STATEMENT OF

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H.R. , THE "FINANCIAL INSTITUTION BANKRUPTCY ACT OF 2014"

Thank you for inviting me to testify once again on the subject of the resolution of financial firms under the Bankruptcy Code. I am Donald S. Bernstein, co-chair of the Insolvency and Restructuring Group at Davis Polk & Wardwell LLP. I am on the Board of Editors of *Collier on Bankruptcy*, a Commissioner on the American Bankruptcy Institute's Commission on the Reform of Chapter 11, and a past Chair of the National Bankruptcy Conference. As I indicated during my testimony at this Subcommittee's oversight hearing on this topic in December, during the last few years, I have spent a significant portion of my time working on resolution plans for large financial firms under Section 165(d) of the Dodd-Frank Act – commonly known as Living Wills. I have also represented financial industry organizations, such as The Clearing House Association and SIFMA on issues related to the resolution of financial firms. I am, however, once again here in my individual capacity and not on behalf of any client, though I expect to be asked by clients to help them evaluate the bill we are discussing today. In any event, the views I express are my own, and not those of Davis Polk, any client or any organization with which I am affiliated.

As the Subcommittee is aware, in my testimony in December, I strongly endorsed the idea that the Bankruptcy Code should be amended to add tools to facilitate a whole-firm recapitalization approach to resolving systemically important financial firms similar to the "single point of entry" approach developed by the Federal Deposit Insurance Corporation under Title II of the Dodd-Frank Act (Orderly Liquidation Authority or OLA). I applaud the bi-partisan effort to develop amendments to the Bankruptcy Code along these lines, and in particular thank the members of this Subcommittee for convening these hearings to delve more deeply into the details of an excellent draft of what might become the Financial Institution Bankruptcy Act of 2014 (the "draft bill" or "draft House bill"). The draft bill embraces the idea of whole-firm recapitalization as a means of resolving SIFIs, which, as I and others have said,[1] is by far the best approach to resolving systemically important financial firms without taxpayer-funded bailouts.

General Background and My Prior Testimony

I want to begin by emphasizing a few of the points I made in my December testimony that will set the stage for my comments on the draft bill. I noted then that the unplanned failure of Lehman Brothers in 2008 was preceded by a run on liquidity that led to Lehman's bankruptcy, which in turn led to wholesale close-outs of open financial contracts, the selling of collateral into distressed markets and ultimately the sale of Lehman's businesses and remaining assets at fire-sale prices. This chaotic sequence of events led to fear in the markets that other firms might suffer the same fate – contagious panic. In the harsh light of these events and their aftermath, I strongly believe that the abrupt unraveling of financial firms must be avoided and that an efficient means must be

[1] *E.g., Too Big to Fail: The Path to a Solution*, A Report of the Failure Resolution Task Force of the Financial Regulatory Reform Initiative of the Bipartisan Policy Center (May 2013) (BPC Report); Federal Deposit Insurance Corporation & Bank of England, Joint Paper, *Resolving Globally Active, Systemically Important, Financial Institutions* (Dec. 10, 2012) (jointly proposing the single-point-of-entry approach); Martin J. Gruenberg, Chairman of the FDIC, & Paul Tucker, Deputy Governor for Financial Stability at the Bank of England, Op. Ed., *Global Banks Need Global Solutions When They Fail*, FINANCIAL TIMES (Dec. 10, 2012); Daniel K. Tarullo, Member, Board of Governors of the Federal Reserve System, *Toward Building a More Effective Resolution Regime: Progress and Challenges*, Remarks at the Federal Reserve Board and Federal Reserve Bank of Richmond Conference, Planning for the Orderly Resolution of a Globally Systemically Important Bank (Washington, D.C., Oct. 18, 2013) ("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 (Washington, 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)."). For step-by-step diagrams illustrating the FDIC's single-point-of-entry resolution strategy, see BPC Report, pp. 23-32. *See also* FDIC, *Resolution of Systemically Important Financial Institutions: The Single Point of Entry Strategy,* 78 Fed. Reg. 76614 (Dec. 18, 2013).

found of speedily causing the distressed firm's losses to be absorbed by private shareholders and creditors so valuable components of the firms can continue in business under new ownership and management, or be wound down in an orderly manner as going concerns.

This is what whole-firm recapitalization – the "single point of entry" approach to the resolution of resolution financial firms – is designed to accomplish, and I believe that if the Bankruptcy Code were amended to add tools to facilitate such recapitalizations, it would help assure that appropriate values could be realized for the firms' assets, that disorderly liquidations and market panic could be avoided, and most importantly that taxpayers would not have to bail out distressed financial firms.

