STATEMENT OF

THOMAS H. JACKSON

DISTINGUISHED UNIVERSITY PROFESSOR & PRESIDENT EMERITUS

UNIVERSITY OF ROCHESTER

BEFORE

THE SUBCOMMITTEE ON FINANCIAL INSTITUTIONS

AND CONSUMER PROTECTION

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

UNITED STATES SENATE

WASHINGTON, D.C.

JULY 29, 2015

THE ROLE OF BANKRUPTCY REFORM

IN ADDRESSING TOO-BIG-TO-FAIL

Thank you for inviting me to testify today. I am Thomas Jackson, Distinguished University Professor and President Emeritus at the University of Rochester. Prior to moving to the University of Rochester, I was a professor of law, specializing in bankruptcy, at Stanford, Harvard, and the University of Virginia schools of law. I am the author of a Harvard Press book, *The Logic and Limits of Bankruptcy Law*, a bankruptcy casebook, and numerous articles on bankruptcy law. Recently, my work in the field of bankruptcy has focused on the use of bankruptcy in resolving systemically important financial institutions (SIFIs). In that capacity, I was co-chair of a Bipartisan Policy Center working group that produced, in May of 2013, *Too Big to Fail: The Path to a Solution*. I have also been, since 2008, a member of the Hoover Institution's Resolution Project, which has produced three books discussing how bankruptcy can be made more effective in terms of the resolution of SIFIs (the most recent one, *Making Failure Feasible*, is in the final publication process). And, since 2013, I have been a member of the Federal Deposit Insurance Corporation's (FDIC's) Systemic Resolution Advisory Committee. I am here today in my individual capacity, and the views I express are my own, not those of any group or organization with which I am affiliated.

I am a firm believer that the Bankruptcy Code, with a few significant changes, can be made an important player in the resolution of SIFIs and that *both* bankruptcy law *and* the Dodd-Frank Act can be made more effective as a result. Before discussing those changes, however, I believe it is important to set out, briefly, (a) the relationship envisioned between the Dodd-Frank Act and bankruptcy law, (b) the current status of the major alternative to bankruptcy—the Orderly Liquidation Authority (OLA) of Title II of the Dodd-Frank Act, (c) why bankruptcy law, without statutory changes, is likely to be inadequate in terms of fulfilling what virtually everyone believes should be its role, and (d) why this creates problems both for the Dodd-Frank Act's Title I provisions for resolution plans under Section 165(d)—so-called "Living Wills"—as well as for its OLA provisions under Title II. After setting out that important backdrop, I will discuss, at a somewhat abstract level, the core of changes that I would suggest be implemented in the Bankruptcy Code in order to make it the primary resolution mechanism, even in light of the FDIC's development of "single-point-of-entry" (SPOE) as its presumptive method of implementing OLA under Title II of the Dodd-Frank Act, thus fulfilling the intent of both Title I and Title II of that Act. A full set of changes I might recommend—including provisions that might be "nice but not necessary"—is discussed in my contribution to *Making Failure Feasible*, a copy of which is attached to this Statement as an Appendix.

The Relationship Envisioned Between the Dodd-Frank Act and Bankruptcy Law

In two key places, the Dodd-Frank Act envisions bankruptcy as the preferred mechanism for the resolution of SIFIs. The first occurs in Title I, with the provision for resolution plans under Section 165(d). Covered financial institutions are required to prepare, for review by the Board of Governors of the Federal Reserve System (Federal Reserve Board or FRB), the Financial Stability Oversight Council, and the FDIC, "the plan of such company for rapid and orderly resolution in the event of material financial distress or failure . . . ."[1] If the Federal Reserve Board and the FDIC jointly determine

[1] Dodd-Frank Act § 165(d)(1).

that a submitted resolution plan "is not credible or would not facilitate an orderly resolution of the company under title 11, United States Code" (*i.e.*, the Bankruptcy Code), the company needs to resubmit a plan "with revisions demonstrating that the plan is credible, and would result in an orderly resolution under title 11, United States Code . . . ."[2] The failure to submit a plan that meets these tests can lead to restrictions, and divestiture, "in order to facilitate an orderly resolution of such company under title 11, United States Code . . . ."[3] For present purposes, the important point is that effective resolution plans are tested against bankruptcy law, *not* OLA under Title II of the Dodd-Frank Act. It therefore goes without saying—but is worth saying nonetheless—that the effectiveness of bankruptcy law in being able to resolve SIFIs is critically important to the development of credible resolution plans under Title I.[4]

Indeed, first-round resolution plans were uniformly rejected as inadequate. The eight U.S. Global Systemically Important Banks (G-SIBs) filed revised plans within the past month; most of them propose a SPOE resolution strategy, keyed off of the FDIC's work for resolution under the Dodd-Frank Act's Title II OLA, and which, in my view, would be awkwardly implemented—perhaps not impossible, but difficult—under today's Bankruptcy Code, for reasons I will discuss.

The second occurs in the context of the ability to initiate the OLA process under Title II of the Dodd-Frank Act. Invocation of Title II itself can only occur if the

[2] Dodd-Frank Act, § 165(d)(4)
[3] Dodd-Frank Act, § 165(d)(5)(A) & (B).
[4] See William F. Kroener III, *Revised Chapter 14 2.0 and Living Will Requirements under the Dodd-Frank Act*, in Kenneth E. Scott, Thomas H. Jackson and John B. Taylor (eds.), MAKING FAILURE FEASIBLE: HOW BANKRUPTCY REFORM CAN END "TOO BIG TO FAIL" (Hoover Institution Press 2015).

government regulators find that bankruptcy is wanting.[5] That is, by its own terms, bankruptcy is designed by the Dodd-Frank Act to be the preferred resolution mechanism.[6] The FDIC has announced that it supports the idea that bankruptcy, not OLA, should be the presumptive resolution procedure.[7] The ability of bankruptcy law to fulfill its intended role as the presumptive procedure for resolution, of course, turns on the effectiveness of bankruptcy law in rising to the challenge of accomplishing a resolution that meets three important goals: One that (a) both minimizes losses and places them on appropriate, pre-identified, parties, (b) minimizes systemic consequences; and (c) does not result in a government bail-out. (In many ways, (c) is actually a direct consequence of (a): If losses are borne by appropriate, pre-identified, parties, the government does not need to absorb losses via a bail-out.) The goal should be *resolution* within these constraints, not necessarily an inefficient liquidation—a goal wholly consistent with that of Chapter 11 of the Bankruptcy Code.[8]

---

[5] Dodd-Frank Act, § 203(a)(1)(F) & (a)(2)(F); § 203(b)(2) & (3).

[6] Federal Deposit Insurance Corporation, *The Resolution of Systemically Important Financial Institutions: The Single Point of Entry Strategy*, 78 Fed. Reg. 76614 (Dec. 18, 2013) (hereafter "FDIC SPOE"), at 76615 ("the statute makes clear that bankruptcy is the preferred resolution framework in the event of the failure of a SIFI"); see Statement of Martin J. Gruenberg, Chairman, Federal Deposit Insurance Corporation on Implementation of the Dodd-Frank Act before the Committee on Banking, Housing and Urban Affairs, United States Senate (December 6, 2011), available at http://www.fdic.gov/news/news/speeches/chairman/spdec0611.html ("If the firms are successful in their resolution planning, then the OLA would only be used in the rare instance where resolution under the Bankruptcy Code would have serious adverse effects on U.S. financial stability").

[7] See Remarks by Martin J. Gruenberg, Chairman, Federal Deposit Insurance Corporation, in Implementation of the Dodd-Frank Act before the Volker Alliance Program (October 13, 2013), available at http://www.fdic/gov/news/news/speeches/spoet1313.html.

[8] There is a separate question—that I do not address (as it is not my area of expertise)—as to whether several financial institutions are simply "too big." I strongly urge that question be addressed directly—and separately. Bankruptcy law should efficiently resolve (through reorganization, recapitalization, sale, *or* liquidation) the entities, including financial institutions, that use it. It should not include a policy—that would be inconsistent with long-standing bankruptcy policy—favoring liquidation simply based on size.

The Current Status of the Orderly Liquidation Authority

Title II of the Dodd-Frank Act, containing the OLA, in many ways adopts many of bankruptcy law's provisions, with a key difference being that the resolution is handled by the FDIC, as receiver, retaining significant discretion, as compared to a bankruptcy court, subject to statutory rules that can and will be enforced by appellate review through the Article III judicial system.

But we are not in 2010, when the Dodd-Frank Act was envisioned and enacted. Much thinking and work has occurred since then, in terms of how, effectively, to resolve a SIFI *without* jeopardizing the financial system and *without* a government bailout. Increasingly, attention has turned, in Europe as well as in the United States, on a rapid recapitalization. Europe has focused on a "one-entity" recapitalization via bail-in[9] while the FDIC has focused, in its SPOE proposal, on a "two-entity" recapitalization rather than a formal bail-in.[10] Under the FDIC's approach,[11] a SIFI holding company (the "single point of entry") is effectively "recapitalized" over a matter of days, if not hours,

---

[9] Financial Stability Board, *Progress and Next Steps Towards Ending "Too-Big-to-Fail,"* Report of the Financial Stability Board to the G-20, available at www.financialstabilityboard.org/publications/r_130902.pdf (Sept. 2013); Thomas Huertas, Vice Chairman, Comm. Of European Banking Supervisors and Dir., Banking Sector, U.K. Fin. Services Auth., *The Road to Better Resolution: From Bail-out to Bail-in*, speech at The Euro and the Financial Crisis Conference (Sept. 6, 2010), available at http://www.fsa.gov.uk/library/communication/speeches/2010/0906_th.shtml; Clifford Chance, *Legal Aspects of Bank Bail-Ins* (2011).

[10] FDIC SPOE, *supra* note 6. See Federal Deposit Insurance Corporation & Bank of England, Joint Paper, *Resolving Globally Active, Systemically Important, Financial Institutions* (Dec. 10, 2012), available at http://www.bankofengland.co.uk/publications/Documents/news/2012/nr156.pdf (jointly proposing the single-point-of-entry approach).

[11] Early signs of which were foreshadowed in Randall Guynn, *Are Bailouts Inevitable?*, 29 YALE J. ON REGULATION 121 (2012).

by the transfer of virtually all its assets and liabilities, except for certain long-term unsecured liabilities, to a new bridge institution whose capital structure, because of the absence of those long-term unsecured liabilities, is both different and presumptively "sound." Because of the splitting off of the long-term unsecured debt, the bridge institution, in the FDIC's model, looks very much like a SIFI following a European-like "bail in." The major difference is that in the "bail in," the SIFI holding company before and after the recapitalization is the same legal entity (thus, the "one-entity" recapitalization), whereas in the FDIC's SPOE proposal, the "recapitalized" bridge institution, a different legal entity, is formed first and effectively receives a "new" capital structure by virtue of having long-term unsecured debt left behind in the transfer to it and the bridge institution, in turn, recapitalizes (where necessary) its operating subsidiaries (thus, the "two-entity" recapitalization)[12] In both cases, the resulting holding company then forgives intercompany liabilities or contributes assets to recapitalize its operating subsidiaries.

There are pre-conditions for making this work. Important among them are legal rules, known in advance, setting forth a required amount of long-term debt (or

---

[12] In part, this difference is driven by different organizational structures common to U.S. SIFI's versus European SIFIs—our SIFIs are much more likely to use a holding company structure; in part this difference is driven by Title II's liquidation "mandate." Section 214(a) of the Dodd-Frank Act explicitly states: "All financial companies put into receivership under this subchapter shall be liquidated." As a bankruptcy scholar, I view this latter mandate, at least in the abstract, as unfortunate. A first-day lesson in a corporate reorganization course is that "understanding that financial and economic distress are conceptually distinct from each other is fundamental to understanding Chapter 11 of the Bankruptcy Code," Barry Adler, Douglas Baird & Thomas Jackson, BANKRUPTCY: CASES, PROBLEMS AND MATERIALS 28 (Foundation Press 4th ed. 2007). Avoiding a bailout requires that losses be borne by appropriate parties, identified in advance, not necessarily by liquidation of the underlying business, which may cause an unnecessary destruction of value. The FDIC's SPOE strategy formally complies with the statutory requirement, by liquidating the SIFI holding company after its assets have been liquidated via the transfer to the bridge company.

subordinate or bail-in debt) to be held by the SIFI that would be legally subordinate to other unsecured debt—in the sense of its debt-holders knowing that this debt would be "bailed-in" (in a one-entity recapitalization) or left behind (in a two-entity recapitalization).[13] Much work has been done on this dimension, both under Basel 3 and through the Federal Reserve Board's Comprehensive Capital Analysis and Review (CCAR).[14] And the effective use of a two-entity recapitalization in Title II of the Dodd-Frank Act needs to straddle the tension between Title II's liquidation mandate (literally met because, following the transfer to the bridge company, the assets of the original holding company will have been removed from the SIFI holding company, which will subsequently itself be liquidated) and the notion of limiting financial contagion and using Title II only when its invocation is required because of serious doubts about the effectiveness of the use of the bankruptcy process. That said, many recognize that the FDIC's SPOE proposal for Title II of the Dodd-Frank Act, consistent with parallel work in Europe, is a significant development in terms of advancing the goals of avoiding "too big to fail"—a resolution process that (a) allocates losses among the appropriate parties, (b) limits systemic consequences, and (c) avoids a government-funded bail-out[15]

---

[13] See John Bovenzi, Randall Guynn & Thomas Jackson, *Too Big to Fail: The Path to a Solution* (Bipartisan Policy Center, Failure Resolution Task Force May 2013).

[14] www.federalreserve.gov/bankinforog/ccar.htm.

[15] See Daniel Tarullo, *Toward Building a More Effective Resolution Regime: Progress and Challenges"* (Oct. 2013), available at http://www.federalreserve.gov/newsevents/speech/tarullo20131018a.html ("The single-point-of-entry approach offers the best potential for the orderly resolution of a systemic financial firm . . ."); William Dudley, President and Chief Executive Officer, Federal Reserve Bank of New York, Remarks at the Federal Reserve Board and Federal Reserve Bank of Richmond Conference, Planning for the Orderly resolution of a Globally Systemically Important Bank, p. 1 (Wash. D.C. Oct. 18, 2013) ("I very much endorse the single-point-of-entry framework for resolution as proposed by the Federal Deposit Insurance Corporation (FDIC)."); John Bovenzi, Randall Guynn & Thomas Jackson, *supra* note13; David Skeel,*Single Point of Entry and the Bankruptcy Alternative*, in Martin Neil Baily & John B. Taylor (eds.), ACROSS THE GREAT DIVIDE: NEW PERSPECTIVES ON THE FINANCIAL CRISIS (Hoover Press 2014).

