (proposed 11 U.S.C. § 1187(a)(3)(B)).

[192] 12 U.S.C. § 5390(c)(16).

account of the assignment or on account of a change of control of any party to the debt, contract, lease, or agreement.[193] This provision generally parallels provisions in Title II that authorize the FDIC as receiver to transfer any asset or liability to a bridge company or other acquirer without obtaining any approval, assignment, or consent with respect to the transfer.[194] It facilitates the transfer of assets and assumption of liabilities by a bridge company over a resolution weekend.

Section 1187(c) supplements the other provisions in section 1187 by providing that a debt, contract, lease or other agreement of the debtor may not be accelerated, terminated or modified as to the bridge company solely because of an ipso facto provision or a provision that prohibits, restricts, or conditions the assignment or that accelerates, terminates, or modifies the debt, contract, lease, or agreement on account of the assignment or a change of control of any party to the debt, contract, lease, or agreement.[195] It further provides that if the debtor is in default under any other provision of a debt, contract, lease, or agreement, the bridge company may assume the debt, contract, lease or agreement only if the bridge company (i) cures the default, (ii) compensates or provides adequate assurance that it will promptly compensate any party for any actual pecuniary loss to the party resulting from the default, and (iii) provides adequate assurance of future performance under the debt, contract, lease or agreement.[196] This provision generally replicates the provision in section 365(b) of the Bankruptcy Code for the assumption of an executory contract and unexpired lease on which there has been a default by the debtor.[197]

Stay of QFCs

Recognizing that QFCs have special features that require different treatment from other executory contracts, section 1188(a) separately deals with the treatment of QFCs to which the debtor or an affiliate is a party. It overrides various safe harbor provisions in the Bankruptcy Code and provides for a 48 hour stay of the exercise of a contractual right:

(i) to cause the modification, liquidation, termination, or acceleration of a QFC of the debtor or an affiliate;

(ii) to offset or net out any termination value, payment amount, or other

[193] H.R. 1667 § 3 (proposed 11 U.S.C. § 1187(b)).

[194] 12 U.S.C. § 5390(a)(1)(G)(i) & (h)(2)(E)(ii).

[195] H.R. 1667 § 3 (proposed 11 U.S.C. § 1187(c)(1)).

[196] H.R. 1667 § 3 (proposed 11 U.S.C. § 1187(c)(2)).

[197] 11 U.S.C. § 365(b)(1).

transfer obligation arising under or in connection with a QFC of the debtor or an affiliate; or

(iii) under any security agreement or arrangement or other credit enhancement forming a part of or related to a QFC of the debtor or an affiliate.[198]

Under section 1188(b), during the stay period the trustee or the affiliate must perform all payment and delivery obligations under the QFC of the debtor or the affiliate, as the case may be, that become due after the commencement of the case.[199] Any failure by the counterparty to perform any payment or delivery of obligation under the QFC, including during the pendency of the stay, constitutes a breach of the QFC by the counterparty.[200]

Section 1188(c) contains additional protections for counterparties to the extent that a QFC is proposed to be assigned to and assumed by a bridge company. Section 1188(c) provides that a QFC between an entity and the debtor may be assigned to and assumed by the bridge company under section 1185 only if all the QFCs between the same entity and the debtor are assigned to and assumed by the bridge company, all claims by the entity against the debtor under the QFCs are assigned and assumed by the bridge company, all claims of the debtor against the entity on the QFCs are assigned to and assumed by the bridge company, and all property securing or other credit enhancement related to the QFCs provided by the debtor is assigned to and assumed by the bridge company.[201] These provisions provide greater protection to the counterparty on a QFC than would be available under the other provisions in the Bankruptcy Code. As noted in the House Report on H.R. 1667, these provisions are specifically intended to protect counterparties from the risk of the debtor "cherry picking" among the QFCs it has with a particular counterparty for purposes of the transfer.[202] Section 1188(c) essentially parallels a provision in Title II that provides the same protections to a counterparty on a QFC with a company that is in a proceeding under Title II.[203]

Section 1188(d) provides that a QFC of the debtor that is assumed or assigned in a transfer under section 1185 may not be accelerated, terminated, or modified after the entry of the order approving the transfer, and any right or

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[198] H.R. 1667 § 3 (proposed 11 U.S.C. § 1188(a)).