In 2008, regulators had a very limited set of tools with which to stem contagious panic and resolve distressed financial institutions without fire-sales of assets and the unraveling of maturity transformation – the main and economically essential business of financial institutions. As I stated in my prior testimony, the inadequacy of those tools and the lack of pre-failure resolution planning put taxpayers in the position of having to invest in financial firms to recapitalize them. Though the large financial institutions repaid those investments with interest, most observers believed that better tools were needed to deal with the failure of financial firms.

As I noted in my December testimony, Title II of the Dodd-Frank Act provides the essential tools to recapitalize failing firms without taxpayer funded bailouts by imposing a financial firm's losses on investors rather than taxpayers,[2] but some of the essential tools available under Title II are currently unavailable or not obviously available under the Bankruptcy Code.

The single-point-of-entry approach to resolution involves commencing resolution proceedings only with respect to the financial firm's top-level parent holding company, with all losses of the distressed financial firm being borne by shareholders and creditors of that entity and not by taxpayers. Operating entities, like the firm's banking or broker-dealer subsidiaries, would not be placed in insolvency or resolution proceedings, would be recapitalized using assets of the holding company and would continue as subsidiaries of a newly created debt-free bridge holding company. The old holding company's creditors and shareholders would be left behind either in bankruptcy proceedings or in an OLA receivership, and a viable recapitalized firm would be created the value of which would be preserved without requiring bankruptcy or a prolonged resolution process for the firm's operating entities. By recapitalizing the firm's operating subsidiaries with holding company assets at the outset of the process, the single-point-of-entry approach preserves the continuity and value of those operating businesses and pushes the firm's operating losses up to the old holding company to be absorbed by the holding company's shareholders and creditors. The holding company's stakeholders nevertheless benefit from the strategy because liquidation of the firm's valuable operating businesses and assets at fire-sale prices is avoided and the going concern value of the operating

[2] These tools include: (1) the power to create and transfer the failed holding company's assets to a bridge financial company; (2) a temporary stay on financial contract terminations and a temporary override of cross-defaults; (3) the ability to assume financial contracts and related guarantees; and (4) the availability of temporary secured liquidity.

subsidiaries is preserved. This value ultimately is available for distribution to the stakeholders at the end of the resolution process.

We are fortunate that, in the United States (unlike some other countries), large financial firms already utilize a holding company structure, and significant amounts of equity and long-term unsecured debt are issued by these holding companies and are structurally subordinated to deposits and other operating liabilities of financial subsidiaries. If a firm's equity becomes impaired as a result of losses, the layer of structurally subordinated loss absorbing debt at the holding company can be utilized to recapitalize the firm if the legal tools are available to speedily push the firm's operating losses up to holding company creditors while keeping systemically critical operating subsidiaries out of resolution proceedings.[3]

Financial firms, together with their primary regulators, are continuing to take steps to enhance the ability to resolve financial firms using this recapitalization model. The firms have undergone substantial changes since 2008 that improve their resiliency, including a substantial increase in capital and balance sheet liquidity to meet regulatory requirements and risk management needs,[4] the de-risking of the balance sheets of U.S.

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[3] The fact that the holding company structure facilitates whole-firm recapitalizations of this type is leading to recommendations that financial firms in other countries be restructured along the lines of the U.S. bank holding company model. *See* Paul Tucker, *The Resolution of Financial Institutions Without Taxpayer Solvency Support: Seven Retrospective Clarifications and Elaborations*, Remarks at European Summer Symposium in Economic Theory, Gerzensee, Switzerland (July 3, 2014), at 10.

[4] *See* Federal Reserve and OCC, Regulatory Capital Rules, 78 Fed. Rev. 62, 018 (Oct. 11, 2013) (to be codified at 12 C.F.R. Pts. 3, 5, 6, 165, 167, 208, 217, and 225); FDIC, Regulatory Capital Rules, 78 Fed. Reg. 55, 340 (Sept 10, 2013) (to be codified at 12.C.F.R. pts. 303, 308, 324, 327, 333, 337, 347, 349, 360, 362, 363, 364, 365, 390, and 391); Federal Reserve, OCC and FDIC, Liquidity Coverage Ratio: Liquidity Risk Measurement, Standards, and Monitoring (Proposed Rule), 78 Fed. Reg. 71, 818 (Nov. 29, 2013). According to the Federal Reserve, the largest U.S. bank holding companies have increased their common equity to more than twice the amount they had during the financial crisis of 2008. Specifically, the (….continued)

financial firms, and capital restructuring to address anticipated regulatory requirements for sufficient amounts of loss absorbing debt and assets in the holding companies of financial firms.[5]

Notably, other countries are amending their laws so that Special Resolution Regimes administered by local regulators can be used to recapitalize foreign financial