Title II's OLA provisions, however, also come with certain defects. The FDIC retains discretion to prefer some creditors over others of equal rank, without limiting it to occasions where there is background legal authority (which will rarely occur at the holding company level), and at important points the FDIC, rather than the market, is making critical determinations regarding the bridge financial company and its equity.[16] Thus, the FDIC proposes that the bridge financial institution created in the SPOE process (treated as a government entity for tax purposes[17]) is effectively run, for a while at least, by the FDIC.[18] In addition, the FDIC's SPOE proposal relies on expert (and FDIC) valuations of the new securities that will form the basis of the distribution to the long-term creditors and old equity interests "left behind,"[19] and the FDIC retains the authority to distribute them other than according to the absolute priority rule so well known in bankruptcy law.[20]

In addition, the FDIC's SPOE proposal is, itself, potentially limited in scope:

> The FDIC's SPOE bridge proposal seemingly applies only to domestic financial companies posing systemic risk (currently, eight bank and three or four non-bank holding companies are so regarded, although more may be added, even at the last minute), not to the next hundred or so bank holding companies with more than #10 billion in consolidated assets, or to all the (potentially over one thousand) "financial companies" covered by Dodd-Frank's Title I definition (at least 85 percent of assets or revenues from financial activities).[21]

---

[16] See FDIC SPOE, *supra* note 6, 76616-18.
[17] Dodd-Frank Act, section 210(h)(1) ("a bridge financial company . . . shall be exempt from all taxation now or hereafter imposed by the United States, by any territory, dependency, or possession thereof, or by any State, county, municipality, or local taxing authority").
[18] FDIC SPOE, *supra* note 6, 76617.
[19] FDIC SPOE, *supra* note 6, 76618.
[20] FDIC SPOE, *supra* note 6, 76619.
[21] Kenneth Scott, *The Context for Bankruptcy Resolutions*, in Kenneth E. Scott, Thomas H. Jackson, and John B. Taylor (eds.), *supra* note 4, at 5-6..

The Inadequacies of Current Bankruptcy Law Seen in Light of SPOE

I believe the "bones" for a comparably-successful resolution of a SIFI under the Bankruptcy Code are already in place. But, without statutory revisions, such as I will be addressing in this Statement, those "bones" are unlikely to translate to a competitive resolution procedure to SPOE, as developed by the FDIC, under Title II of the Dodd-Frank Act.

While it is probably the case that the original "intent" of Section 363 of the Bankruptcy Code—a provision providing for the use, sale, and lease of property of the estate—at the time of its enactment in 1978 was to permit piecemeal sales of unwanted property, Chapter 11 practice began, over time, to move in the direction of both (a) pre-packaged plans of reorganization and (b) procedures whose essential device was a going-concern sale of some or all of the business (whether prior to or in connection with a plan of reorganization), leaving the original equity and much of the debt behind and with the proceeds of the sale forming the basis of the distribution to them according to the plan of reorganization and bankruptcy's priority rules.[22] While these going-concern sales don't fit perfectly with the original vision, which assumed the Chapter 11 company would be reorganized, not sold, such sales have been used, repeatedly, as a way of continuing a business outside of bankruptcy while the claimants and equity interests, left behind, wind up as the owners of whatever was received by the bankruptcy estate in connection with the sale. And it, at least in rough contours, has

[22] David Skeel, Debt's Dominion: A History of Bankruptcy Law in America 227 (Princeton 2001); Barry Adler, Douglas Baird & Thomas Jackson, *supra* note 12, at 466-467 ("between [1983 and 2003] a sea change occurred through which an auction of the debtor's assets has become a commonplace alternative to a traditional corporate reorganization").

structural features in common with the two-step recapitalization that is envisioned under the FDIC's SPOE procedure.

That said, a Section 363 sale is an imperfect competitor to SPOE in its current form. While both will require identification of long-term debt (or capital structure debt) that will be left behind—again, work that is well underway[23]—a successful two-entity recapitalization essentially requires the bridge company to be able to acquire all of the remaining assets, contracts, permits, rights, and liabilities of the SIFI holding company, while preserving the businesses of the transferred, non-bankrupt, operating subsidiaries.

That seems to me very difficult to accomplish under the current Bankruptcy Code. First, because of a series of amendments designed to insulate qualified financial contracts—swaps, derivatives, and repos—from many of bankruptcy's provisions, most notably the automatic stay and the unenforceability of ipso facto clauses, there is no effective mechanism in the current Bankruptcy Code to preclude counterparties on qualified financial contracts from running upon the commencement of a bankruptcy case.[24] Importantly, even if most such contracts reside in non-bankrupt operating subsidiaries of the bridge company, such creditors may have cross-default or change-of-

---

[23] See text accompanying notes 8-15, *supra*.

[24] Bankruptcy Code §§ 362(b)(6), (7), (17), (27), 546(e), (f), (g), (j), 555, 556, 559, 560, 561. (The FDIC SPOE proposal, consistent with statutory authorization, Dodd-Frank Act § 210(c)(8), (9), (10), (16), will override any such provisions in counterparty contracts (and subsidiary cross-default provisions); bankruptcy, being a judicial proceeding, cannot (and should not) do that without comparable statutory authorization which currently not only is missing but is expressly contradicted by provisions that exist.) While my statement today focuses on changes that are necessary in these existing protective provisions for counterparties on qualified financial contracts in the Bankruptcy Code in order to permit an effective two-step recapitalization of a SIFI holding company, I believe these existing Bankruptcy Code provisions, and their relationship to bankruptcy law more generally, needs to be rethought. See David Skeel & Thomas Jackson, *Transaction Consistency and the New Finance in Bankruptcy*, 112 COLUM. L. REV. 152 (2012).

control provisions triggered by the Chapter 11 filing of their former holding company. (As a result of a dialogue with regulators sensitive to this problem in resolution proposals outside of bankruptcy, a major step in "solving" this concern—at least for adhering parties (initially, the eighteen largest dealer banks)—occurred with the International Swaps and Derivatives Association's (ISDA's) 2014 Resolution Stay Protocol.[25]) Nor would it be clear under existing bankruptcy law that operating licenses, permits, and the like could be transferred to the bridge company, either because it legally is a new company or because there has been a change of control of the holding company and its operating subsidiaries in derogation of change-of-control provisions or requirements applicable to individual entities.[26]

Moreover, while the Bankruptcy Code clearly contemplates an ability to move with necessary speed, including when a provision calls for a notice and hearing before any decision (such as under Section 363(b)),[27] the lack of clear statutory authority for a very rapid transfer to a bridge company may leave too much—for the comfort of a SIFI *or* a regulatory body—up to the discretion of a particular judge who first gets a SIFI holding company requesting such a transfer. Nor is there a clear necessity for notice to, or hearing by, a government regulator—whether the FDIC or Federal Reserve Board, in the case of the holding company, or a foreign regulator, in the case of a foreign

---

[25] See ISDA, "Resolution Stay Protocol—Background," October 11, 2014; see also Tom Braithwaite and Tracy Allway, "Banks Rewrite Derivative Rules to Cope with Future Crisis," *Financial Times*, October 7, 2014.

[26] Many of these will not be executory contracts, subject to the assumption and assignment provisions of §365 of the Bankruptcy Code. Nor does the current Bankruptcy Code directly deal, apart from those provisions, with change-of-control triggers in licenses and the like.

[27] Bankruptcy Code § 102(1) provides that "after notice and a hearing" includes (B) "authoriz[ing] an act without an actual hearing if such notice is given properly and if . . . (ii) there is insufficient time for a hearing to be commenced before such act must be done, and the court authorizes such act . . . ."

subsidiary that is proposed to be transferred to a bridge company. These uncertainties, even with a robust resolution plan, may inspire enough lack of confidence by the FDIC and the Federal Reserve Board so as to view the commencement of an OLA proceeding under Title II of the Dodd-Frank Act to be the preferable course—or, alternatively, lack of sufficient confidence by foreign regulators so as to acquiesce in allowing the bankruptcy process to unfold without the regulator intervening at the foreign subsidiary level.

The Problems These Inadequacies Create for the Dodd-Frank Act

As noted above, resolution plans under Title I of the Dodd-Frank Act focus on bankruptcy, and Title II of the Dodd-Frank Act is, explicitly, designed to be a fall-back solution to be invoked when bankruptcy is determined to be inadequate to avoid serious financial consequences on the U.S. financial system. But if the "best" resolution process we currently envision—one that, as noted above, (a) both minimizes losses and places them on appropriate, pre-identified, parties, (b) minimizes systemic consequences, and (c) does not result in a government bail-out—involves, indeed, a recapitalization such as proposed by the FDIC with its SPOE procedure under Title II,[28] then there is a disconnect between design and implementation. As a result, the resolution plans will fail to do what they are supposed to do—prepare a SIFI for the most successful possible resolution—leading to OLA under Title II assuming primacy in terms of the resolution process. Moreover, the resolution plans, relentlessly focused on a bankruptcy process

[28] See sources cited, *supra* note 15.

under Title I's own standards, will be addressing a different set of issues and will provide little guidance to the FDIC in its OLA proceeding. To have the statutory pieces "fit" together—to have resolution plans effectively prepare a firm for resolution, to have bankruptcy serve as its intended role as the primary resolution device, and (beneficially) to have the resolution plans be relevant to a proceeding under Title II of the Dodd-Frank Act "just in case"—it makes sense to move, through limited but important changes to the Bankruptcy Code, from the "bones" of a successful two-step recapitalization process in the current Bankruptcy Code to a process that can deliver what it can only incompletely promise today.

Proposed Amendments to the Bankruptcy Code

Bankruptcy *can* be an effective resolution mechanism, tracking major features of the FDIC's SPOE proposal (but run through a bankruptcy process, with bankruptcy rules and market-based controls) that will usually, if not virtually always, obviate the need to invoke OLA under Title II of Dodd-Frank.[29] But to do so, it needs some focused amendments.

What are these changes? While any resulting bill will necessarily be complicated,[30] at the center of effectuating a bankruptcy-based two-entity

[29] Again, the Dodd-Frank Act is *explicit* that Title II cannot be invoked without a determination that bankruptcy resolution would be inadequate. See notes 5 & 6, *supra*.

[30] In addition to the proposal contained in the Appendix, both the Senate and the House had introduced in the last session focused bankruptcy bills that largely incorporated the features I discuss next. See S. 1861, 113th Congress, 1st Sess. ("The Taxpayer Protection and Responsible Resolution Act") (December 2013); H. 5421, 113th Congress, 1st Session ("The Financial Institution Bankruptcy Act") (approved by the House via a voice vote on December 1, 2014).

recapitalization of a SIFI holding company, are two principles. First, that there is sufficient long-term unsecured debt (or "capital structure debt") at the holding company level to be "left behind" in the transfer to a bridge company so as to effectuate the recapitalization. (This is—or should be—largely an issue outside of bankruptcy law itself—and, indeed, as noted earlier, is central to a basically rule-based application of the FDIC's SPOE proposal under Title II of the Dodd-Frank Act. The precise level of those mandated capital requirements are being worked on, and already are significantly above those of 2008.) Second, that the bridge company otherwise be able to acquire all the assets, rights, and liabilities of the former holding company, including ownership of the former holding company's operating subsidiaries.[31]

Thus, the "guts" of the proposed amendments I believe are necessary to place bankruptcy law where the Dodd-Frank Act—in both Title I and Title II—envisions it

---

[31] There is a third, important, question of access to liquidity by the bridge company that, formally is not a part of the bankruptcy process. While a potentially contentious issue, I believe there is a great deal of wisdom in David Skeel's analysis of this in *Financing Systemically Important Financial Institutions*, Chapter 3 of Kenneth E. Scott, Thomas H. Jackson, and John B. Taylor, *supra* note 4. In summary:

> I argue in this chapter that the widespread pessimism about a SIFI's ability to borrow sufficient funds—sufficiently quickly—to finance resolution in Chapter 11 is substantially overstated. The criticism appears to be based on the assumption that the largest banks have essentially the same structure as they had prior to the 2008 panic, thus ignoring the effects of the regulatory changes that have taken place as a result of the Dodd-Frank Act. Critics also do not seem to have fully considered the likelihood that the quick sale resolution of a SIFI—like prepackaged bankruptcies of other firms should require less new liquidity than the traditional bankruptcy process. (pp. 63-64)

Recognizing, however, that there is still some residual concern, Professor Skeel "conclude[s] that lawmakers should give SIFI's limited, explicit access to Fed funding, preferably by expanding the Fed's emergency lending authority under section 13(3) of the Federal Reserve Act," p. 65—where "the Fed [is] constrained under 13(3) by the requirement that it lend on a fully secured basis" as well as by the requirement that "the Fed must also determine that the loan is needed to prevent systemic or other harm." (p. 85). In general, I think the Bankruptcy Code amendments outlined here should be made irrespective of the availability of government-based liquidity. That discussion can be held separately, and should include whether an inability of the bridge company to access government-based liquidity under some circumstances will make more likely use of OLA under Title II of the Dodd-Frank Act, where access to the orderly liquidation fund (OLF) is clear.

should be, center on a provision that substantially sharpens the nature and focus of a sale of assets under Section 363 of the Bankruptcy Code. This provision contemplates a rapid transfer to and, in effect, recapitalization of, a bridge company (e.g., within the first 48 hours of a bankruptcy case) by a SIFI holding company (the debtor), after which the bridge company can recapitalize, where necessary, its operating subsidiaries. If the court approves the transfer, then the SIFI holding company's operations (and ownership of subsidiaries) shift to a new bridge company *that is not in bankruptcy*—and will be perceived as solvent by market-participants, including liquidity providers because it will be (effectively) recapitalized, as compared to the original SIFI, by leaving behind in the bankruptcy proceeding previously-identified long-term unsecured (capital structure) debt of the original SIFI. *After* the transfer, the debtor (i.e., the SIFI holding company) remains *in bankruptcy* but is effectively a shell, whose assets usually will consist only of its beneficial interest in a trust that would hold the equity interests in the bridge company until they are sold or distributed pursuant to a Chapter 11 plan, and whose claimants consist of the holders of the long-term debt that is not transferred to the bridge company and the old equity interests of the SIFI holding company. This debtor in Chapter 11 has no real business to conduct, and essentially waits for an event (such as the sale or public distribution of equity securities of the bridge company by the trust) that will value or generate proceeds from its assets (all equity interests in the new, recapitalized entity) and permit a distribution of those equity interests or proceeds, pursuant to bankruptcy's normal distribution rules, to the holders of the long-term debt and original equity interests of the debtor (the original SIFI holding company).

The details of accomplishing this are somewhat intricate and, of course, can vary, but it is useful, I believe, to trace the general ideas of how I envision this two-step recapitalization might be implemented in bankruptcy. The transfer motion would be heard by the court no sooner than 24-hours after the filing (so as to permit 24-hour notification—I would propose—to the 20 largest holders of unsecured claims, the Federal Reserve Board, the FDIC, and the Secretary of the Treasury, and the primary financial regulatory authority—whether US or foreign—with respect to any subsidiary whose ownership is proposed to be transferred to the bridge company). And, because the provisions must stay qualified financial contract termination (and related) rights (including those based on cross-defaults in non-bankruptcy subsidiaries) for a period to allow the transfer to the bridge company to be effective in a seamless fashion, the transfer decision essentially must be made within a designated period (e.g., 48-hours) after the filing. There should be conditions on the ability of the court to authorize the transfer to the bridge company—but conditions that can be satisfied by advanced planning (e.g., resolution plans) or otherwise determined within a very short time-frame.