[199] H.R. 1667 § 3 (proposed 11 U.S.C. § 1188(b)(1)).

[200] H.R. 1667 § 3 (proposed 11 U.S.C. § 1188(b)(2)).

[201] H.R. 1667 § 3 (proposed 11 U.S.C. § 1188(c)).

[202] H.R. Rep. No. 115–80, at 8 (2017).

[203] 12 U.S.C. § 5390(c)(9).

obligation under the QFC may not be accelerated, terminated, or modified solely because of an ipso facto clause relating to the debtor or a clause that prohibits, restricts, or conditions the assignment or that relates to a change of control other than a condition that occurs after the property of the estate no longer includes a direct or indirect beneficial interest through the special trustee in more than 50 percent of the equity securities of the bridge company.[204]

Section 1188(e) provides that an agreement of an affiliate, including an executory contract, unexpired lease, QFC or agreement under which the affiliate has issued or is obligated for debt, may not be accelerated, terminated, or modified solely because of an ipso facto clause relating to the debtor or a clause that prohibits, restricts or conditions the assignment or that relates to a change of control, if all the direct and indirect interests in the affiliate that are property of the estate are transferred to the bridge company within 48 hours of the commencement of the case and the bridge company assumes any guarantee or other credit enhancement issued by the debtor relating to the agreement of the affiliate as well as any obligation in respect of setoff, netting arrangement, or debt of the debtor directly arising out of or relating to the guarantee or credit arrangement.[205] Any property of the estate that directly serves as collateral for the guarantee or credit enhancement must also be transferred to the bridge company.

Section 1188 is in several respects broader than the contractual stays provided by the ISDA protocols. For example, section 1188 would operate as a stay with respect to direct defaults as well as cross-defaults. Section 1188(a) would prevent a counterparty (including a central counterparty) from terminating QFCs with an affiliate of a party that entered into a bankruptcy proceeding as long as the affiliate continued to perform its payment and delivery obligations under the QFC. In contrast, the ISDA protocols generally permit counterparties of an affiliate of a debtor in resolution to exercise default rights under QFCs based on the affiliate's own entry into resolution, even if the affiliate continues to meet payment and delivery obligations. Furthermore, the ISDA protocols generally do not stay central counterparties from exercising any of their contractual default rights.[206] The import of the special provisions for QFCs in Title II and in H.R. 1667 has been somewhat diminished by the

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[204] H.R. 1667 § 3 (proposed 11 U.S.C. § 1188(d)).

[205] H.R. 1667 § 3 (proposed 11 U.S.C. § 1188(e)).

[206] It is possible that the stay provisions in section 1188 might be deemed to be preempted by the provisions of 12 U.S.C. § 4404, which protect the rights of a "clearing organization" to terminate, liquidate, accelerate and net financial contracts with a failed financial institution in accordance with the rules of the clearing organization.

adoption of Federal Reserve Board's clean holding company requirement, which generally prevents the eight systemically important U.S. bank holding companies and the U.S. intermediate holding companies of systemically important foreign banking organizations from entering into QFCs with third parties.[207]

Licenses, Permits and Registrations

To facilitate the continued operation of the bridge company and the subsidiaries assigned to the bridge company, section 1189(a) provides that in connection with a transfer of property under section 1185, any federal, state or local license, permit or registration that the debtor *or* any affiliate had immediately before the commencement of the case and that is proposed to be transferred under section 1185 may not be accelerated, terminated, or modified at any time after the transfer solely on account of:

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

(ii) the commencement of a case under title 11 concerning the debtor;

(iii) the appointment of or taking possession by a trustee in a case under title 11 concerning the debtor; or

(iv) a transfer under section 1185.[208]