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weighted tier 1 common equity ratio, which is the ratio of common equity to risk-weighted assets, of the 18 bank holding companies that participated in the Federal Reserve's Comprehensive Capital Analysis and Review (CCAR) has more than doubled from 5.6% at the end of 2008 to 11.3% in the fourth quarter of 2012, reflecting an increase in common equity from $393 billion to $792 billion during the same period. *See* Federal Reserve, Press Release – Federal Reserve Announces Results of Comprehensive Capital Analysis and Review (CCAR) (Mar. 14, 2013), *available at* http://www.federalreserve.gov/newsevents/press/bcreg/20130314a.htm. The results of the Federal Reserve's 2013 Dodd-Frank and CCAR stress tests show that the largest U.S. bank holding companies have enough common equity to absorb all of their projected losses under the Federal Reserve's severely adverse stress scenario and still have enough common equity left to exceed the minimum risk-based and leverage capital requirements. *See* Federal Reserve, Comprehensive Capital Analysis and Review 2013: Assessment Framework and Results (Mar. 14, 2013), *available at* http://www.federalreserve.gov/newsevents/press/bcreg/ccar-2013-results-20130314.pdf. Besides a significant increase in levels of loss-absorbing capital, U.S. banks have also substantially improved their liquidity profiles. For example, U.S. banks' holdings of cash and high-quality liquid securities have more than doubled since the end of 2007 and now total more than $2.5 trillion. *See* Ben S. Bernanke, Chairman, Board of Governors of the Federal Reserve System, Stress Testing Banks: What Have We Learned? (Apr. 8, 2013), *available at* http://www.federalreserve.gov/newsevents/speech/bernanke20130408a.pdf.

[5] *See* Daniel K. Tarullo, Member, Board of Governors of the Federal Reserve System, *Toward Building a More Effective Resolution Regime: Progress and Challenges*, Remarks at the Federal Reserve Board and Federal Reserve Bank of Richmond Conference, Planning for the Orderly Resolution of a Globally Systemically Important Bank (Washington, D.C., Oct. 18, 2013) (announcing that the Federal Reserve expects to propose minimum long-term debt and eligible assets requirements applicable at the bank holding company level for the largest U.S. banking groups within the next few months in order to ensure they have sufficient loss-absorbing resources to facilitate a single-point-of-entry resolution). *See also* Paul Tucker, *The Resolution of Financial Institutions Without Taxpayer Solvency Support: Seven Retrospective Clarifications and Elaborations*, Remarks at European Summer Symposium in Economic Theory, Gerzensee, Switzerland, at 7-8 (July 3, 2014); International Monetary Fund, *Cross-Border Bank Resolution: Recent Developments*, at 12 (June 2014); Mark Carney, Chairman, Financial Stability Board, *Financial Reforms – Update on Progress*, at 2 (Apr. 4, 2014); *Progress and Next Steps Towards Ending "Too-Big-To-Fail" (TBTF)*, Report of the Financial Stability Board to the G-20 (Sep. 2, 2013) (announcing that the Financial Stability Board is developing minimum gone-concern loss-absorbing capacity requirements to ensure that global and domestic systemically important financial institutions have enough loss-absorbing capacity in the form of equity, long-term debt and assets to recapitalize the institutions without the need for taxpayer capital in the event of severe financial distress). *See also* Morgan Stanley Research North America, Large and Midcap Banks, *OLA: More Debt Sooner?* (Dec. 13, 2012); Goldman Sachs Research, *Loss Absorbency in Banks* (Dec. 2012); J.P. Morgan North America Credit Research, *Tarullo Speech Increases Momentum for Debt Buffers* (Dec. 6, 2012)

firms using the same whole-firm recapitalization model we are developing here in the United States, adapted to the structure of financial firms outside the U.S. Among other recent developments in this regard is the approval by the European Parliament of the Bank Recovery and Resolution Directive (BRRD), which, when finally implemented by EU member states, will provide for the *"bailing in"* of capital structure debt, the preservation of financial contracts and the power to recognize foreign resolution regimes.[6]

In addition, because of initiatives by regulators at the multinational level, including those of the Financial Stability Board and crisis management groups organized among key regulators of individual firms, there is increasing alignment among national regulatory authorities regarding the benefits of the recapitalization and bail-in approaches to dealing with distressed financial firms.[7] A single-point-of-entry recapitalization, for example, protects host-country interests by making resolution proceedings for host-country operations unnecessary. Since the counterparty credit exposures of the largest

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[6] *See Directive 2014/59/EU of the European Parliament and of the Council establishing a framework for the recovery and resolution of credit institutions and investment firms* (May 15, 2014). *See also* Andrea Thomas, *Germany Approves Plans to Force Creditors to Prop Up Struggling Banks*, THE WALL STREET JOURNAL (July 9, 2014)