Many of the remaining provisions that I believe would need to be adopted as well would be designed to permit the successful transfer of assets, contracts, liabilities, rights, licenses, and permits—of both the holding company and of the subsidiaries—to the bridge company.

First, there are provisions applicable to debts, executory contracts, and unexpired leases, including qualified financial contracts. Conceptually, the goal of these provisions would be to keep operating assets and liabilities "in place" so that they can be transferred to the bridge company (within a 48-hour window) and, thereafter, remain "in place" so that "business as usual" can be picked up the bridge company and its operating subsidiaries once it assumes the assets and liabilities. This requires overriding "ipso facto" clauses (of the type that would otherwise permit termination or modification based on the commencement of a bankruptcy case or similar circumstance, including credit-rating agency ratings, whether in the holding company or in its operating subsidiaries), [32] and it requires overriding similar provisions allowing for termination or modification based on a change of control, again whether in the holding company or in its operating subsidiaries, since the ownership of the bridge company will be different than the ownership of the debtor prior to the bankruptcy filing. These provisions need to be broader than Section 365 of the Bankruptcy Code, for at least two reasons. First, perhaps because of the limited scope of the original "purpose" of Section 363, bankruptcy doesn't have a provision expressly allowing for the "transfer" of debt (although many debts are in fact transferred as a matter of existing practice under Chapter 11 "going concern sales"). Unlike executory contracts, which might be viewed as net assets (and thus something to "assume") or as net liabilities (and thus something to "reject"), debt is generally considered breached and accelerated (think "rejected")

[32] While these provisions would affect the contracts, permits, liabilities, and the like of entities (e.g., affiliates such as operating subsidiaries) not themselves in bankruptcy, I believe they are fully authorized (at least for domestic subsidiaries), if not by Congress' Article I bankruptcy power, then by application of the independent (albeit related) Congressional power pursuant to the "necessary and proper" clause of Article I, as interpreted since *McCulloch v. Maryland*, 4 Wheat. 316 (1819), see also *United States v. Comstock*, 560 U.S. ___ (2010), since the bankruptcy of the SIFI cannot successfully be concluded without these provisions that permit the unimpeded transfer of the operating subsidiary's ownership to the bridge company. (The question of foreign subsidiaries, while complex, is being actively discussion by U.S. and foreign regulators, and legislation is being discussed in Europe and elsewhere that is designed to help assure these results extend to non-U.S. operations in the case involving the resolution of a U.S.-based SIFI holding company.)

upon the filing of a petition in bankruptcy.[33] But, if there is going to be a two-step recapitalization, the bridge company needs to take the liabilities it would assume "as if nothing happened." Thus, provisions designed to accomplish that need to be included. Second, Section 365 doesn't deal with change-of-control provisions; amendments need to add that and extend it to debt agreements as well.

With respect to qualified financial contracts, there should be provisions in addition to those just mentioned. The stay on termination, offset, and net out rights should apply for the period from the filing until the transfer occurs, it is clear it won't occur, or 48 hours have passed. Because of this interregnum, when there is a likelihood that the transfer will be approved, and all of these qualified financial contracts (and related guarantees, if any) go over "in their original form" to the bridge company, there is a requirement that the debtor and its subsidiaries shall continue to perform payment and delivery obligations. Conversely, because the counterparty may not know for sure what the outcome will be during this interregnum, there is a provision that the counterparty may promptly "cure" any unperformed payment or delivery obligations after the transfer.

Just as the principle of having the bridge company have the same rights, assets, and liabilities drive the provisions regarding debts, executory contracts, and unexpired leases just discussed (including qualified financial contracts), a similar provision is necessary to keep licenses, permits, and registrations in place, and does not allow a

[33] See David Skeel & Thomas Jackson, *supra* note 24.

government to terminate or modify them based on an "ipso facto" clause or a transfer to a bridge company.

There are many other considerations. For example, in addition to voluntary bankruptcy proceedings initiated by the SIFI holding company, should government regulators (such as the FDIC or FRB) have the power, under specified conditions, to initiate a bankruptcy case, and should it doing so be contestable? I believe government regulators *should* be able to commence such proceedings, and (because of the very narrow time window between the filing and the transfer to a bridge company) such commencements *should not* be contestable in advance.[34] But I can imagine a system in which the government regulators *could not* place a SIFI holding company in bankruptcy, as they retain enormous powers, either to "induce" a so-called voluntary filing (as was the case in Lehman Brothers(, or to go directly to the initiation of an OLA proceeding under Title II of Dodd-Frank. While the issue needs to be decided, in my view, *which way* it is resolved is not integral to the integrity of the Bankruptcy Code or the proposed amendments I have discussed. Similarly, whether the proceedings should be in front of district judges, or bankruptcy judges, and whether the judges are from a pre-designated panel, are details that may be important in ensuring the effectiveness of a 24 hour transfer, but are not at the heart of the needed amendments.

[34] Although ex post damage remedies should then be available for what was judicially-determined to be an improper filing. See Kenneth Scott, *supra* note 24, at 9-10.

Conclusion

While the details are many, the concept is simple. Through modest amendments to the Bankruptcy Code, expressly enabling it to effectuate a rapid two-step recapitalization from a SIFI holding company to a bridge company (by leaving long-term unsecured debt behind), it indeed can be considered the primary resolution vehicle for SIFIs, as envisioned by the Dodd-Frank Act, limiting the role of Title II—and therefore administrative-based resolution—to the cases, that almost inevitably may occur, where we cannot contemplate today the causes or contours of the next crisis, so that the FDIC's inevitable discretion, compared to a judicial proceeding, becomes a virtue rather than a concern.

Absent that (hopefully rare) need, however, I view the virtues of bankruptcy resolution over agency resolution to be several. First, the new company formed in the Section 363-like recapitalization sale (or transfer) is neither (a) subject to the jurisdiction of a bankruptcy court nor (b) subject to "control" by a government agency, such as the FDIC, whereas the bridge company created in the SPOE process is effectively run, for a while at least, by the FDIC.[35] In this bankruptcy process, the bridge company, appropriately, faces market-discipline first and foremost; in Title II, there inevitably is a heavier layer of regulatory overlay and control. Second, and related, a bankruptcy process envisions at least the possibility that the market can determine the equity value of the new company (and thus the amount to be

[35] See, e.g., FDIC SPOE, *supra* note 6, p. 76617 ("The FDIC would retain control over certain high-level key matters of the bridge financial company's governance, including approval rights for . . . capital transactions in excess of established thresholds; asset transfers or sales in excess of established thresholds; merger, consolidation or reorganization of the bridge financial company; any changes in directors of the bridge financial company (with the FDIC retaining the right to remove, at its discretion, any or all directors); any distribution of dividends; any equity based compensation plans . . . . Additional controls may be imposed by the FDIC as appropriate.").

distributed to the creditors and old equity interests "left behind"), whereas the FDIC's SPOE proposal relies on expert valuations for those distributions.[36] Third, because of language in the Dodd-Frank Act,[37] the FDIC may push on its own initiative for the replacement of management (i.e., not permit management of the former SIFI holding company take similar positions in the bridge company).[38] In the bankruptcy process, the Board of Directors, and management, of the newly-created bridge-company, ideally, would be identified with the input both of the SIFI's primary regulators as well as the beneficiaries of the transfer and, importantly, would be subject to the approval of the district court in an open and transparent process at the time of the transfer of the holding company's assets and liabilities to the bridge company. Fourth, at various points, the FDIC has discretion that can amount to ex post priority determinations (such as whether liabilities other than pre-defined long-term unsecured debt gets transferred to the bridge company)—discretion that may be useful in extraordinary cases, but that is potentially a cause for undermining market confidence in the rule of law in other circumstances.[39] Fifth, Title II treats the bridge company created in an OLA under Title II as a government entity, exempt from taxes;[40] I think that provision is a mistake, preferring the bridge company to its non-protected

---

[36] FDIC SPOE, *supra* note 6, p. 76618 ("the SPOE strategy provides for the payment of creditors' claims in the receivership through the issuance of securities in a securities-for-claims exchange. This exchange involves the issuance and distribution of new debt, equity and, possibly, contingent securities . . . to the receiver. The receiver would then exchange the new debt and equity for the creditors' claims. . . . Prior to the exchange of securities for claims, the FDIC would approve the value of the bridge financial company. The valuation would be performed by independent experts . . . selected by the board of directors of the bridge financial company. Selection of the bridge financial company's independent experts would require the approval of the FDIC, and the FDIC would engage its own experts to review the work of these firms and to provide a fairness opinion.").
[37] Dodd-Frank Act § 206(4) (the FDIC shall "ensure that management responsible for the failed condition of the covered financial company is removed"); see also Dodd-Frank Act § 206(5) (similar provision for members of a board of directors).
[38] See FDIC SPOE, *supra* note 6, p. 76617 ("As required by the statute, the FDIC would identify and remove management of the covered financial company who were responsible for its failed condition").
[39] See, e.g., FDIC SPOE, *supra* note 6, p. 76618 (in addition to identified categories, the FDIC retains "a limited ability to treat similarly situated creditors differently.").
[40] Dodd-Frank Act § 210(h)(10) ("Notwithstanding any other provision of Federal or State law, a bridge financial company, its franchise, property, and income shall be exempt from all taxation now

competitors, and should not be replicated in any bankruptcy amendments, whose goal is to have the bridge company treated "just as" the holding company was before the two-entity recapitalization. Sixth, and (perhaps) finally, I am concerned—as I suspect the FDIC is as well—that the actual use of SPOE under Title II of the Dodd-Frank Act will be subject to ex post criticism and investigation. Bankruptcy, with appropriate amendments—and its underlying judicial process subject to the rule of law, is in a more robust position to "do the right thing" in terms of fairly addressing the consequences of financial failure without having it necessarily lead to economic failure.

I want to thank the Subcommittee for allowing me this opportunity to present my views. It is an honor to appear before you today. I would of course be delighted to answer any questions you may have about my testimony.

---

or hereafter imposed by the United States, by any territory, dependency, or possession thereof, or by any State, county, municipality, or local taxing authority.").

APPENDIX

CHAPTER 2

Building on Bankruptcy: A Revised Chapter 14 Proposal for the Recapitalization, Reorganization, or Liquidation of Large Financial Institutions

Thomas H. Jackson

Introduction

In 2012, building off of work first published in 2010, the Resolution Project proposed that a new Chapter 14 be added to the Bankruptcy Code, designed exclusively to deal with the reorganization or liquidation of the nation's larger financial institutions.[1] This proposal was, in turn, the Resolution Project's studied perspective on the most appropriate way to respond to the financial crisis of 2008 and the federal government's role in it, highlighted by the bankruptcy of Lehman Brothers. There quickly emerged a consensus—certainly among our working group, but more widespread—that the institutions, and the government, lacked important tools to deal effectively with financially distressed large financial institutions without the Hobson's choice of either potential systemic consequences affecting the nation's economy as a whole or a bailout—a financial "rescue" of the institution so that it would not fail. Chief among the perspectives that new tools were necessary was the widespread perception that bankruptcy, as it existed at that time, was simply not up to the task of resolving, according to

1. Kenneth E. Scott and John B. Taylor, eds., *Bankruptcy Not Bailout: A Special Chapter 14* (Stanford, CA: Hoover Institution Press, 2012); Kenneth E. Scott, George P. Shultz, and John B. Taylor, *Ending Government Bailouts as We Know Them* (Stanford, CA: Hoover Institution Press, 2010), particularly chapter 11, pp. 217–51.

the rule of law, such institutions in a fashion that would contain systemic effects.

This conclusion was the result of a number of subsidiary beliefs—some correct, some not. The bankruptcy process was too slow and cumbersome. The adversarial bankruptcy process was conducted before a judicial officer who might know the law, but didn't have the requisite economic or financial expertise or the power to consider systemic consequences. Bankruptcy had too many exclusions to deal effectively with a complex financial group (depository banks and insurance companies were wholly excluded; stockbrokers and commodity brokers were assigned to a specialized provision of Chapter 7).[2] And a series of amendments to the Bankruptcy Code, originally driven by the International Swaps and Derivatives Association (ISDA) and the Federal Reserve Board, had increasingly immunized counterparties on qualified financial contracts from the major consequences of bankruptcy, prominently including bankruptcy's automatic stay under section 362.[3]

While members of the Resolution Project believed that a number of those criticisms were justified, we also believed that thoughtful revisions to the Bankruptcy Code could ameliorate or eliminate many of them, improving the prospect that our largest financial institutions—particularly with pre-bankruptcy planning—could be reorganized or liquidated pursuant to the rule of law (especially respecting priorities to ensure that losses fell where they were anticipated). Out of that grew our proposal for a special chapter designed for such financial institutions: a Bankruptcy Code Chapter 14.[4] Key features in that proposal included: (a) allowing an entire covered financial institution, including its non-bank subsidiaries, to be resolved in bankruptcy without the existing Bankruptcy Code's potpourri of

---

2. These criticisms are outlined more fully in Scott et al., *Ending Government Bailouts*, 218.

3. Criticized both in Scott and Taylor, *Bankruptcy Not Bailout*, 45–46; and in David Skeel and Thomas Jackson, "Transaction Consistency and the New Finance in Bankruptcy," *Columbia Law Review* 112 (2012): 152.

4. See Scott and Taylor, *Bankruptcy Not Bailout*.

exemptions; (b) the ability of the institution's primary regulator, who may be aware of potential systemic consequences otherwise not before a bankruptcy court, to file an involuntary petition, including one based on "balance sheet" insolvency, as well as to have standing to be heard as a party or to raise motions relevant to its regulation, including filing a plan of reorganization notwithstanding a debtor's exclusive period and motions for the use, sale, and lease of property; (c) numerous changes to the protections afforded by existing bankruptcy law to holders of qualified financial contracts, especially derivatives and swaps, to ensure that they were treated according to their basic underlying attributes (that of secured liabilities, in the case of repos; that of executory contracts, in the case of derivatives and swaps); (d) provisions allowing, with designated protections against favoritism or bailout, funding for the pre-payment of certain distributions to identified creditors; and (e) the assignment of Chapter 14 cases and proceedings to designated Article III district judges, rather than to bankruptcy judges without the political independence provided by Article III.[5]

In proposing this, we wrote:

> We, the members of the Resolution Project group, believe it is possible through these changes to take advantage of a judicial proceeding—including explicit rules, designated in advance and honed through published judicial precedent, with appeals challenging the application of those rules, public proceedings, and transparency—in such a way as to minimize the felt necessity to use the alternative government agency resolution process recently enacted as a part of the Dodd-Frank Wall Street Reform and Consumer Protection Act. The new chapter could be adopted either in addition or as an alternative to the new resolution regime of Dodd-Frank.
>
> The crucial feature of this new Chapter 14 is to ensure that the covered financial institutions, creditors dealing with them, and other market participants know in advance, in a clear and predictable way, how losses will be allocated if the institution fails. If the creditors of a

5. For more detail, see ibid., 26–70.

failed financial institution are protected (bailed out), then the strongest and most rapidly responding constraint on risk taking by the financial institution's management is destroyed, and their losses are transferred to others.[6]

Even with the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010,[7] with its own Title II resolution process run by the Federal Deposit Insurance Corporation—the Orderly Liquidation Authority—we believe these changes to bankruptcy law remain vital to accomplish several of the announced goals of Dodd-Frank itself. First, Title I's resolution plans—which we believe are an important part of pre-bankruptcy planning—require a focus on using bankruptcy as the standard against which their effectiveness will be measured.[8] And, second, invocation of Title II itself can only occur if the government regulators find that bankruptcy is wanting.[9] Unless bankruptcy can be seen as a viable alternative for the resolution of a large and complex systemically important financial institution (SIFI) in economic distress, (a) the resolution plans could technically be found not credible or facilitating an orderly liquidation (since they are to be based on bankruptcy) and (b) breakup, or use of Title II of Dodd-Frank, will be the only perceived effective responses to the "too big to fail" problem.[10]

Those remain important reasons for the adoption of many of the proposals the Resolution Project put forth in its original 2012 Chapter 14 proposal. That proposal, however, consistent with most of

6. Ibid., 26.

7. Pub. L. No. 111-203, 124 Stat. 1376 (Dodd-Frank Act).

8. Dodd-Frank Act, section 165(d). The ways in which a proposal such as the one contained in this chapter would bring congruity to those provisions is explored in William Kroener, "Revised Chapter 14 2.0 and Living Will Requirements under the Dodd-Frank Act," chapter 8 in this volume.