Section 1189(b) further provides that any federal, state, or local license, permit, or registration that the debtor had immediately before the commencement of the case included in the transfer under section 1185 "shall be valid and all rights and obligations thereunder shall vest in the bridge company."[209] The House Report on H.R. 1667 explains that section 1189 overrides all nonbankruptcy laws to prevent the termination or modification of any federal, state or local license, permit, or registration that the debtor or an affiliate had immediately before the commencement of the case based solely on any of the specified ipso facto events.[210]

Exemption from Securities Laws

Section 1190 clarifies that with respect to section 1145 of the Bankruptcy Code (which exempts the offer or sale of securities from certain federal, state

[207] *See* Part V, *supra* note 5, at 442–45 for a discussion of the clean holding company requirement. The import of the stay provisions in Title II and in R.R. 1667 is undiminished, however, in their application to cross-default provisions in QFCs entered into by the subsidiaries of a holding company subject to the clean holding company requirement.

[208] H.R. 1667 § 3 (proposed 11 U.S.C. § 1189(a)).

[209] H.R. 1667 § 3 (proposed 11 U.S.C. § 1189(b)).

[210] H.R. Rep. No. 115-80, at 20 (2017).

and local laws requiring the registration of the offer or sale if it occurs under a plan), a bridge company's security will be deemed to be the security of the debtor's successor under a plan if the court approves the disclosure statement as providing adequate information (as defined in 1125(a)) about the bridge company and the security.[211]

Inapplicability of Avoiding Powers

As discussed in Part V, the SPOE strategy envisions that a top-tier holding company will support the financial operations of its operating subsidiaries by providing additional capital or funding to those subsidiaries prior to or upon the top-tier company filing for bankruptcy protection. This capital and funding support from the top-tier holding company is essential to the continued operation of the subsidiaries and to forestall the need for these operating subsidiaries to seek bankruptcy protection of their own. As the SPOE strategy was originally envisioned under Title II, the FDIC as receiver would transfer virtually all the assets of the top-tier holding company, consisting principally of the shares of the operating subsidiaries and loans due to the holding company from the operating subsidiaries, to a new bridge company. Virtually all the liabilities of the top-tier holding company, consisting principally of subordinated debt and long-term unsecured debt issued to third parties and specifically designed to the loss-absorbing, would be left behind in the receivership. The effect of these actions would be to create at least on paper a strongly capitalized bridge company because it is projected that many more assets than liabilities would be transferred from the failing firm to the bridge company.

The other step would be for the top-tier holding company (or the bridge company) to recapitalize as necessary the operating subsidiaries by contributing assets to the subsidiaries or by converting existing debt obligations due from the subsidiaries to the top-tier holding company (or the bridge company as its successor) into equity in the operating subsidiaries. The conversion of the intercompany debt into equity nominally recapitalizes the operating subsidiaries and in effect allows the losses incurred at the operating subsidiaries to be absorbed by the subordinated and long-term unsecured debt previously issued by the top-tier company. (It should be noted that the conversion of debt into equity at the level of the operating subsidiary may nominally recapitalize the operating subsidiary, but it does not provide funding to the operating subsidiary.)

The recapitalization of the operating subsidiaries shortly before or upon filing for bankruptcy by the top-tier holding company presents potential

[211] H.R. 1667 § 3 (proposed 11 U.S.C. § 1190).