[7] *See, e.g.*, International Monetary Fund, *Cross-Border Bank Resolution: Recent Developments* (June 2014); Financial Stability Board, *Key Attributes for Effective Resolution Regimes of Financial Institutions* (Oct. 2011) (endorsing recapitalization (bail-in) within resolution strategies and advocating the creation of legal tools to effect such strategies); Federal Deposit Insurance Corporation & Bank of England, Joint Paper, *Resolving Globally Active, Systemically Important, Financial Institutions* (Dec. 10, 2012) (endorsing and advocating single-point-of-entry resolution strategies for systemically important financial institutions); *Progress and Next Steps Towards Ending "Too-Big-To-Fail" (TBTF),* Report of the Financial Stability Board to the G-20 (Sep. 2, 2013) (endorsing single-point-of-entry and multiple-point-of-entry resolution strategies and announcing plans for minimum gone-concern loss-absorbing capacity requirements to ensure the feasibility of such strategies).

U.S. financial firms are highly concentrated in a few jurisdictions, such as the UK,[8] coordination and alignment among the relevant authorities can readily occur if appropriate advance planning among regulatory authorities can be done. Key to these efforts is the fact that recapitalization and bail-in strategies allow the firms to continue their business and meet their operating obligations in the ordinary course in both home and host countries. As a result, local regulators should not feel compelled to take precipitous actions that can hinder the resolution of the overall group.

Regulators and private sector organizations like ISDA are also developing contractual approaches to facilitating the resolution of financial firms, including by limiting, subject to appropriate conditions, termination rights under certain types of financial contracts, so the new legislation in home countries can be enforced across international borders.

In the United States, the Dodd-Frank Act makes clear that the use of our Special Resolution Regime, OLA, is to be limited to situations where bankruptcy is not a viable resolution strategy,[9] and the FDIC has announced that it supports the idea that

[8] *See* FDIC Presentation to the FDIC Systemic Resolution Advisory Committee Meeting, Panel on International Resolution Strategy (Dec. 10, 2012) (over 90% of the total reported foreign activity for the top seven U.S. SIFIs is located in three foreign jurisdictions, with the UK having the largest footprint). Video available at http://www.vodium.com/MediapodLibrary/index.asp?library=pn100472_fdic_SRAC. Presentation slides from the meeting are available at http://www.fdic.gov/about/srac/2012/2012-12-10_international-resolution-strategy.pdf.

[9] Section 203(b) of the Dodd-Frank Act provides in relevant part that the Orderly Liquidation Authority of Title II of the Dodd-Frank Act may not be legally invoked unless the Secretary of the Treasury determines that "the failure of the financial company and its resolution under otherwise applicable Federal or State law [e.g., the Bankruptcy Code] would have serious adverse effects on financial stability in the United States" and "any action under section 204 [of the Dodd-Frank Act] would avoid or mitigate such adverse effects . . . ."

bankruptcy, not OLA, should be the presumptive resolution procedure.[10] As I noted in my prior testimony, however, because of the absence or lack of clarity regarding essential tools in the Bankruptcy Code to address the special circumstances of distressed financial firms, the resolution plans of financial firms submitted under Title I of the Dodd-Frank Act have typically adopted hybrid approaches, in which some operating businesses and entities continue and are sold or recapitalized, while others are allowed to wind-down in an orderly way.

Because of the clear benefits of the whole-firm recapitalization approach to resolving financial firms, in December I recommended that amendments be made to the Bankruptcy Code to add or improve the tools available to facilitate a single-point-of-entry approach to resolution in bankruptcy.[11] Specifically, I suggested that such amendments should (1) clarify that bank holding companies can recapitalize their operating subsidiaries prior to or in connection with bankruptcy proceedings, (2) clarify that the Bankruptcy Code can be used to accomplish the transfer of recapitalized entities to a new holding company using a bridge company structure, (3) include provisions that provide

[10] *See* Remarks by Martin J. Gruenberg, Chairman, Federal Deposit Insurance Corporation, on Implementation of the Dodd-Frank Act before the Volcker Alliance Program (October 13, 2013) *available at* http://www.fdic.gov/news/news/speeches/spoct1313.html; *See also* 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) ("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"), *available at* http://www.fdic.gov/news/news/speeches/chairman/spdec0611.html.