9. Ibid., sections 203(a)(1)(F) and (a)(2)(F); sections 203(b)(2) and (3).

10. Reducing the size, and not just the complexity, of large financial institutions may be independently desirable, but that goal—if indeed it is one—should not be conflated with designing an appropriate mechanism for the effective resolution of a financial institution in distress.

the thinking and work being done at that time, was focused on the resolution of an operating institution—which, in the case of a large financial institution, is usually at the subsidiary level of a holding company. Yet, in addition to the concerns with existing bankruptcy law, Title II, as enacted, had its own set of difficulties with effective resolution of any such financial institutions. Title II is designated the "Orderly *Liquidation* Authority,"[11] and section 214(a) explicitly states: "All financial companies put into receivership under this subchapter shall be liquidated."[12] A first-day lesson in a corporate reorganization course is that "understanding that financial and economic distress are conceptually distinct from each other is fundamental to understanding Chapter 11 of the Bankruptcy Code."[13] Thus, what of a company whose going-concern value exceeds its liquidation value? But if bankruptcy is perceived not to be up to the task and Title II required an actual liquidation of the business, there may be many cases in which the condition precedent for the use of Title II—that it will be more effective than bankruptcy—will not be met, and current bankruptcy will (or, under the terms of Dodd-Frank, should) be the (rather inefficient) result.

Since then, however, a sea change in perspective has occurred.[14] Increasingly, the focus, in Europe as well as in the United States, has been on a reorganization or recapitalization that focuses, in the first instance, on the parent holding company (many or most of the assets of which are the equity ownership of its subsidiaries). Europe has focused on a

11. Dodd-Frank Act sections 206 and 208 (emphasis added).

12. Ibid., section 214(a). See also Thomas Jackson and David Skeel, "Dynamic Resolution of Large Financial Institutions," *Harvard Business Law Review* 2 (2012): 435, 440–41.

13. Barry Adler, Douglas Baird, and Thomas Jackson, *Bankruptcy: Cases, Problems, and Materials,* 4th ed. (St. Paul, MN: Foundation Press, 2007), 28.

14. A useful discussion of whether and how well Title II of Dodd-Frank would have responded to the 2008 crisis—prior to the development of the SPOE proposal—is contained in David Skeel, "Single Point of Entry and the Bankruptcy Alternative," in *Across the Great Divide: New Perspectives on the Financial Crisis* (Stanford, CA: Hoover Institution Press, 2014). Cf. Emily Kapur, "The Next Lehman Bankruptcy," chapter 7 in this volume.

"one-entity" recapitalization via bail-in[15] while the FDIC has focused in its single-point-of-entry (SPOE) proposal on a "two-entity" recapitalization.[16] Under the FDIC's approach, a SIFI holding company (the "single point of entry") is supposed to effectively achieve "recapitalization" of its business virtually overnight by the transfer of its assets and liabilities, except for certain long-term unsecured liabilities and any subordinated debt, to a new bridge institution. The bridge institution then is supposed to forgive intercompany liabilities or contribute assets to recapitalize its operating subsidiaries. Because of the splitting off of the long-term unsecured debt, the bridge institution, in the FDIC's model, looks very much like a SIFI holding company following a European-like bail-in. The major difference is that in the bail-in, the SIFI holding company before and after the recapitalization is the same legal entity (thus, the one-entity recapitalization), whereas in the FDIC's SPOE proposal, the recapitalized bridge institution is legally different than the pre-SPOE SIFI holding company (thus, the two-entity recapitalization).

There are preconditions for making this work. Important among them are legal rules, known in advance, setting forth a required amount of long-term debt to be held by the holding company that would be legally subordinate to other unsecured debt—in the sense of being known that it would be bailed-in (in a one-entity recapitalization) or left behind (in a two-entity recapitalization).[17] And its

15. Financial Stability Board, *Progress and Next Steps Towards Ending "Too-Big-to-Fail,"* Report of the Financial Stability Board to the G-20, September 2, 2013, www.financialstabilityboard.org/publications/r_130902.pdf; Thomas Huertas, "The Road to Better Resolution: From Bail-out to Bail-in," speech at The Euro and the Financial Crisis Conference, September 6, 2010, http://www.fsa.gov.uk/library/communication/speeches/2010/0906_th.shtml; Christopher Bates and Simon Gleeson, "Legal Aspects of Bank Bail-Ins," Clifford Chance client briefing, May 3, 2011.

16. FDIC SPOE, Federal Deposit Insurance Corporation, The Resolution of Systemically Important Financial Institutions: The Single Point of Entry Strategy, 78 Fed. Reg. 76614 (Dec. 18, 2013).

17. See Kenneth E. Scott, "The Context for Bankruptcy Resolutions," chapter 1 in this volume; see also John Bovenzi, Randall Guynn, and Thomas Jackson, "Too Big to Fail: The Path to a Solution," panel discussion, Bipartisan Policy Center, Failure Resolution Task Force, Washington, DC, May 2013.

effective use in Title II—as of this writing the FDIC has promulgated for comments a working document on its SPOE proposal[18]—needs to straddle the tension between Title II's liquidation mandate (literally met because, following the transfer to the bridge company, the original holding company will be liquidated) and the notion of limiting financial contagion and using Title II only when its results are better than would occur in bankruptcy. That said, many recognize that the FDIC's SPOE proposal for Title II of Dodd-Frank, consistent with parallel work in Europe, is a significant advance in terms of undermining the presumption that some firms are "too big to fail."[19]

But it also comes with the defects that have always made us uncomfortable with a resolution proceeding run and dominated by a government agency. The FDIC retains discretion to prefer some creditors over others of equal rank, without limiting it to occasions where there is background legal authority (which will rarely occur at the holding company level), and at important points the FDIC, rather than the market, is making critical determinations regarding the bridge financial company and its equity.[20] Thus, the FDIC proposes that the bridge financial institution created in the SPOE process (treated as a government entity for tax purposes[21]) is effectively run, for a while at least, by the FDIC.[22] In addition, the FDIC's SPOE proposal relies on expert (and FDIC) valuations of the new securities that will form the basis of the distribution to the long-term creditors and old equity interests "left behind,"[23] and the FDIC retains the authority to distribute them other than according to the absolute priority rule so well known in bankruptcy law.[24]

---

18. See FDIC SPOE.

19. See Bovenzi et al., "Too Big to Fail," and Skeel, "Single Point of Entry."

20. See FDIC SPOE, 76616–18.

21. Dodd-Frank Act, section 210(h)(10) ("a bridge financial company . . . shall be exempt from all taxation now or hereafter imposed by the United States, by any territory, dependency, or possession thereof, or by any State, country, municipality, or local taxing authority").

22. FDIC SPOE, 76617.

23. Ibid., 76618.

24. Ibid., 76619.

Moreover, the SPOE proposal for Title II has the potential to create an even greater disconnect with both Title I of Dodd-Frank and the presumptive preference for use of bankruptcy in Title II. The first occurs because Title I's resolution plans are to be focused on what would happen to the financial institution *in bankruptcy*.[25] Without the ability to do a comparable recapitalization at the holding company level in bankruptcy, any resolution plan would not be focused on how to most effectively do such a recapitalization. And that would be particularly unfortunate because, without the kind of changes in bankruptcy law we propose, Title II—and its SPOE process—would become the default, not the extraordinary, process, which runs contrary to the express preference in Dodd-Frank for bankruptcy as a resolution process for financial institutions.[26]

Accordingly, the Resolution Project focused on what further changes might be appropriate in its Chapter 14 proposal to both (a) meet the original goals of an effective reorganization or liquidation of an operating company and (b) provide an effective mechanism that would accomplish the goals inherent in the one- or two-entity recapitalizations of the holding company suggested by bail-in and SPOE proposals. Again, the bones of a response to this are already inherent in the Bankruptcy Code. While it is probably the case that the original intent of section 363 of the Bankruptcy Code—a provision providing for the use, sale, and lease of property of the estate—was to permit piecemeal sales of unwanted property, following the enactment of the Bankruptcy Code of 1978, Chapter 11 practice began, over time, to move in the direction of both (a) pre-packaged plans and (b) plans whose essential device was a going-concern sale of some or all of the business, leaving the original equity and much of the debt behind—with the proceeds of the sale forming the basis of their distribution according to the absolute priority rule.[27] It doesn't fit perfectly, but it

25. Dodd-Frank Act, section 165(d); and Kroener, "Revised Chapter 14 2.0."

26. Dodd-Frank Act, sections 203(a)(1)(F) and (a)(2)(F); sections 203(b)(2) and (3).

27. David Skeel, *Debt's Dominion: A History of Bankruptcy Law in America* (Princeton, NJ: Princeton University Press, 2001), 227; and Adler et al.,

has been used, repeatedly, as a way of creating a viable business outside of bankruptcy while the claimants, left behind, wind up as the owners of the estate of the former business entity.

Thus, the Resolution Project Working Group decided to expand its 2012 Chapter 14 proposal (which, for the purpose of clarity, we will designate Chapter 14 1.0) to include a direct recapitalization-based bankruptcy alternative—a Chapter 14 2.0. Chapter 14 2.0 accommodates *both* a conventional reorganization of an operating company *and* a two-entity recapitalization of a holding company (as well as, in appropriate circumstances, an operating company).[28] While there is a great deal of merit in considering ways of successfully implementing one-entity recapitalization, especially for the many financial companies that are not systemically important (and we have considered those possibilities extensively among ourselves), in the United States, at least, it is simpler for SIFIs to build upon the two-entity recapitalization model. This is both because (a) Chapter 14 may operate in parallel to the FDIC's SPOE proposal under Title II of Dodd-Frank and because Dodd-Frank itself looks to bankruptcy as the primary "competitor" to Title II[29] and (b) because it is, for a variety of reasons, easier to use the existing bankruptcy framework for a two-entity recapitalization than it is for a one-entity recapitalization.

While there are certainly overlaps with the way Chapter 14 1.0 works—and would continue to work for conventional reorganizations of operating companies—the features that facilitate a two-entity recapitalization through bankruptcy are structurally somewhat distinct. They—together with the basic features of Chapter 14 1.0—are incorporated in the Chapter 14 2.0 proposal.[30] In this paper, we will,

Bankruptcy: Cases, Problems and Materials, 466–67 ("Between [1983 and 2003] a sea change occurred through which an auction of the debtor's assets has become a commonplace alternative to a traditional corporate reorganization").

28. A section-by-section outline of this Chapter 14 2.0 proposal is contained in the Appendix, and will be referred to throughout.

29. Dodd-Frank Act, sections 203(a)(2)(F) and (b)(2).

30. A Senate bill, S. 1861, 113th Congress, 1st Sess. ("The Taxpayer Protection and Responsible Resolution Act") (December 2013) focuses on amending the Bankruptcy Code so as to incorporate provisions for a two-entity recapitalization,

first, outline the basic features of Chapter 14 1.0 vis-à-vis the reorganization or liquidation of an operating company and point to where they (sometimes with modifications) are located in Chapter 14 2.0. We will then focus on the additional provisions that form the basis for the two-entity recapitalization of a holding company that is at the center of the differences between the two versions.

But, first, a brief description of the differences between the two processes. The reorganization or liquidation of an operating company that was the focus of Chapter 14 1.0, and the "quick sale" recapitalization that is the major driver of the changes in Chapter 14 2.0, trigger off of whether there is a motion for, and approval of, a "section 1405 transfer"[31] (as defined in our section-by-section proposal that forms an appendix to this chapter) within the first forty-eight hours of a bankruptcy case. If the court approves such a section 1405 transfer, then the covered financial corporation's operations (and ownership of subsidiaries) shift to a new bridge company *that is not in bankruptcy*, in exchange for all its stock.

Through the transfer, this new bridge company will be (effectively) recapitalized, as compared to the original covered financial corporation, by leaving behind in the bankruptcy proceeding certain preidentified (by regulators such as the Federal Reserve Board or by the parties themselves through subordination or bail-in provisions) long-term unsecured debt (called in the proposal "capital structure debt") of the original covered financial corporation. *After* the transfer, the covered financial corporation (the debtor) remains *in bankruptcy* but is effectively a shell, whose assets usually will consist only of beneficial

without ancillary provisions for a more traditional reorganization or liquidation as contemplated by Chapter 14 1.0. The House Judiciary Committee has introduced a similar bill, "The Financial Institution Bankruptcy Act," H. 5421 (August 2014) on a unanimous voice vote. That bill, with minor changes, was subsequently approved by the full House, also via a voice vote, on December 1, 2014—although, without action by the Senate, the process is restarted with the new session of Congress in 2015. We believe this is a positive step, though a complete bankruptcy solution should incorporate not just two-entity recapitalization provisions, but also provisions teed off of Chapter 14 1.0.

31. Appendix, section 2(6).

ownership of the equity interests in the bridge company (held on its behalf by a special trustee) and whose claimants consist of the holders of the long-term debt, any subordinated debt, and the old equity interests of the covered financial corporation. It has no real business to conduct, and essentially waits for an event (such as an IPO for public trading in equity securities of the bridge company) that will value its assets (all equity interests in the new, recapitalized entity) and permit a sale or distribution of those assets, pursuant to bankruptcy's normal distribution rules, to the holders of the long-term and subordinated debt and original equity interests of the debtor (the original covered financial corporation).