problems such as under the fraudulent conveyance and voidable preference provisions of the Bankruptcy Code. Conscious of these issues, the Federal Reserve Board and the FDIC have directed the systematically important U.S. bank holding companies to implement strategies and structures designed to mitigate the risks of challenges to the recapitalization of their operating subsidiaries in an SPOE resolution. As discussed above, in guidance issued in April 2016, the Federal Reserve Board and the FDIC directed the firms to hold a minimum amount of total loss-absorbing capital as well as long-term debt (external TLAC) to ensure that the firms have sufficient capacity to meet the recapitalization needs on a consolidated basis. A firm's external TLAC should be complemented by appropriate positioning of loss-absorbing capacity within the firm (internal TLAC). The 2016 guidance provides that the resolution plan should include a detailed legal analysis of the potential state law and bankruptcy law challenges and mitigants to the planned provision of capital and liquidity funding to the subsidiaries prior to or upon the top-tier holding company's bankruptcy filing. The 2016 guidance also directs the firms to take steps to insulate the capital and liquidity support actions against legal challenge. One step is to create an intermediate holding company without third-party creditors who otherwise would have standing to challenge actions that the intermediate holding company takes to downstream support to the operating subsidiaries. Another step is to use a CBM that includes a perfected security interest to secure support obligations to the operating subsidiaries and a liquidated damages provision.

The drafters of the bankruptcy reform provisions for financial institutions also recognized the problems that might be presented by the SPOE strategy. Section 1191 in the proposed subchapter V provides a broad exclusion from the avoidance powers in sections 544, 547, 548(a)(1)(B) and 549 of the Bankruptcy Code (or under any similar nonbankruptcy law) for any transfer or obligation incurred by the debtor to an affiliate prior to or after the commencement of the case, including any obligation released by the debtor or the estate to or for the benefit of an affiliate, in contemplation of or in connection with a transfer under section 1185.[212] This provision is intended *inter alia* to protect the conversion of internal TLAC debt into equity at the level of the operating subsidiaries of the debtor and other support payments made to the operating subsidiaries. It provides an express protection from the avoidance powers of the Bankruptcy Code and state law that the Federal Reserve Board and FDIC guidance also sought to achieve by specific prepositioning and structural means outlined in the 2016 guidance. This provision

[212] H.R. 1667 § 3 (proposed 11 U.S.C. § 1191).

provides finality and clarity to the parties that are involved in the sale and related restructuring by precluding the avoidance or clawback of prepetition transactions. Some commentators have, however, objected to the breadth of the protections provided in section 1191.[213]

Consideration of Financial Stability

Section 1192 provides that the court may consider the effect that any decision made in connection with subchapter V may have on financial stability in the United States.[214] Section 1185 already expressly requires the court to analyze the effect of the resolution of the firm on financial stability in the United States.

Bankruptcy Panel

Providing the necessary expertise for a speedy bankruptcy court process for large financial institutions has preoccupied the sponsors of the bankruptcy reform process. Section 4 of H.R. 1667 provides that the Chief Justice of the United States will designate not fewer than 10 bankruptcy judges to be available to hear a case under subchapter V of Chapter 11.[215] It is presumably envisioned that the designated bankruptcy judges will, to the extent necessary, be tutored in the complexities of the operation of large financial institutions and the financial system itself so that they are in a better position to act upon a bankruptcy filing over a "resolution weekend."[216] As noted above in the discussion of section 1183, the chief judge of the court of appeals for the circuit embracing the district in which the case is going to be filed will assign a designated bankruptcy judge to the case. As also noted above, the provisions of section 1186 state that after the transfer to the special trustee of the equity interests in the bridge company, the bankruptcy court would have no jurisdiction over the special trustee or the bridge company. Section 4 of H.R. 1667 amends section 1334 of title 28 to confirm that after a transfer order has been approved under section 1185, a district court would likewise not have jurisdiction over any proceeding related to a special trustee appointed, or to a

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[213] *See H.R. 1667, The Financial Institution Bankruptcy Act of 2017: Hearing Before the Subcomm. on Regulatory Reform, Commercial and Antitrust Law of the House Comm. on the Judiciary*, 115th Cong. (2017) (written testimony of Bruce Grohsgal), https://judiciary.house.gov/legislation/hearings/hr-financial-institution-bankruptcy-act-2017.

[214] H.R. 1667 § 3 (proposed 11 U.S.C. § 1192).

[215] H.R. 1667 § 4(a) (proposed 28 U.S.C. § 298).