[11] *See* Thomas H. Jackson, *Bankruptcy Code Chapter 14: A Proposal*, in BANKRUPTCY NOT BAILOUT: A SPECIAL CHAPTER 14 (Hoover Institution, Kenneth E. Scott & John B. Taylor, eds., 2012); Thomas H. Jackson, *Building on Bankruptcy: A Revised Chapter 14 Proposal for the Recapitalization, Reorganization, or Liquidation of Large Financial Institutions*, Hoover Institution, The Resolution Project (Draft, July 9, 2014); Ken Scott, *The Context for Bankruptcy Resolutions* (Draft, July 9, 2014). *See also* BPC Report, pp. 11-14 (recommendations for amending the Bankruptcy Code to facilitate the execution of a single-point-of-entry strategy under the Bankruptcy Code).

for a short stay of financial contract close-outs and allow the assumption and preservation of financial contracts, overriding ipso facto (bankruptcy) defaults and cross-defaults that might impede the resolution process, and (4) provide some form of fully secured liquidity resource that makes backstop financing available if needed to help stabilize the recapitalized firm and prevent fire sales until access to market liquidity returns.

These recommendations, made seven months ago, offer an excellent starting point for providing reaction to the draft bill, which includes some, but not all of the amendments I suggested.

Thoughts on the Draft House Bill

The draft House bill strongly embraces whole-firm recapitalization as a tool for resolving "covered financial corporations" under the Bankruptcy Code. The bill includes key features to facilitate a recapitalization of a distressed financial firm in bankruptcy, and the overall approach of the bill is quite consistent with the thrust of the recommendations I made in December. I would like to offer comments on a few specific, and in my view important, provisions the bill, and request the opportunity to provide additional, more detailed, comments after the hearing.

1. *Commencement of Proceedings Under Subchapter V*

The bill provides for the commencement of Chapter 11 proceedings with respect to a bank holding company, either voluntarily by the distressed firm itself, or involuntarily by the Federal Reserve Board, and includes a set of procedures for a speedy hearing and appeals if an involuntary petition is contested.

My principal comment regarding these provisions is that the statute should do everything it can to encourage voluntary rather than involuntary proceedings. Voluntary proceedings will facilitate the firm's smooth transition into Chapter 11, and its recapitalization and reopening under the ownership of the newly created bridge company, as contemplated by the bill. Concerns about director liability for the simple act of commencing bankruptcy proceedings often unnecessarily delay or discourage boards of distressed companies from acting, and this risk is especially acute with respect to financial firms, which tend to be forced into failure only at the point of a collapse of their liquidity and after many assets have already been liquidated at fire-sale prices.

In order to encourage timely voluntary action by directors of failing financial firms, Title II of the Dodd-Frank Act insulates directors from liability for consenting to the appointment of the FDIC as receiver.[12] I concur with the recommendation of the National Bankruptcy Conference in its letter to the Subcommittee of January 29, 2014 (the "NBC Letter") that it would be advantageous to adopt a corresponding provision for the commencement of voluntary resolution proceedings under the Bankruptcy Code, such as those contemplated by the bill. Financial institution boards will remain accountable for their other pre-failure actions, but they should not have to concern themselves over the risk of liability to shareholders or creditors when they are invoking, presumably with the support of their primary regulators, provisions designed to resolve the failing firm, maximize its value to stakeholders and minimize systemic risk.

[12] Dodd-Frank Act § 207.

2. *Definition of Capital Structure Debt*

One of the key definitions in the bill is the definition of "capital structure debt." Under the provisions of the draft bill, in connection with authorizing a transfer of operating subsidiaries to a bridge company under Section 1185, the Bankruptcy Court is required to make a finding that no capital structure debt is being assumed by the bridge company. The companion Senate bill contains a similar provision, but the draft House bill defines "capital structure debt" differently from the definition proposed in the Senate bill. Specifically, the Senate bill defines "capital structure debt" as follows:

> The term 'capital structure debt' means debt, other than a qualified financial contract, of the debtor for borrowed money with an original maturity of at least a year.

In contrast, the draft House bill defines "capital structure debt" as follows:

> The term 'capital structure debt' means all unsecured debt of the debtor, other than a qualified [sic] contract, for which the debtor is primary obligor.

As can be seen from this language, the House bill removes the requirement that capital structure debt consist of "debt for money borrowed," adds the requirement that the debtor be the primary obligor in respect of the debt (presumably to exclude guarantees of operating company obligations from the definition) and removes the requirement that capital structure debt have an original maturity of at least a year.