Essentially, Chapter 14 2.0 includes four types of rules. One set, centered around the section 1405 transfer, is specific to the mechanics of the two-entity recapitalization's transfer to the bridge company—keeping the other assets, debts, executory contracts, qualified financial contracts, and the like, "in place" and "intact" so they can be transferred to the bridge company. Another set of Chapter 14 rules, as noted above, is specific to the mechanisms of the reorganization of an operating company by keeping the covered financial corporation a "going concern" during its reorganization. A third set of rules deals with the conceivable possibility that the section 1405 transfer won't be approved, and thus provides for the transition from rules appropriate to the two-entity recapitalization to those appropriate to the reorganization (or liquidation) of the covered financial corporation in bankruptcy. Finally, a fourth set of rules is common for all cases in Chapter 14, and thus applies to both a one-entity reorganization and a two-entity recapitalization. Many of these rules are those provided by Chapters 1, 3, 5, and 11 of the current Bankruptcy Code, which Chapter 14 expressly makes relevant (unless overridden by a provision of Chapter 14 itself) to all Chapter 14 cases, as augmented by the proposals suggested in our 2012 Chapter 14 1.0 proposal.

Chapter 14 1.0

The 2012 Chapter 14 1.0 proposal centered around five basic areas where new provisions were added and existing bankruptcy provisions were modified. They were: (A) provisions applying to the creation of a new Chapter 14;[32] (B) provisions relevant to the commencement of a Chapter 14 case;[33] (C) provisions involving the role of the primary regulator in the bankruptcy proceeding;[34] (D) provisions involving debtor-in-possession financing;[35] and (E) provisions applicable to qualified financial contracts in Chapter 14.[36] The essence of these proposals is summarized next, although fuller treatment, of course, is contained in the 2012 Chapter 14 1.0 proposal itself.

Provisions Applying to the Creation of a New Chapter 14

Recognizing that the provisions for a reorganization proceeding in Chapter 11 and a liquidation proceeding in Chapter 7 provided a solid starting point—together with the general provisions in Chapters 1, 3, and 5—Chapter 14 was built around the premise that a large financial institution (and its subsidiaries) would generally use those rules *except* where Chapter 14 was designed to explicitly change them. It accordingly called for a large financial institution[37] to concurrently file for both Chapter 14 and either Chapter 7 or Chapter 11.[38] Because of concerns about political independence, as well as judicial expertise, a Chapter 14 case would be funneled to pre-designated district judges in the Second and District of Columbia circuits, who were expected to hear the cases themselves rather than referring them to bankruptcy judges.[39] The district judges were given the express right to appoint a special master from a predesignated panel to hear Chapter 14 cases and proceedings connected with a Chapter 14 case, as well as the designation of bankruptcy judges and experts to provide advice and input.[40]

32. Scott and Taylor, *Bankruptcy Not Bailout*, 27–33.
33. Ibid., 34–38.
34. Ibid., 39–40 and 44–45.
35. Ibid., 40–44.
36. Ibid., 45–66.
37. See Scott and Taylor, *Bankruptcy Not Bailout*, 28; Appendix, section 1(1).
38. Ibid., 29–30; Appendix, section 1(2).
39. Ibid., 33; Appendix, section 3(1).
40. Ibid., 33; Appendix, section 3(1).

Provisions Relevant to the Commencement of a Chapter 14 Case

To ensure that the entire financial institution could be dealt with in the Chapter 14 case, Chapter 14 1.0 proposed to eliminate the exclusion in existing bankruptcy law for domestic and foreign insurance companies, as well as stockbrokers and commodity brokers, from Chapter 11 when a Chapter 14 case applied, although existing rules for the treatment of customer accounts would be made applicable to the bankruptcy proceedings of stockbrokers and commodity brokers. The Securities Investor Protection Corporation (for stockbrokers) or the Commodity Futures Trading Commission (for commodity brokers) would be given a right to be heard and file motions.[41] Chapter 14 1.0, however, did not change the current resolution practice of the FDIC over depository banks.[42]

Provisions Involving the Role of the Primary Regulator in the Bankruptcy Proceeding

In addition, a financial institution's primary regulator would be given the right to file an involuntary case against that financial institution and the right to do so, if contested, not just in the case of the institution generally not paying its debts as they become due, but also on the ground that either the financial institution's assets were less than its liabilities, at fair valuation, or the financial institution had an unreasonably small capital.[43]

Beyond the filing of an involuntary petition by a financial institution's primary regulator, the regulators of the business of a financial institution or any subsidiary thereof would have standing, with respect to the financial institution or the particular subsidiary, to be heard as parties and to raise motions relevant to their regulation.[44] The primary regulator would additionally be given the power, in parallel with the trustee or debtor-in-possession, to file motions for the use, sale, or lease of property of the estate pursuant to the procedures of section

41. Ibid., 35–36; Appendix, section 1(1).
42. Ibid., 36; Appendix, section 1(1).
43. Ibid., 37–38; Appendix, sections 2(3) and (4).
44. Ibid., 39; Appendix, sections 2(2) and (5).

363 of the Bankruptcy Code.[45] Either the primary regulator or a creditors' committee would be permitted to file a plan of reorganization at any time.[46]

Provisions Involving Debtor-in-Possession Financing

The Chapter 14 1.0 proposal would make it clear that debtor-in-possession (DIP) financing is available in Chapter 14, pursuant to section 364's procedures and limitations, for financing that will permit partial or complete payouts to some or all creditors where liquidity or solvency of those creditors is a systemic concern, with those payments intended as "advances" for the likely payouts such creditors would receive in a liquidation or a reorganization at the end of the bankruptcy process. To ensure that this was not a backdoor way of providing financial favoritism, these distributions would be subject to several burden-of-proof requirements, to be passed on by the district judge, as well as subordination of the claim of the entity providing such funding to the extent that the creditors receiving such distributions received more than they would have in the bankruptcy proceeding absent such funding. Moreover, if the government was the entity providing such funding, it would additionally be required to show that no private funding on reasonably comparable terms was available within the time frame required.[47]

45. Ibid., 40; Appendix, section 2(2).

46. Ibid., 45; Appendix, section 2(5).

47. Ibid., 43–44; Appendix, section 2(14). That provision, which adds a section 1413, picks up the provisions regarding debtor-in-possession financing from Chapter 14 1.0. This provision is essentially for use in Chapter 14 1.0's reorganization of an operating entity model that is carrying on an active business and that needs liquidity in the bankruptcy proceeding, and perhaps may need, for financial stability purposes, prepayments to some claimants. It builds on the debtor-in-possession financing provisions of section 364 of the Bankruptcy Code. In the case of a section 1405 transfer (see Appendix, section 2(6)), the judge will retain jurisdiction over the bridge company, on its application, sufficient to allow the Chapter 14 court to authorize for a limited period comparable funding, subject to conditions, available to a debtor-in-possession under section 1403.

Provisions Applicable to Qualified Financial Contracts in Chapter 14

Rules written into the Bankruptcy Code over the past several decades have increasingly exempted counterparties on qualified financial contracts from many of bankruptcy law's special rules, including the automatic stay and preference law. Occasionally, these exemptions make underlying sense, but often they do not. In Chapter 14 1.0, our Working Group proposed revisiting all these Code provisions, and treating the counterparties according to the underlying attributes of the contracts they possessed. In the case of counterparties on repo (repurchase) contracts, which are comparable to secured loans, the automatic stay would not apply in terms of netting, setoff, or collateral sales by the counterparty of cash-like collateral that is in its possession—each being an instance of rights that the counterparty could exercise without detriment to the debtor or its estate.[48] In the case of counterparties on derivatives, however, more significant short-term changes in existing law were proposed, again consistent with the idea that most derivatives were comparable to executory contracts, and should be treated as such. Thus, for three days, the counterparty would be subject to bankruptcy's automatic stay, so as to enable the debtor to exercise its choice between assumption and rejection of the derivative (although the debtor would need to accept or reject all of the counterparty's derivatives without cherry-picking). After three days, and unless the debtor had previously assumed the derivative, the counterparty would be free to exercise any rights it may have to terminate the derivative and, upon termination (either by action of the counterparty or by rejection by the debtor), the counterparty will have the netting, setoff, and collateral sale rights of a repo counterparty in bankruptcy.[49]

Finally, counterparties on qualified financial contracts would be given no blanket exemption from the trustee's avoiding powers, including preference law, although preference law would be amended

48. Ibid., 50–52; Appendix, section 2(8).

49. Ibid., 56–60; Appendix, section 2(8).

to provide a "two-point net improvement test" safe harbor for certain payments and collateral transfers.[50]

Incorporating a "Quick Sale" Recapitalization into Chapter 14

While most of these provisions continue to make sense, and apply as well to the reorganization or liquidation of an operating company, they—by themselves—are not focused sufficiently on a rapid recapitalization of a financial institution at the holding company level (or, indeed, the rapid recapitalization of an operating covered financial corporation), in which—in the course of a very short period of time—it is intended that the financial institution, through the recapitalization, would (a) likely be solvent, (b) appear solvent to market participants, and (c) be subject to market discipline, rather than be under the "protection" of a bankruptcy proceeding (or subject to the interference with market-based decisions by a judge overseeing the bankruptcy proceeding of the holding company).

Doing this requires several new provisions and counsels for some modifications in the proposals contained in Chapter 14 1.0. The most significant change in the Chapter 14 2.0 proposal is its focus on provisions implementing a quick recapitalization of a covered financial corporation (usually a holding company), via a sale of its assets and liabilities (other than certain pre-identified long-term unsecured debt and subordinated debt) to a bridge company immediately following the commencement of a bankruptcy case.[51] In essence, this quickly removes the assets from the bankruptcy process, in the form of a new,

50. Ibid., 62–66; Appendix, section 2(12).

51. Appendix, section 2(6) (describing a section 1405 "Special Transfer"). If the entity does not have regulatory-required capital structure debt, and does not have contractually subordinated debt, it will be unlikely to be able to use section 1405's "quick transfer," as there will be little, if anything, left behind in the transfer (other than equity). This will almost certainly mean the financially distressed covered financial institution will be unable to demonstrate, as section 1405 requires, that the bridge company can provide adequate assurance of future performance of the debts and contracts being transferred to it. Thus, while not limited to holding companies, the use of section 1405 will require that the covered financial

and hopefully clearly solvent, company, while leaving full beneficial ownership rights of that company (as between the holders of the long-term and subordinated debt that is not transferred and the old equity holders who are also left behind) to be realized over time in the bankruptcy estate. In addition to requiring pre-identified long-term debt in sufficient quantity—a non-bankruptcy issue but critical to the ability of *either* Chapter 14's quick sale *or* the FDIC's SPOE process to succeed[52]—it requires a series of rules permitting assets, liabilities, contracts, and permits to be transferred to the bridge company notwithstanding restrictions on transfer, or change-of-control provisions, or the like. In essence, a number of rules need to be in place to ensure that, but for the recapitalization, the bridge company has all of the rights and liabilities that the holding company had the moment before the commencement of the bankruptcy case. Virtually all of the new rules in the Chapter 14 2.0 proposal are designed to deal with this, although there are also some transitional rules, some changes in the Chapter 14 1.0 proposal based on making the "quick sale" effective, and some (modest) changes in the Chapter 14 1.0 proposal based on our current thinking.

The Section 1405 Transfer

The heart of the change is what we have denominated the section 1405 transfer.[53] This transfer is, in many ways, the key concept implementing the two-entity recapitalization idea in Chapter 14. It permits the debtor or either the Board (in cases where the Board has supervisory authority over the debtor—usually the largest financial institutions) or its primary regulator (in other cases)[54] that commences a bankruptcy case to immediately make a motion for a transfer of the property of the estate, contracts, and liabilities (except for "capital

corporation have debt that can be left behind, thus accomplishing the financial reorganization contemplated by the section 1405 transfer.

52. See Scott, "The Context for Bankruptcy Resolutions."

53. Appendix, section 2(6).

54. Defined in Appendix, section 2(3) (and slightly modified from the Chapter 14 1.0 proposal).

structure debt"—our term for the debt that is left behind—and, of course, equity)[55] of the debtor to a newly created bridge company.[56] If the transfer is approved, every asset, liability, and executory contract of the debtor will be included in the transfer to the bridge company *except* for capital structure debt (and equity). If the debtor owns collateral that secures a loan (other than via a qualified financial contract) with an original maturity of at least one year, upon its transfer pursuant to section 1405 to the bridge company, the secured lender's claim against the bridge company will be non-recourse if its deficiency claim would otherwise be considered capital structure debt.[57] However, through that definition of capital structure debt, such a lender will, if the collateral is insufficient, continue to have an unsecured claim for any deficiency in the Chapter 14 case.[58]

The section 1405 transfer motion shall be heard by the court no sooner than twenty-four hours after the filing (so as to permit twenty-four-hour notification to the debtor, the twenty largest holders of the capital structure debt, the Board and the FDIC [in the case of a debtor over whom the Board has supervisory authority], and also the primary financial regulatory authority—whether US or foreign—with respect to the debtor as well as any subsidiary whose ownership is proposed to be transferred to the bridge company in the section 1405 transfer).[59] Based on limited stays in other provisions in Chapter 14, the transfer decision essentially must be made within forty-eight hours after the filing.[60] The court can order the transfer only if it finds, or the Board or primary regulator (as the case may be) certifies that it

55. Defined in Appendix, section 2(3). A part of this definition of capital structure debt begins the idea, finished in Appendix, section 2(6), that under-collateralized long-term secured debt will be treated as follows: (a) the secured portion of the debt will be transferred (along with the collateral) to the bridge company on a non-recourse basis and (b) the debt holder will retain an unsecured claim in the debtor's bankruptcy for the remainder.

56. Ibid., section 2(3).

57. Ibid., sections 2(3) and (6).

58. Ibid., section 2(3).

59. Ibid., section 2(6).

60. See ibid., sections 2(7) and (8).

has found, that the bridge company adequately provides assurance of future performance of any executory contract, unexpired lease, or debt agreement being transferred to the bridge company.[61] The court must also confirm that the bridge company's bylaws allow its board to be replaced, pursuant to a decision of the Chapter 14 judge after a notice and hearing for the equity owners of the bridge company (collectively, the debtor; individually, the holders of the capital structure debt and equity interests of the debtor), and other parties in interest (such as the Board and/or primary regulator), during the first thirty days following the section 1405 transfer to that bridge company.[62] Moreover, while the bridge company is not otherwise subject to the jurisdiction of the Chapter 14 judge following the transfer, that judge shall retain jurisdiction for one year, upon application of the bridge company, to award financing on the terms and conditions applicable to DIP financing pursuant to section 1413. This is done in order to provide access to liquidity in the (hopefully rare) occasions where market-based liquidity to the presumptively solvent bridge company is unavailable. It is limited to six months on the view that any market-based liquidity restrictions (whether local or global) will have dissipated or otherwise been dealt with by that time and the bridge company is thereafter on its own.[63]

Commencing the Chapter 14 Case

While many of the commencement provisions in the Chapter 14 1.0 proposal have been carried forward, there have also been some modest changes, based largely on the necessity for a decision on a section 1405 transfer within forty-eight hours of the filing. While Chapter 14 itself is new, there will be provisions noting that, except where otherwise expressly provided by Chapter 14, the "non-substantive" chapters of the Bankruptcy Code (Chapters 1, 3, and 5) apply in Chapter 14, and

61. Ibid., section 2(6). If the certifications are challenged, the Chapter 14 judge, after appropriate proceedings, may award damages, ibid., section 2(4), and sovereign immunity is to that extent abrogated, ibid., section 1(3).