[216] The National Bankruptcy Conference has suggested that the Federal Judicial Center might be used to provide training to the designated panel of bankruptcy judges. *See supra* note 169.

bridge company formed, in connection with a case under subchapter V.[217]

Senate Consideration of a Proposed Chapter 14

The Senate Judiciary Committee resumed consideration of a bankruptcy bill for financial institutions under the title of the Taxpayer Protection and Responsible Resolution Act in November 2018.[218] The draft of the bill considered at the hearing differs from the versions of the bill introduced in the Senate in 2013 and 2015 in not providing for a repeal of Title II. The other substantive provisions in the draft bill for the most part parallel the provisions in H.R. 1667. The current draft bill differs from H.R. 1667 in providing authority for the Federal Reserve Board to initiate an involuntary case against global systemically important U.S. bank holding companies (of which there are currently eight).[219] It also seeks to refine the scope of the exculpation provision for the members of the board of a company that initiates a voluntary case.[220]

CONCLUSION

The resolution plan provision in Title I of the Dodd-Frank Act and the Orderly Liquidation Authority provision in Title II promise to reshape the resolution of large banking organizations in the United States. Although separate in original conception, the Title I resolution plan requirement and the Title II Orderly Liquidation Authority in implementation have been mutually reinforcing. Resolution plans under Title I have provided significant insights to the challenges of managing a resolution not only under the Bankruptcy Code, but also under Title II. At the same time the development of the SPOE strategy under Title II has been fully extended to resolution planning under Title I and the Bankruptcy Code.

The SPOE strategy is widely recognized as a significant breakthrough in resolution planning. The SPOE strategy has been accompanied by developmental work on the predicates for an SPOE resolution, such as a TLAC requirement and a clean holding company requirement. The SPOE strategy together with the TLAC and clean holding company requirements are now fully integrated into the resolution planning process under the Bankruptcy Code and

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[217] H.R. 1667 § 4(b) (proposed 28 U.S.C. § 1334(f)).

[218] *See Big Bank Bankruptcy: 10 Years After Lehman Brothers: Hearing Before the S. Comm. on the Judiciary*, 115th Cong. (2018), https://judiciary.senate.gov/meetings/big-bank-bankruptcy-10-years-after-lehman-brothers.

[219] *Id.* (statement of Stephen E. Hessler discussing the provision authorizing the Federal Reserve Board to initiate a bankruptcy case).

[220] *Id.* (statement of Stephen E. Hessler discussing the exculpation provision).

Title II. It is important to recognize, however, that the SPOE strategy still represents a thought experiment, albeit a very robust thought experiment. As the Chairman of the FDIC has recently noted, SPOE in bankruptcy remains untested.[221] By the same token, Title II also remains untested. Notwithstanding the significant actions taken by the agencies and the firms themselves to facilitate an SPOE strategy, the success of an SPOE strategy under the Bankruptcy Code or under Title II is dependent certain factors, such as the reaction of the creditors and customers of the operating subsidiaries, that cannot be tested in advance.

The Federal Reserve Board and the FDIC have prompted significant improvements in the resolvability of the largest bank holding companies through the Title I resolution plan process. The Federal Reserve Board and the FDIC have used their authority under the Title I resolution plan rule to require contractual "work-arounds" for resolution problems. For instance, in their 2014 guidance the Federal Reserve Board and the FDIC called upon the largest banking institutions to take action on an industry-wide basis to amend their QFCs to provide a temporary stay of early termination rights triggered by insolvency proceedings. This contractual work-around was intended to address the lack of any stay on the acceleration and close-out of QFCs under the Bankruptcy Code. This contractual work-around was subsequently incorporated into regulation by the Federal Reserve Board. As another example, in their 2016 guidance the Federal Reserve Board and the FDIC called upon the largest banking institutions to implement a work-around in the form of a CBM that provides for a perfected security interest and a liquidated damages provision. These contractual provisions are intended to protect the capital and liquidity support measures for the operating subsidiaries from possible legal challenge under the Bankruptcy Code or state law. The provisions in the bankruptcy bills for financial institutions such as H.R. 1667 are intended to address the contractual work-arounds that have been used to deal with problems such as the lack of a temporary stay on QFCs or the risk of legal challenge to the downstreaming of capital and liquidity support to the operating subsidiaries of the holding company in a bankruptcy proceeding. It would be desirable as a statutory matter to address these potential issues and more broadly to confirm and facilitate the use of an SPOE strategy in bankruptcy through the enactment of a bill like H.R. 1667.