The definition in the Senate bill appears to have been designed to anticipate the expected promulgation of regulations by the Federal Reserve Board requiring systemically important financial firms to maintain at least a threshold amount of "long term debt" that would be available to absorb losses by being "left behind" or "bailed-in" during a whole-firm recapitalization of the firm, either under OLA or under the Bankruptcy Code. Under the definition of capital structure debt in the Senate bill, shorter term obligations (with maturities of less than a year), which might be held by money market funds or other systemically sensitive holders, could in appropriate circumstances – presumably based on input to the Bankruptcy Court from the Federal Reserve Board and other regulators regarding systemic concerns – be assumed by the bridge company and paid. Notably, the definition in the Senate bill, which is limited to borrowed money, allows obligations to employees and critical vendors, as well as debts under assumed non-financial contracts of the debtor to be transferred to and assumed by the bridge company, as contemplated by Section 1407 of the Senate bill (retained in the draft House bill as Section 1187). Finally, guarantees of ongoing qualified financial contracts (QFCs) of affiliates could, under both the Senate and House definitions, be transferred to and assumed by the bridge company pursuant to Section 1408 of the Senate bill (retained as Section 1188 in the draft House bill) in order to avoid termination of the firm's QFCs by external counterparties, as discussed below.[13]

As revised in the House bill, however, the definition of "capital structure debt, coupled with the findings the Bankruptcy Court must make in connection with a Section 1185 transfer, appears to preclude the assumption by the bridge company of ordinary operating debts and short-term borrowings of the debtor in connection with a Section 1185 transfer. I am aware that the NBC Letter recommended that the definition of capital structure debt remove the exclusion of short term debt because of the NBC's concern that

[13] The clear reference in the House bill that limits the definition of capital structure debt to "primary obligations" is, however, an enhancement that provides clarity in this regard.

"debt can be too easily structured to avoid characterization as capital structure debt if the definition is based on the original maturity date," but, while recommending this change, the NBC also acknowledged that flexibility would be required to let the bridge company assume some capital structure debt. Rejecting the idea of restricting the types of debts that the bridge company could assume, the NBC stated that "*the Bankruptcy Code should give the Federal Reserve Board and the special trustee flexibility in creating the optimum bridgeco.*" While the draft House bill uses a broad definition of capital structure debt similar to the one suggested by the NBC, it omits to give the Federal Reserve Board the ability to designate, and to provide the bankruptcy court with the authority to allow in connection with a Section 1185 transfer, capital structure debts to be assumed by the bridge company, even where necessary for reasons of systemic stability, operational stability or value maximization of the bridge company.

It is also notable that, although the NBC suggested that the definition of capital structure debt abandon the distinction between long and short term debt, the NBC's proposal would limit the definition of capital structure debt to debt *for money borrowed.* These words, which also appear the Senate bill's definition, are dropped in the proposed House bill.

The changes to the definition of capital structure debt and failure to adopt the NBC's suggestion of giving the Federal Reserve Board the authority to designate some capital structure debts to be assumed by the bridge company could make it difficult to address systemic, business continuity and value maximization concerns, even where the Federal Reserve Board feels urgently that some debts need to be paid to address those concerns. It is worth reemphasizing that the Federal Reserve Board has announced its intention to impose a long-term loss absorbing debt requirement for systemically important financial firms.[14] This will, as a practical matter, limit opportunities for structuring around the definition of capital structure debt if the definition in the Senate bill, including the distinction between long- and short-term debt, were adopted. There is a significant benefit to having a bright line test for debts that are likely to absorb losses when the bridge company is formed so the market can understand, price and monitor the risk.

Accordingly, I believe the Senate's definition of 'capital structure debt' is more consistent with the objectives of Subchapter V, and the expected action from prudential regulators to insure the sufficiency of loss absorbing long-term debt should allay the principal concerns expressed in the NBC Letter. In any event, whatever definition is adopted, the bill should provide the Federal Reserve Board with the flexibility in appropriate circumstances to designate some capital structure debts – especially short-term capital structure debts – to be assumed by the bridge company.

3. *Special Trustee*

The ability of the bridge company to be recapitalized and speedily reopen under private ownership and new management after the proverbial "resolution weekend" is especially important in bankruptcy proceedings, where regulators do not take over the

[14] *See* Daniel K. Tarullo, Member, Board of Governors of the Federal Reserve System, *Toward Building a More Effective Resolution Regime: Progress and Challenges*, Remarks at the Federal Reserve Board and Federal Reserve Bank of Richmond Conference, Planning for the Orderly Resolution of a Globally Systemically Important Bank, at 11 (Washington, D.C., Oct. 18, 2013); *see also* Financial Stability Board, *Progress and Next Steps Toward Ending "Too-Big-To-Fail" (TBTF)* at 5 (Sept. 2, 2013) ("The FSB, in consultation with standard-setting bodies, will prepare proposals on the adequate of G-SIFI loss absorbing capacity in resolution.")

firm as they would in a receivership under the Federal Deposit Insurance Act or OLA. The idea of allowing the bridge company to be transferred to a private trustee, the "special trustee," a fiduciary for the benefit of the Chapter 11 estate, and of permitting the bridge company to continue its business, subject to reporting obligations and under close regulatory supervision, but without the need for Bankruptcy Court approval of its or the special trustee's actions, is an excellent way of accomplishing this result. It offers transparency to the Bankruptcy Court and left-behind creditors, as well as a hand-picked fiduciary to protect the estate's and stakeholders' interests. From the point of view of the markets and foreign regulators, it connotes the restoration of stability and normalcy to the recapitalized firm, and the confidence of U.S. regulators and the court in the viability of the firm. It also eliminates any concerns that the value of the company will be impaired by disputes among conflicting constituencies in the bankruptcy process.