62. Ibid.

63. The more general subject of financing such institutions is explored in David Skeel, "Financing Systemically Important Financial Institutions in Bankruptcy," chapter 3 in this volume.

that, again except where otherwise expressly provided by Chapter 14, the provisions of Chapter 11 apply in a case under Chapter 14.[64] While there is no provision for the direct use of Chapter 7, liquidations are permitted under Chapter 11 and a conversion to Chapter 7 under section 1112 of the Bankruptcy Code is expressly allowed.[65] Because Chapter 14 generally incorporates the provisions of Chapter 11, there is no need for a concurrent filing under Chapters 14 and 11, as proposed in Chapter 14 1.0, although the substance is the same. (The current Chapter 14 2.0 proposal is, in substance, similar to making the provisions of Chapter 14 a new subchapter of Chapter 11.)

Chapter 14 can only be used by a "covered financial corporation,"[66] whose definition picks up institutions that are "substantially engaged in providing financial services or financial products," including subsidiaries that are neither banks (that currently are, and would remain, subject to FDIC resolution procedures), nor a stockbroker or commodity broker (which goes into special Chapter 7 provisions).[67] (While subsidiaries of a covered financial corporation—that are themselves excluded banks, stockbrokers, or commodity brokers—cannot file in Chapter 14, a parent institution owning such subsidiaries can nevertheless use Chapter 14.) In common with Chapter 14 1.0, there is no exclusion of insurance companies.[68] The minimum size requirement of Chapter 14 1.0 has been dropped on the view that Chapter 14 provides a superior reorganization mechanism for all financial institutions. The definition of "covered financial corporation," however, specifically excludes financial market infrastructure corporations (such as central counterparty clearinghouses) as unsuited for Chapter 14, even if they otherwise meet the definition of a covered financial corporation.[69]

As for the commencement of a Chapter 14 case, Chapter 14 2.0 picks up on, but modifies, the provisions for the commencement of

---

64. Appendix, section 1(2).

65. Ibid., section 1(3).

66. Ibid.

67. Ibid., section 1(1).

68. Ibid.

69. Ibid. See Darrell Duffie, "Resolution of Failing Central Counterparties," chapter 4 in this volume.

a Chapter 14 case in Chapter 14 1.0. It continues with the ability of the covered financial corporation itself (the debtor) to file a voluntary petition under section 301 of the Bankruptcy Code.[70] It does not, however, permit three or more creditors of a covered financial corporation to file an involuntary petition under section 303 of the Bankruptcy Code, as this was thought to be both potentially disruptive and unnecessary, particularly when a section 1405 transfer might be the preferred solution, as the time-table for that determination simply doesn't accommodate time for a distinct hearing and resolution on the merits of the involuntary petition itself.[71] It does allow the Federal Reserve Board to file what is tantamount to a voluntary petition for covered financial corporations over which it has supervisory authority, in legal effect (e.g., the filing commences the case and constitutes an order for relief), if the Board certifies (and makes a statement of the reasons) that it has determined (after consultation with the secretary of the treasury and the FDIC) that either the commencement of a Chapter 14 case is necessary to avoid serious adverse effects on the financial stability of the United States[72] or the covered financial corporation has substantial impairment of regulatory capital. In other cases, the primary regulator may file a comparable petition in which the commencement of the case and the order for relief are simultaneous, upon a certification that the primary regulator has determined that the covered financial corporation's assets are less than its liabilities, at fair valuation, or the covered financial corporation has unreasonably small capital. This substitutes the Board, in instances where it is has supervisory authority, for Chapter 14 1.0's proposal regarding the primary regulator, makes several other changes in the standard, and makes the petition function equivalent to a voluntary petition (i.e., immediate order for relief) rather than an involuntary petition (that can be challenged before an order for relief). This was done with the thought that because of the very tight time constraint to approve a section 1405 transfer (after notice and hearing), in cases

70. Appendix, section 2(4).
71. Ibid.
72. Ibid.

where it is otherwise appropriate, there simply wasn't time to have a meaningful insolvency hearing; in addition, once the filing was made, it was likely to be a self-fulfilling prophecy. In its place is a Board certification regarding impairment of regulatory capital or financial stability or a primary regulator's certification concerning balance sheet insolvency (e.g., assets less than liabilities) or unreasonably small capital. However, the court would retain jurisdiction to subsequently hear and determine damages proximately caused by such filing, if it finds that the Board's or primary regulator's certification was not supported by substantial evidence on the record as a whole (analogous in some respects to the damages provision of section 303(i)(2)(A)), so that there is an understanding that aggrieved parties (mostly the original equity holders of the debtor) could have ex post damage remedies.[73]

In terms of who oversees the Chapter 14 case, the Chapter 14 1.0 proposal essentially displaced non–Article III bankruptcy judges with Article III district judges to handle Chapter 14 cases, and funneled all such cases to the Second and District of Columbia circuits. We propose the same basic idea of using district judges, but have made some modifications in the original proposal. First, rather than funneling cases to the Second Circuit or the DC Circuit, it has at least one designated district court judge (selected by the chief justice of the United States) in each circuit who will be involved in Chapter 14 cases.[74] Ordinary venue rules (in 28 USC section 1408) determine where the covered financial corporation files (or the Board commences a case involving a covered financial corporation). Because a designated judge, while within the judicial circuit, may not be within the judicial district where the Chapter 14 case is commenced, the provision deems the judge to be temporally assigned to the district in which the bankruptcy case is commenced.[75] (This decision to involve a judge

73. Ibid., section 2(4). Sovereign immunity is thereby abrogated. Section 1(3). Cf. Scott, "The Context for Bankruptcy Resolutions."

74. Appendix, section 3. No need to exclude the Federal Circuit Court of Appeals, as that circuit has no district judges.

75. Ibid.

from every judicial circuit, rather than funneling cases to the Second or DC Circuit, is responsive to likely political reactions by senators and representatives who focus on their own respective jurisdictions.) Moreover, the designated judge "goes with the case," so if venue is changed, the district judge will be deemed temporarily assigned to the new district.[76] Second, it requires two-entity recapitalization cases—those involving a section 1405 transfer—to be handled up to the point of the transfer by the designated district judge, but not necessarily thereafter (again, since most of the debtor's business has been transferred to the bridge company).[77] In other cases—conventional reorganization cases of the type contemplated by the original Chapter 14 1.0 proposal—the designated district judge, as with the *Bankruptcy Not Bailout* proposal, must keep the case and proceedings without referral to a bankruptcy judge.[78] Referral to a bankruptcy judge, however, can occur if there is a decision to convert the case to Chapter 7 pursuant to section 1112.[79] Third, the designated district judge can appoint a bankruptcy judge to assist the district judge as a special master.[80] Finally, because some circuits require that appeals from bankruptcy judges go to the Bankruptcy Appellate Panel (consisting of non–Article III bankruptcy judges), and the remaining circuits may otherwise send appeals to other district judges, this provision will require 28 USC section158(a) appeals from bankruptcy judges to go to the designated district judge.[81] (As usual, appeals from the designated district judge in cases and proceedings that haven't been referred to a bankruptcy judge will go to the relevant court of appeals.)

Role of Regulators

In addition to the Board's ability to file what is tantamount to a voluntary petition, as discussed above, Chapter 14 2.0 provides several

76. Ibid.
77. Ibid.
78. Ibid.
79. Ibid.
80. Ibid.
81. Ibid.

other roles for regulators.[82] First, it gives the Board standing to be heard on any issue relevant either to the regulation of the debtor by the Board or to the financial stability of the United States.[83] It gives the FDIC more limited standing—to be heard in connection with a section 1405 transfer.[84] And it gives the primary financial regulator of any subsidiary (domestic or foreign) or its parent standing to be heard on any issue relevant to its regulation of that entity (including transfer of its ownership interests in a section 1405 transfer as well as its ownership by the debtor in a reorganization rather than a two-entity recapitalization).[85] If there is a section 1405 transfer, where the bridge company effectively continues as the recapitalized debtor (in a two-entity recapitalization), the Board's regulatory interest should shift to the bridge company, so Chapter 14 provides that, after such a section 1405 transfer, the Board's remaining standing vis-à-vis the debtor is with respect to its equity ownership of the bridge institution.[86] If there is not a section 1405 transfer, the Board, analogous to the primary regulator in the original Chapter 14 proposal, can file a plan of reorganization at any time. (In the typical section 1405 transfer, we propose the appointment of a trustee immediately after the section 1405 transfer, and thus all parties in interest, including the Board, are authorized to file a plan of reorganization without delay under section 1121(c) of the Bankruptcy Code.)[87]

---

82. References to the United States trustee as having a role are removed (Appendix, section 2(2)), and our proposal essentially substitutes the (Federal Reserve) Board (a defined term from Appendix, Section 2(3)), thus, for example, giving the Board the power to move for the appointment of a trustee under section 1104. While Chapter 14 1.0 had provisions to give the primary regulator a role in the Chapter 14 proceeding, nothing exactly parallel to this exists in the Chapter 14 2.0 proposal. Appendix, section 2(5), follows, and modifies, the "regulator standing" proposal from Chapter 14 1.0.

83. Appendix, section 2(5).

84. Ibid.

85. Ibid.

86. Ibid.

87. Ibid.

Provisions Related to Making the Section 1405 Transfer Effective

As noted, at the heart of the two-entity recapitalization are two principles: first, that there is sufficient long-term unsecured debt—capital structure debt—to be "left behind" in the transfer to a bridge company so as to effectuate the recapitalization; and, second, that the bridge company otherwise have the assets, rights, and liabilities of the former holding company. A number of provisions in Chapter 14 2.0 are designed to effectuate this latter principle.

First, there are provisions applicable to debts, executory contracts, and unexpired leases, including qualified financial contracts.[88] Conceptually, the goal of these provisions is to keep assets and liabilities in place so that they can be transferred to the bridge company (within a forty-eight-hour window) and, thereafter, remain in place so that business as usual can be picked up by the bridge company once it assumes the assets and liabilities. This requires overriding "ipso facto" clauses (of the type that would otherwise permit termination or modification based on the commencement of a Chapter 14 case or similar circumstance, including credit-rating agency ratings), and it requires overriding similar provisions allowing for termination or modification based on a change of control, since the ownership of the bridge company will be different than the ownership of the debtor prior to the bankruptcy filing.[89] It needs to be broader than section 365 of the Bankruptcy Code, for at least two reasons. First, bankruptcy doesn't have a provision expressly allowing for the transfer of debt (although many debts are in fact transferred as a matter of existing practice under Chapter 11 "going concern sales"). Unlike executory contracts, which might be viewed as net assets (and thus something to "assume") or as net liabilities (and thus something to "reject"), debt is generally considered breached and accelerated (think "rejected") upon the filing of a petition in bankruptcy. But, if there is going to be a two-entity recapitalization, the bridge company needs to take the debt "as if nothing has happened." Thus, Chapter 14 2.0 has provisions (sections 1406

88. See generally Appendix, sections 2(7) and (8).
89. Ibid.

and 1407) that are designed to accomplish that.[90] Second, section 365 doesn't deal with change-of-control provisions; these provisions add that and extend it to debt agreements as well.[91]

A complexity is that the brief stay to allow the section 1405 transfer needs itself to be terminated with respect to the termination or modification of any debt agreement if there is no section 1405 transfer but, rather, a regular bankruptcy of the type contemplated by the original Chapter 14 proposal.[92] (Debts—liabilities that normally are deemed breached upon the filing of bankruptcy—are in this respect treated differently than executory contracts and unexpired leases, since the provisions of sections 362 and 365 of the Bankruptcy Code are expected to continue, as they do in other reorganization cases.)

With respect to qualified financial contracts, similar rules apply. If there is a filing with a motion for a section 1405 transfer, there is a stay of efforts to liquidate, terminate, or accelerate a qualified financial contract of the debtor or subsidiary or to offset or net out, other than rights that exist upon the normal maturation of a qualified financial contract.[93] (Unlike the detailed provisions in the qualified financial contracts proposal in Chapter 14 2.0, these provisions are distinct in that they apply rules that didn't apply—and continue not to apply—in the Chapter 14 1.0 reorganization proposal, particularly with respect to repo counterparties and their ability to sell cash-like collateral.)

The stay applies for the period essentially until the section 1405 transfer occurs, it is clear it won't occur, or forty-eight hours have passed.[94] Because of this interregnum, when there is a likelihood that the section 1405 transfer will be approved, and all of these qualified financial contracts go over in their original form to the bridge company, there is a requirement that the debtor and its subsidiaries shall continue to perform payment and delivery obligations.[95] And,

90. Ibid.
91. Ibid.
92. Ibid., section 2(7).
93. Ibid., section 2(8).
94. Ibid.
95. Ibid.

as long as the debtor and/or its subsidiaries are performing payment and delivery obligations, a counterparty is expected to comply with its contractual obligations as well; the failure to do so shall constitute a breach in accordance with the terms of the qualified financial contract.[96] Finally, if the filing of the bankruptcy case does not involve a motion for a section 1405 transfer, or if the motion is denied, or if forty-eight hours pass, then the case will be considered to be a conventional reorganization case (rather than a two-entity recapitalization case), and thus the original proposed rules for qualified financial contracts in Chapter 14 1.0 shall come into play.[97]

Just as the principle of having the bridge company have the same rights, assets, and liabilities drives the provisions regarding debts, executory contracts, and unexpired leases just discussed (including qualified financial contracts), a similar provision is necessary to keep licenses, permits, and registrations in place, and does not allow a government to terminate or modify them based on an ipso facto clause or a section 1405 transfer.[98]

---

96. Ibid.

97. Ibid. These provisions are somewhat complex. To summarize them, without every nuance, under our provisions, from Chapter 14 1.0, we treat repos as debts, and consider them automatically breached by the commencement of the case. (Although there may be a stay up to forty-eight hours, if there is a motion for a section 1405 transfer, as described above.) However, we allow a counterparty to dispose of highly liquid collateral in its possession and exercise set-off rights without court permission, and allow it to sell other, non-firm-specific collateral in its possession upon motion to the court and the court's determination of the collateral's value. We also give the counterparty the right to reach comparable collateral in the hands of the debtor on motion of the court. We treat most swaps/derivatives as executory contracts, and give the debtor seventy-two hours to decide to accept or reject them (without permitting cherry-picking within a counterparty's portfolio). If they are accepted, then the swap/derivative continues as an enforceable contract, notwithstanding ipso facto clauses and the like. If they are breached, then the swap/derivative counterparty has essentially the rights of a repo counterparty (i.e., to sell highly liquid collateral, etc.).

98. Ibid., section 2(10). We assume that the "name" of the bridge company will be close enough to that of the debtor that filed financing statements will remain effective under Article 9, Section 9-508, of the Uniform Commercial Code.