Several caveats are nonetheless in order even if a bankruptcy bill like H.R. 1667 were to be enacted. First, enactment of a bankruptcy bill for financial institutions cannot substitute for the need to retain Title II as a backstop or

[221] *See supra* note 144.

even frontstop to a bankruptcy process. As the Treasury Report acknowledges, one of the most significant challenges to the resolution of a large financial company in a bankruptcy process is the availability of sufficient private financing to fund its operations and the operations of its material subsidiaries.[222] As the Treasury Report recognizes, Title II contains a funding mechanism that can be used to stabilize a resolution of a large firm, particularly if significant customer "runs" occur at the operating subsidiaries. Perhaps the greatest unknown in an SPOE resolution is how the creditors and customers of the operating subsidiaries will respond to the resolution actions taken over the weekend. To cope with the risks presented by this unknown, the Treasury Report recommends that Title II with its funding authority (subject to several proposed changes) be retained as an option of last resort.[223]

Another significant unknown is how the regulators of the foreign subsidiaries will respond to the weekend resolution of a large U.S. banking organization under the Bankruptcy Code. It has been assumed that foreign regulators will have more confidence in a Title II resolution process administered by their U.S. regulatory peers than in a bankruptcy process administered by an unfamiliar judge.[224] One of the challenges recognized by the Treasury Report is establishing robust coordination with foreign regulators in advance of any bankruptcy process to minimize the risk that the foreign regulators will feel compelled to intervene and ring-fence the operations of the U.S. firm in their country.[225] The concern among foreign regulators in relying on an unfamiliar bankruptcy process would be compounded by the lack of any government liquidity backstop in a bankruptcy process (unlike the situation in a Title II process). For this reason as well, the Treasury Report recommends the retention of Title II as a backstop.

The final caveat is perhaps the most important. Neither Title II nor an enhanced Bankruptcy Code is designed to address the effects of a pandemic crisis like that of 2008. Both Title II and an enhanced Bankruptcy Code approach represent a response only on the micro level. Even on the micro level, the failure of a number of large financial institutions close in time would strain the capacity of the bankruptcy courts and the regulators to respond. In any event a pandemic crisis requires a response on the macro level, including broad-based liquidity support measures for the financial system as a whole as the Treasury and the regulators mounted in 2008. Ironically, the Dodd-Frank

[222] *Treasury Report*, *supra* note 17, at 2 and 27–25.

[223] *Id.* at 27–28.

[224] *Id.* at 22.

[225] *Id.* at 22–23.

Act has imposed additional constraints on the ability of the Treasury and the Federal Reserve Board to design future support measures in response to a pandemic crisis.[226] These constraints introduce yet another unknown to the analysis of the options that will be available to the government in the next financial crisis.[227]

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[226] *See*, *e.g.*, John L. Walker, *Emergency Tools to Contain a Financial Crisis*, 35 Rev. Banking & Fin. L. 672 (2015) (critiquing the constraints imposed by the Dodd-Frank Act on federal emergency assistance programs).

[227] *See, e.g.* Glenn Hubbard & Hal Scott, *A Financial System Still Dangerously Vulnerable to a Panic: The Federal Reserve's powers to act as lender of last resort need to be restored and strengthened*, Wall St. J., March 1, 2015, http://www.wsj.com/articles/glenn-hubbard-and-hal-scott-a-financial-system-still-dangerously-vulnerable-to-a-panic-1425249064; Ben S. Bernanke, Fed emergency lending (Dec. 3, 2015), https://www.brookings.edu/blog/ben-bernanke/2015/12/03/fed-emergency-lending/.