I would, however, like to make an important technical point about the operation of the special trustee provisions.

If it is not already clear from the bill, once the stock of the bridge company is transferred to the special trustee, it will cease to be property of the Chapter 11 estate. This is a corollary to the idea, embodied in Section 1186 of the draft bill, that no Bankruptcy Court approvals are required for the special trustee to take actions with respect to the bridge company and its shares. It will be the express provisions of the Trust Agreement, as dictated by Section 1186 of the bill, and state law fiduciary duties to the bankruptcy estate, that govern the special trustee's actions. In light of this, a provision should be added to the draft bill making it clear that the shares of the bridge company cease to be property of the Chapter 11 estate once transferred to the special trustee. Of course, the beneficial interests in the trust created by the Trust Agreement and the rights of the bankruptcy estate under the Trust Agreement and as a beneficiary of the trust (including, most importantly, the right to direct the value of the bridge company under a plan of reorganization) become property of the estate at the time of creation of the trust.

4. *Qualified Financial Contracts*

One of the key provisions of the bill is designed to preserve the distressed financial firm's book of QFCs by suspending the right of contract counterparties to terminate and net their QFCs with the distressed financial firm based on "ipso facto" defaults, such as the commencement of bankruptcy proceedings by the parent holding company and the failure to meet credit ratings criteria by the bankrupt holding company as long as the QFCs are performed and, in the case of QFCs of non-bankrupt affiliates, as long as related guarantees by the debtor holding company are transferred to and assumed by the bridge company and certain other requirements to protect counterparties are met.

Despite the infrastructure in Section 1188 around QFCs of the debtor holding company, in fact most of the QFCs of financial firms are in the operating affiliates of financial firms, and not in their holding companies. Accordingly, one the most important provisions for the preservation of the recapitalized firm's QFCs is Section 1188(f), which limits counterparty termination rights in QFCs of the (non-bankrupt) affiliates based on events associated with the holding company's bankruptcy. Overriding cross-defaults in QFCs of affiliates of a covered financial corporation is crucial to a single point of entry recapitalization because affiliate QFCs are often guaranteed by the holding company and, if the holding company files for bankruptcy or loses its credit rating, termination rights may be triggered, even though the affiliate counterparty is healthy, well capitalized (having been recapitalized) and has not been placed into bankruptcy proceedings or receivership. These cross-defaults to the holding company's bankruptcy or downgrades accordingly need to be overridden by the statute if the external counterparty's termination rights are to be eliminated.

Owing to what is probably a scrivener's error in Section 1408(f) of the proposed Senate bill, which appears to have been carried over into the version of the draft House bill available at the time of this writing, Section 1188(f) of the draft bill refers to Section 1187(b) rather than 1187(c)(1), where the relevant cross-defaults would be picked up. As a result, the provision fails to address this critically important cross-default issue. This failure is likely the result of an inadvertent cross reference drop when sections were renumbered,[15] but the glitch, though technical, is a critical one and needs to be fixed if Section 1188(f) is to have its intended effect.[16]

5. *Avoidance Power Safe Harbor*

Section 1191 of the draft bill purports to provide a safe harbor from avoidance actions for the newly created bridge company and its subsidiaries. However, in its

[15] Notably the version of a Subchapter V bill attached to Professor Thomas Jackson's testimony before this Subcommittee last March included the bankruptcy and ratings triggers with respect to the debtor in Section 1187(b). It appears that the Senate moved the relevant ipso facto default references from 1187(b) [1407(b) in the Senate bill] to 1187(c)(1) [Section 1407(c)(1) in the senate bill], but they failed to change the cross reference in 1188(f) [1408(f) in the Senate bill] from 1187(b) [1407(b)in the Senate bill] to 1187(c)(1) [1407(c)(1) in the Senate bill].

[16] There is a similar, presumptively inadvertent, cross-reference error in Section 1188(e), which refers to Section 1187(a), but should also refer to Section 1187(c)(1).

current form the section can be read to do nothing but exempt from avoidance transfers in a court-approved transaction – the Section 1185 transfer. To achieve the objectives of single-point-of-entry recapitalization, it is essential to immunize the newly recapitalized bridge company from attack for any efforts made by the holding company, as a "source of strength," to recapitalize or provide liquidity to support subsidiary operations during the period prior to bankruptcy. It would defeat the main goal of single point of entry recapitalization if the newly recapitalized bridge company were to suffer an overhanging risk for a prepetition transaction intended to facilitate the recapitalization. Such an overhang would make it much more difficult for the recapitalized firm to stabilize its operations, find private sector sources of liquidity, and maximize its value – all critical goals of the Subchapter V process.