Many avoiding power provisions use as a baseline what a creditor would receive in a Chapter 7 liquidation. That potentially brings into play various avoiding powers, such as preference law, against holders of short-term debt (such as commercial paper) who, in a Chapter 7 liquidation, might not be paid in full, but in a two-entity recapitalization under a section 1405 transfer, will be paid in full. Thus, section 1411 is designed to call off avoiding powers (other than section 548 (a)(1)(A) of the Bankruptcy Code dealing with intentional fraud) in the case of a section 1405 transfer, except with respect to transfers to, or for the benefit of, holders of long-term unsecured debt or subordinated debt (which is not transferred and is likely not to be paid in full) and transfers to the debtor's equity holders (such as dividends made pre-bankruptcy while the SIFI was insolvent).[99]

Finally, while all of these provisions deal with those in a relationship with the holding company, similar provisions need to be implemented with respect to contracts and permits held by a subsidiary whose ownership interests are transferred to the bridge company. Thus, we provide that a counterparty to such contracts with the subsidiary cannot terminate, accelerate, or modify any executory contract, unexpired lease, or debt agreement based on either an anti-assignment provision or a change-of-control provision.[100] Nor may a party to an agreement

99. Appendix, section 2(12). In an ordinary recapitalization case (not involving a section 1405 transfer), there are special avoiding power rules specified in Chapter 14 1.0 for holders of qualified financial contracts. Those provisions have been incorporated in Appendix, section 2(12) as well.

100. Ibid., Section 2(9). While these provisions affect the contracts of entities not themselves in bankruptcy, we believe they are fully authorized, if not by Congress's Article I bankruptcy power, then by application of the "necessary and proper" clause of Article I, as interpreted since McCulloch v. Maryland, 4 Wheat. 316 (1819). See also United States v. Comstock, 560 U.S. 126 (2010). The issue of reaching foreign subsidiaries cannot be directly resolved by US bankruptcy law and, in general, cross-border issues of international institutions remain nettlesome. See Jacopo Carmassi and Richard Herring, "The Cross-Border Challenge in Resolving Global Systemically Important Banks," chapter 9 in this volume. That said, domestic and foreign regulators and banks, in conjunction with the International Swaps and Derivatives Association (ISDA), have promulgated a Resolution Stay Protocol that will (with sufficient regulatory support) impose similar rules

with a subsidiary enforce a cross-default provision involving the debtor for the period during which a section 1405 transfer motion is under consideration.[101] Again, these provisions, like sections 1406 and 1407, are designed to allow the two-entity recapitalization effected by a section 1405 transfer to occur seamlessly with respect to the bridge company's ownership of the debtor's subsidiaries. Similarly, in the case of a subsidiary whose ownership is transferred to the bridge company in a section 1405 transfer, those licenses, permits, and registrations cannot be terminated based on a "change-of-control" provision.[102]

Transitional Provisions Designed to Make the Section 1405 Transfer Effective

Upon consummation of a section 1405 transfer, the newly created bridge company will have little to no long-term unsecured debt (as capital structure debt has been left behind with the debtor). It will, however, presumably have residual (equity) value—which is, indeed,

on qualified financial contract counterparties in major foreign jurisdictions (as well as the United States). See ISDA, "Resolution Stay Protocol—Background," October 11, 2014; see also Tom Braithwaite and Tracy Alloway, "Banks Rewrite Derivative Rules to Cope with Future Crisis," *Financial Times*, October 7, 2014. There are two points to note about the ISDA Resolution Stay Protocol. First, it does not supplant the need for the provisions in proposed sections 1407 and 1408. They originally apply (as of January 1, 2015) to eighteen major financial institutions and certain of their affiliates, although this is described as "[t]he first wave of banks." Second, they are, in principle, voluntary, although the eighteen financial institutions have committed themselves to the Protocol, and there are expectations that governmental regulators, who pushed for the ISDA Protocol, will make compliance effectively necessary. The provisions of sections 1407 and 1408 apply irrespective of whether a particular financial institution is bound to the ISDA Resolution Stay Protocol. See Scott, "The Context for Bankruptcy Resolutions." Second, to the extent that an institution *is* subject to the ISDA Resolution Stay Protocol, and foreign regulators recognize a Chapter 14 resolution proceeding, the Protocol will go a long way to resolving the inability of US bankruptcy law to impose, at least vis-à-vis derivatives, the provisions of section 1408 directly on foreign subsidiaries (and their counterparties) of a covered financial corporation that is in Chapter 14.

101. Appendix, section 2(9).

102. Ibid, section 2(10).

the basis ultimately for payment to the debtor's claimants that were not transferred to the bridge company. Whether the bridge will be able to meet legal and regulatory capital requirements with that equity value alone will depend both on ex post valuation and on whether the regulatory scheme requires (as we believe it must in order to effectuate a two-entity recapitalization in the first place) a certain amount of debt (and not just equity) for loss absorbency purposes. The bridge will initially have substantial capital (equity) on a book basis, but its initial book value may not be validated by market performance. Moreover, initially the bridge company will have little to no long-term unsecured debt—since capital structure debt was left behind—and such debt may be crucial in terms of regulatory requirements.[103] The equity value in market terms will need to be sufficient for the bridge company, over time, to issue new long-term unsecured debt, but until that occurs, the bridge company is likely to be non-compliant with the debt side of minimum capital requirements. Thus, Chapter 14 2.0 proposes giving the bridge company a window in which it does not have to be in compliance with those capital requirements. That period of effective exemption from those capital requirements ends at the earlier of (a) the confirmation of the debtor's plan of reorganization involving (as will usually be the case) the distribution of securities (or proceeds from their sale) of the bridge company or (b) the passage of one year from the section 1405 transfer.[104] By the end of that window of exemption, the bridge company must be in compliance with relevant regulatory capital requirements, including those involving minimum long-term unsecured debt.

Section 1145 of the Bankruptcy Code allows a reorganized debtor to issue securities pursuant to a plan of reorganization without complying with most securities laws, the idea being that the required disclosure in a plan of reorganization, under section 1125, confirmed by a court, should substitute. Given that an envisioned end of a bankruptcy case of a debtor where there has been a section 1405 transfer will be the sale or distribution of securities of the bridge company

103. Ibid, section 2(11).

104. Ibid.

pursuant to a plan of reorganization, section 1412 treats this situation as equivalent to the typical reorganization case involving securities of the debtor, and thus provides that a security of the bridge company shall be treated as a security of a successor to the debtor under a plan of reorganization, in cases where the court has approved the plan's disclosure statement as providing adequate information about the bridge company and the security—thus fitting it within the provisions of section 1145.[105] Additionally, the exemption from any law imposing a stamp tax or similar tax, in section 1146(a), applicable to securities issued pursuant to a conventional plan of reorganization, is provided to securities of the bridge company in connection with a confirmed plan of reorganization following a section 1405 transfer.[106] (Importantly, unlike the ill-advised provision in Title II of Dodd-Frank that treats a bridge financial institution as equivalent for a government entity not subject to federal, state, or local tax,[107] there is no comparable provision for the bridge company created in a section 1405 transfer. It is, and should be thought of as, a private company subject to no favorable tax considerations not applicable to its competitors. This is distinct from the issue of a holding company's tax loss carry-forwards that should be treated as an asset that can be transferred to the bridge company in the Section 1405 transfer.)

If there is a section 1405 transfer, the management, at least originally, of the bridge company is very likely to be the management of the entity that filed for bankruptcy. Given that, it would be a conflict of interest to have that same management having the status of the "debtor in possession" of the debtor, which is now the equity owner of the bridge company. As a consequence, and given (as noted in the prior numbered paragraph) that the debtor after the section 1405 transfer isn't likely to be operating an ongoing business, there really is no need for prior management to be the "debtor in possession."

Thus, section 1414 requires the replacement of the debtor in possession with a trustee, appointed by the court after a notice and

105. Ibid, section 2(13).

106. Ibid.

107. Dodd-Frank Act, section 210(h)(10).

hearing, who shall be chosen from a preapproved list of trustees.[108] This trustee will represent the estate before the judge, together with a creditors' committee (consisting of representatives of the holders of capital structure debt), an equity holders committee (consisting of representatives of the former equity owners of the debtor), and other parties in interest.[109] The appointment of the trustee will also, importantly, permit "a party in interest" to file a plan of reorganization without needing to wait out (or call off) the exclusivity period for the debtor in possession in section 1121(c) of the Bankruptcy Code. In cases not involving a section 1405 transfer—that is to say, cases involving a conventional reorganization as contemplated by the Chapter 14 1.0 proposal—this will permit, but not require, the appointment of a trustee, but if a trustee is appointed, it will be from the same preapproved list.[110]

In addition, because of the concern that the Chapter 14 trustee will be subject to conflicting pressures from his constituents (debt and equity left behind) concerning using the equity ownership of the bridge company to direct the bridge company's actions, which would be resolved by the judge overseeing the bankruptcy case, Chapter 14 2.0 places the actual equity interests of the bridge in the hands of a special trustee, appointed by the court at the time of the section 1405 transfer. The special trustee will hold the equity interests for the sole benefit of the Chapter 14 estate. This additional step, albeit a complicating feature, is designed to give third parties additional assurance that the bridge company is, indeed, not being run by an entity in bankruptcy or by the judge overseeing the Chapter 14 case. The special trustee will have ongoing reporting requirements to the Chapter 14 trustee; major corporate decisions that require equity input or approval can be taken by the special trustee only after consultation with the Chapter 14 trustee. The bridge company shall be responsible for paying the reasonable expenses of the special trustee.

108. Appendix, section 2(15).

109. Ibid.

110. Ibid.

In the situation of a Chapter 14 case where there is a two-entity recapitalization pursuant to a section 1405 transfer, resolution of the Chapter 14 case will involve the debtor essentially awaiting a sale or distribution of equity securities of the bridge company that will be valued by the market. This distribution of stock or proceeds from it will form the basis of a plan of reorganization, including disclosure, solicitation of acceptances, a court hearing, and court confirmation of the plan (sections 1123–1129 of the Bankruptcy Code). While the Bankruptcy Code does not expressly provide a timetable for these events, it seems appropriate, given the hoped-for market-based determination of the value of the bridge company's equity securities that will be distributed in a plan, together with the desire to conclude the bankruptcy case (and wind down the debtor), to authorize explicitly a rapid time frame for solicitation, voting, and the court's hearing (and decision) on confirmation of the plan.[111]

Interface with Title II of Dodd-Frank

Currently, in order to commence an orderly liquidation proceeding under Title II of Dodd-Frank against a "covered financial company," where the board of that company does not acquiesce or consent to the proceeding, the secretary of the treasury must petition the District Court for the District of Columbia.[112] The court is given twenty-four hours to determine that the secretary's findings (a) that the "covered financial company is in default or in danger of default" or (b) that the company "satisfies the definition of a financial company under section 2019a)(11)" are arbitrary and capricious; if the court does not make a determination within that time frame, Dodd Frank provides that the petition is granted by operation of law.[113]

Given this very tight timetable, and given that if a Chapter 14 case was previously commenced there is already an involved district judge, the revised Chapter 14 proposal would amend Dodd-Frank by substituting the Chapter 14 district court (and judge) for the District

111. Ibid., section 2(16).

112. Dodd-Frank Act, section 202(a)(1)(A)(i).

113. Ibid., section 202(a)(1)(A)(v).

Court for the District of Columbia.[114] It would, in addition, subject the finding required of the government agencies under Dodd-Frank section 203(a)(2) that bankruptcy is not a viable alternative for the resolution of the financial institution to the same determination and issuance procedures currently outlined under section 202(a)(1)(A)(iii) and (iv) for the section 202(a)(1)(A)(iii) determination "that the covered financial company is in default or in danger of default and satisfies the definition of a financial company under section 201(a)(11)."[115]

APPENDIX
Proposed Bankruptcy Code Chapter 14 2.0

Section 1: General Provisions Relating to Covered Financial Corporations

1) Amend **Section 101** of the Bankruptcy Code by adding a new subsection defining a "covered financial corporation" as any corporation that is substantially engaged in providing financial services or financial products (other than financial market infrastructure corporations such as central counterparty clearinghouses), and any subsidiary of that corporation that both (i) is substantially engaged in providing financial services or financial products and (ii) is neither (a) an entity, other than a domestic insurance company, that is included on the lists in Section 109(b)(2) and (b)(3)(B) nor (b) a stockbroker (Section 741) nor (c) a commodity broker (Section 761).

2) Amend **Section 103** of the Bankruptcy Code to provide that (a) except as provided in Chapter 14, Chapters 1, 3, and 5 of the Bankruptcy Code apply in a case under Chapter 14 and (b) the provisions of Chapter 14 apply only in a case where the debtor is a covered financial corporation. Also, amend Section 103 to provide that, except as

114. Appendix, section 4 (amending Dodd-Frank Act, section 202(a)(1)(A)(i)).

115. Dodd-Frank, section 203(a)(2) (the FDIC and the Board must both "contain . . . (F) an evaluation of why a case under the Bankruptcy Code is not appropriate for the financial company. . . .").

provided in Chapter 14, the provisions of Chapter 11 apply in a case under Chapter 14.

3) Amend **Section 106** of the Bankruptcy Code by adding Section 1403 to the list of sections where sovereign immunity is abrogated.

4) Amend **Section 109** of the Bankruptcy Code to provide that only a covered financial corporation may be a debtor under Chapter 14. Also, exclude the ability of a covered financial corporation to be a debtor under Chapter 11 or under Chapter 7 (unless, in the case of Chapter 7, it is pursuant to the application of Section 1112 in the Chapter 14 case).

5) Amend **Section 1506** of the Bankruptcy Code to provide that the court has the discretion not to enforce foreign home country stay orders, or not to issue orders barring domestic ring-fencing actions against US-based assets, if the foreign home country has not adopted comparable provisions respecting ancillary proceedings in that foreign home country for U.S.-based home proceedings.

Section 2: Liquidation, Reorganization, or Recapitalization of a Covered Financial Corporation

1) Amend the Bankruptcy Code by adding a new **Chapter 14** ("Liquidation, Reorganization, or Recapitalization of a Covered Financial Corporation").

2) Add a **Section 1401**, "Inapplicability of other sections," that provides that Sections 321(c) (allowing the U.S. trustee for the district to serve as a trustee) and 322(b) (essentially the same) do not apply to a case under Chapter 14. References to "the United States trustee" in Chapter 11 shall be deemed replaced by references to "the Board" (defined below).

3) Add a **Section 1402**, "Definitions for this chapter," that defines (a) the "Board" as referring to the Board of Governors of the Federal Reserve System, (b) "bridge company" as the recipient of the transfer under Section 1405, whose equity interests are received by the Chapter 14 debtor in that transfer, (c) "capital structure debt" as unsecured debt (including the under-secured portion of secured debt that would otherwise constitute capital structure debt), other than a qualified financial contract, of the debtor for borrowed money with an original

maturity of at least one year that is either (i) of a kind required by the Board or other applicable government agency, (ii) contractually subordinated to other unsecured debt, or (iii) convertible upon specified financial events or conditions to a security that would have a lower priority in bankruptcy than unsecured debt; (c) "qualified financial contract" as contracts as defined in Section 101(25), (38A), (47), or (53B), Section 741(7), or Section 761(4), (5), (11), or (13); (d) "special trustee" as the trustee of a trust created under Section 1405.

4) Add a **Section 1403**, dealing with the "Commencement of a case concerning a covered financial corporation," that permits a case to be commenced (a) by the filing of a voluntary petition by the debtor under Section 301, (b) in the case of a covered financial corporation as to which the Board has supervisory authority, by the Board if the Board certifies that it has determined, following consultation with the Secretary of the Treasury and the FDIC, that the immediate commencement of a Chapter 14 case is necessary to avoid serious adverse effects on the financial stability of the United States or that the covered financial corporation has substantial impairment of regulatory capital, or (c) in the case of other covered financial corporations, by the filing of a petition by the primary regulator of that corporation if the primary regulator certifies that it has determined that the covered financial corporation's assets are less than its liabilities, at fair valuation, or the covered financial corporation has unreasonably small capital. A filing by the Board under (b) or by the primary regulator under (c) with the requisite certification will be treated as equivalent to a Section 301 voluntary filing (that is, the commencement of the case will itself constitute an order for relief), except that, analogous to Section 303(i)(2)(A), the court, before or after a Section 1405 transfer, would retain jurisdiction so as, on motion and hearing, to determine any damages proximately caused by such a filing or transfer pursuant to Section 1405, if the court further makes the determination that the certifications required by either Section 1403 or Section 1405 were not supported by substantial evidence on the record as a whole.

5) Add a **Section 1404**, "Regulators," permitting (a) the Board to be heard on any issue relevant to the regulation of the debtor by the

Board or to financial stability in the United States, (b) the FDIC to be heard in connection with a transfer under Section 1405, (c) the primary financial regulatory agency (as defined in section 2(12) of Dodd-Frank) of the covered financial corporation, any subsidiary of the covered financial corporation, or the primary financial regulator of any foreign subsidiary of the covered financial corporation or its parent, to be heard on any issue relevant to its regulation of that entity. If there is a transfer under Section 1405, following that transfer, the Board can be heard only in connection with the debtor's ownership of the bridge company. If there is not a transfer under Section 1405, then the Board is deemed a party in interest who can file a plan of reorganization at any time after the later of (a) the order for relief and (b) the failure to timely approve of a transfer under Section 1405, in a case where such transfer is sought.

6) Add a **Section 1405**, "Special Transfer of Property of the Estate, Contracts, and Debts." On motion by the debtor, the Board, or the primary regulator (in the latter two cases, only if the Board or the primary regulator was eligible to file a petition under Section 1403) at the time of the commencement of the case, and after a hearing, the court may order a transfer of the property of the estate, executory contracts, unexpired leases, and debt agreements, with the exception noted next, from the debtor to a bridge company. Neither capital structure debt nor equity interests may be transferred. All other assets and liabilities of the debtor shall be transferred to the bridge company if the court orders a transfer under this section. The transfer under this section shall specify that any debt for borrowed money that (a) is secured by collateral included in the transfer, (b) is not associated with a qualified financial contract, and (c) has an original maturity of at least one year, shall be non-recourse upon the transfer if the deficiency claim would otherwise constitute capital structure debt. Prior to the hearing, 24-hour electronic or telephonic notice shall be given to (a) the debtor, (b) the 20 largest holders of capital structure debt, (c) the Board and the FDIC (if the Board has supervisory authority over the debtor), and (d) each primary financial regulatory authority, whether US or foreign, of the covered financial corporation and any subsidiary whose ownership is proposed to be transferred, each of

whom have standing, with respect to its particular regulatory jurisdiction, concerning the motion for a Section 1405 transfer. After the hearing, the court may not order the transfer unless it finds (or the Board or the primary regulator, as the case may be, certifies to the court that it has found) that the bridge company provides adequate assurance of future performance of any executory contract, unexpired lease, or debt agreement being transferred to the bridge company. In addition, the court may not authorize the transfer to the bridge company unless it determines that the by-laws of the bridge company will allow a thirty-day period in which the debtor, with the approval of the Chapter 14 judge after notice and a hearing, can determine the composition of the board of the bridge company, notwithstanding the charter or by-laws of the bridge company or applicable nonbankruptcy law. A transfer under this section shall provide for the transfer to a special trustee, appointed by the court, of all of the equity securities of the bridge company to be held in trust for the sole benefit of the Chapter 14 estate, as well as the responsibility of the bridge company to pay the reasonable expenses of the special trustee. The court shall approve the trust agreement and shall require the special trustee to inform and consult with the Chapter 14 trustee about material corporate actions of the bridge company. The special trustee shall distribute the assets held in trust, and shall thereafter terminate the trust, upon either (a) the effective date of a confirmed plan of reorganization of the covered financial corporation or (b) the conversion of the case to Chapter 7. Finally, while the court otherwise does not retain jurisdiction over the bridge company following the transfer, it does retain jurisdiction for one year, on application by the bridge company, for liquidity financing at the priority levels of, and on the conditions specified in, Section 1413.

7) Add a **Section 1406**, dealing with "Automatic Stay; Assumed Debt." (I) Provide in this section that the filing of a petition operates as a stay, applicable to all entities, of the termination, acceleration, or modification of any debt agreement (other than a capital structure debt agreement or a qualified financial contract), executory contract (other than a qualified financial contract), or unexpired lease with the

debtor, or of any right or obligation under any such debt, contract, lease, or agreement, solely because of a provision that is conditioned on (a) the insolvency or financial condition of the debtor at any time before the closing of the case; (b) the commencement of a Chapter 14 case; (c) a cross-default, or (d) a change in a credit-rating agency rating (i) of the debtor at any time after the commencement of the case or (ii) of a subsidiary during the 48 hours after the commencement of the case, or (iii) of the bridge company or a subsidiary of the bridge company prior to the earlier of 90 days or the confirmation of a plan involving the debtor under Section 1129. The stay under this Section 1406 terminates, as to the debtor and with respect to any debt agreements with the debtor, upon the earliest of (a) a commencement of a Chapter 14 case without a motion for a Section 1405 transfer, (b) 48 hours after the commencement of the case, (c) the transfer of the debt agreement under an order authorizing a Section 1405 transfer, or (d) a determination by the court not to order a Section 1405 transfer. In addition, in the case of a subsidiary, the stay terminates not only upon the foregoing conditions but by a determination by the court not to order the transfer of the interests of the debtor in the subsidiary to the bridge company.

(II) Provide, as well, in this section, that such a debt agreement, executory contract, or unexpired lease of the debtor, may be transferred (and thus assumed) by the bridge company under Section 1405 notwithstanding any provision in an agreement or applicable non-bankruptcy law that (a) prohibits, restricts, or conditions the assignment of such debt agreement, executory contract, or unexpired lease, or (b) terminates, accelerates, or modifies any such debt agreement, executory contract, or unexpired lease, based on a change in control in any party.

8) Add a **Section 1407**, "Treatment of Qualified Financial Contracts," that provides that the filing of a petition to commence a Chapter 14 case that is accompanied by a motion for a Section 1405 transfer operates as a stay, notwithstanding Sections 362(b)(6), (b)(7), (b)(17), (b)(27), 555, 556, 559, 560, and 561, for the period specified in the stay duration in Section 1406, above, of the exercise of any contractual

right (i) to liquidate, terminate, or accelerate a qualified financial contract of the debtor or a subsidiary or (ii) to offset or net out any termination value, payment amount, or the like except the exercise of contractual rights that arise upon the non-accelerated maturity of a qualified financial contract shall not be subject to the stay. During the period in which this Section 1407 stay is applicable, the debtor and its subsidiaries shall perform all payment and delivery obligations under a qualified financial contract that become due after the commencement of the case; if the debtor or a subsidiary, as the case may be, fails to perform any such obligation, the stay provided by this Section 1407 terminates. As long as the debtor and/or its subsidiaries are performing all payment and delivery obligations under a qualified financial contract that become due after the commencement of the case, the failure of a counterparty to perform its obligations under that qualified financial contract shall constitute a breach of such contact according to its terms. A Section 1405 transfer of a qualified financial contract to the bridge company may not occur unless (i) all qualified financial contracts between the counterparty and the debtor are transferred to the bridge company and (ii) all property acting as security to the qualified financial contract is likewise transferred to the bridge company. Upon the transfer of a qualified financial contract to the bridge company under Section 1405, notwithstanding any provision in the qualified financial contract or in applicable law, that qualified financial contract may not be terminated, accelerated, or modified, for a breach of a provision of the type identified in Section 1406 (I) between the time of the Section 1405 transfer until the conclusion of the Chapter 14 case involving the debtor. If there is not a request for a transfer under Section 1405, or if such transfer is not approved, or 48 hours from the filing of the petition have expired, then the provisions for qualified financial contracts originally outlined in "Chapter 14 version 1.0" in BANKRUPTCY *NOT* BAILOUT apply.

9) Add a **Section 1408**, "Subsidiary Contracts," that provides that, notwithstanding any provision in an agreement or applicable nonbankruptcy law, an agreement of a subsidiary (including an executory contract, unexpired lease, or agreement under which the subsidiary issued or is obligated for debt) where the subsidiary's ownership

interests that are property of the estate are transferred to the bridge company in a Section 1405 transfer, such agreement may not be terminated, accelerated, or modified, at any time after the commencement of the case, because of a provision prohibiting, restricting, or conditioning the assignment of the agreement or because of the change-of-control of a party to the agreement. Nor may a cross-default provision respecting the debtor in an agreement of the subsidiary be enforced in any case of the debtor involving a Section 1405 transfer motion during the earliest of 48 hours from the commencement of a case under this Chapter involving the debtor or the denial of a Section 1405 transfer motion.

10) Add a **Section 1409**, dealing with "Licenses, Permits, and Registrations," that provides, notwithstanding any other provision of nonbankruptcy law, a Section 1405 transfer motion stays, for the period of time specified in Section 1406, any termination or modification of any Federal, State, or local license, permit or registration that the debtor or a subsidiary had immediately before the commencement of the case that is proposed to be transferred, based upon (i) the insolvency or financial condition of the debtor at any time before the closing of the case, (ii) the commencement of a case under this title, or (iii) a transfer under Section 1405. Following a Section 1405 transfer, all such licenses, permits, and registrations shall vest in the bridge company. In addition, where a subsidiary's ownership interests that are property of the estate are proposed to be transferred to the bridge company in a Section 1405 transfer, a Section 1405 transfer motion stays, for the period of time specified in Section 1406 and thereafter if the subsidiary's ownership interests that are property of the estate are transferred to the bridge company in a Section 1405 transfer, any termination or modification of any Federal, State, or local license, permit or registration that the subsidiary had immediately before the commencement of the case, based on a change-of-control of the subsidiary.

11) Add a **Section 1410**, "Bridge Company Capital Requirements," giving the bridge company an exemption from applicable debt or capital requirements (such as might be required by the Board or Basel III) until such time as (a) the confirmation of a plan of reorganization for the debtor that involves the distribution or sale of securities of

the bridge company or (b) one year from the Section 1405 transfer, whichever is earlier.

12) Add a **Section 1411**, "Avoiding Powers," providing that in a case where there is a request for a Section 1405 transfer, and such transfer occurs, the avoiding powers in Sections 544, 547, 548(a)(1)(B), or 549, do not apply, except for transfers of (i) an interest of the debtor in property to or for the benefit of a holder of capital structure debt under Section 547 or (ii) an interest of the debtor in property to or for the benefit of a holder of equity of the debtor under Section 548(a)(1)(B). Additionally, if there is not a motion for a Section 1405 transfer or if such transfer is not approved, the provisions for the application of avoiding powers with respect to qualified financial contracts contained in BANKRUPTCY *NOT* BAILOUT apply.

13) Add a **Section 1412**, "Exemption from Securities Laws and Special Tax Provisions," providing that, for purposes of Section 1145, a security of the bridge company shall be deemed to be a security of a successor to the debtor under a plan of reorganization if the court approves the disclosure statement for the plan as providing adequate information (as defined in Section 1125(a)) about the bridge company and the security. In addition, securities issued by the bridge company in connection with a confirmed plan of reorganization shall have the protection from any law imposing a stamp tax or similar tax under Section 1146(a).

14) Add a **Section 1413**, "Debtor-in-Possession Financing," that picks up the provisions regarding Section 364 in the original Chapter 14 version 1.0.[116]

15) Add a **Section 1414**, "Trustee in a Chapter 14 Case" that provides, if there is an approved Section 1405 transfer, then there shall be a trustee appointed by the court, after notice and a hearing, in lieu of the debtor in possession, for all purposes of the debtor after the Section 1405 transfer. The trustee shall be appointed by the court from a pre-approved list of trustees that has been determined by the Chief Judge of the Circuit. In other cases, a trustee, chosen from the

116. Pursuant to section 1405, these provisions will also be applicable to the bridge company. See section 2(6).

pre-approved list of trustees, can be appointed pursuant to the provisions of Section 1104.

16) Add a **Section 1415**, "Solicitation, Acceptance, and Confirmation of a Plan," providing that, in the case of a plan of reorganization proposed at or following the approval of a Section 1405 transfer, that a court may hold a confirmation hearing under Section 1128, within ten days of the circulation of the plan if voting for purposes of Section 1126 is sufficient, at the time of the hearing, to allow the court to make the determinations required by Section 1129.

Section 3: Amendments to Title 28

1) Provide, in **Section 298**, that, notwithstanding Section 295, the Chief Justice of the United States shall designate at least one district judge from each circuit to be available to hear a case under Chapter 14. And that district judge, again notwithstanding Section 295, shall hear a Chapter 14 case filed in that circuit, and shall be considered, for purposes of the case, to be temporally assigned to the district in which the bankruptcy case is commenced or any district to which the case is removed pursuant to 28 USC §1412. The district judge may not refer a motion for a Section 1405 transfer to a bankruptcy judge, notwithstanding Section 157. In a case in which there is not a motion for a Section 1405 transfer, or the motion is denied, the district court may not assign the case or proceedings under the case to a bankruptcy judge, unless there has been approved a motion to convert the case to Chapter 7 pursuant to Section 1112. In all cases where the district judge may not refer a case or proceeding to a bankruptcy judge, the district judge may appoint a bankruptcy judge as a special master. Appeals under Section 158(a) in a Chapter 14 case shall be heard by the assigned district judge.

Section 4: Amendment to Dodd-Frank Wall Street Reform and Consumer Protection Act

1) Amend **Section 202** by adding at the end of (a)(1)(A)(i) that, notwithstanding the provisions of this subsection, if a case has been commenced under Chapter 14 of Title 11, the relevant district court shall be the district court where the Chapter 14 case is pending, and

the judge overseeing the Chapter 14 case shall be assigned to hear and decide the order under (a)(1)(A) of this section. In addition, amend (a)(1)(A)(iii) and (iv) so as to subject the finding required of the government agencies under section 203(a)(2)(F) to the same determination and issuance procedures currently outlined under (a)(1)(A)(iii) and (iv) of this section for the (a)(1)(A)(iii) determination.