Section 1191 should accordingly be revised to address more clearly the holding company's actions prior to failure supporting, under regulatory supervision, the activities of its operating affiliates. Section 1191 might, for example, be modified to read as follows:

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

The exclusion for "capital structure debt" would be removed in recognition of the fact that capital structure debt may be owed to operating subsidiaries of the firm, and its repayment may on occasion be a means through which liquidity is provided by the holding company to operating subsidiaries prior to failure. The addition of a reference to actions in contemplation of a transfer under section 1185 would subsume actions prior to commencement of the Chapter 11 proceedings in furtherance of the recapitalization of the firm's operations and the creation of the bridge company, as contemplated under Subchapter V.

6. *Provisions Relating to Bankruptcy Judges*

In the NBC Letter, the NBC suggests that the criteria for the selection of the panel of sufficiently experienced bankruptcy judges for Subchapter V cases be clarified to include reference to appropriate training. Given that the failure of systemically important financial institutions should be a rare event, it may be difficult to find a sufficient number of judges with actual case experience relevant to Subchapter V proceedings. Accordingly, mandating training regarding financial firm failures and the operation of Subchapter V as a precondition to designation as a bankruptcy judge eligible to hear Subchapter V cases seems like a sensible requirement. It may accordingly make sense to include in the bill a mandate to relevant regulators and agencies to develop such a training program, with appropriate input and participation from the academy, experienced sitting and retired judges, financial firms and trade organizations.

7. Other Issues to Consider

There are two other tools that I believe Congress should consider addressing in the draft bill.

First, I share the concerns expressed in the NBC Letter about the desirability of lender-of-last resort liquidity to assure the success of whole-firm recapitalization under the Bankruptcy Code. Even well-capitalized banks and other financial firms can face panic liquidity runs, and the recognition of this possibility has long been the justification for the availability of central bank lender-of-last resort liquidity to solvent and otherwise healthy banks. The objective of recapitalizing a financial firm under proposed Subchapter V is to put it on a sound financial footing, stabilize it quickly, maximize its value and minimize systemic disruption. Once the distressed financial firm has been restored to sound capital levels through recapitalizing it, it shortchanges the objectives of Subchapter V not to then assure that the firm has access to secured liquidity until it stabilizes. This liquidity would not be risk capital. It would be provided only to solvent and otherwise healthy firms as loans on a fully secured basis and, as suggested by some commentators, with above market interest rates to discourage use and encourage repayment and replacement by private sector resources.[17] I can say from three-and-a-half decades of experience working with troubled companies, that the simple availability of a committed liquidity source is the best way to assure that the liquidity source is not needed. Once the market is comfortable that liquidity will be available when needed, the market does not hesitate to extend credit – making the use of the committed liquidity source unnecessary.

Second, the United States wants resolution of U.S. based financial firms under both the Bankruptcy Code and OLA to be recognized and enforced against non-U.S. parties under foreign law. The BRRD in Europe, when implemented by member states, is expected to include authority for local regulators and courts to give such recognition to

[17] *See* BPC Report, p. 19; *see also* Walter Bagehot, *Lombard Street: A Description of the Money Market* (1873) (developing classic principles that extensions of credit under lender-of-last-resort facilities must only be made to solvent entities on a fully secured basis at above-market cost.

U.S. resolution proceedings.[18] The addition of a reciprocal provision to U.S. law that permits U.S. regulators and courts to afford recognition to foreign resolution regimes should be considered. Such recognition provisions might require amendments both to Chapter 15 of the Bankruptcy Code and Title II of the Dodd-Frank Act, or to other laws.

Conclusion

As I stated the last time I appeared before this Subcommittee, no single resolution procedure will be perfect for all situations. Expanding the options available by continuing to develop resolution approaches under both the existing Bankruptcy Code and OLA will maximize the flexibility to resolve distressed financial firms in a manner that minimizes systemic risk and does not put taxpayers at risk while preserving due process and the rule of law. For these reasons, I strongly support the efforts being made to improve the Bankruptcy Code in this regard and also support retaining OLA as a back-up resolution option for large financial firms. We should want regulators and courts to have a variety of sensible tools in their toolkit so they can use the right one when the time comes, while preserving due process and the rule of law.

While the draft amendments to Bankruptcy Code in the proposed House bill remain a work in progress, once perfected (hopefully with some of the improvements I have suggested), I believe their enactment should help assure that U.S. taxpayer money will never again be needed to bail out distressed financial firms.

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[18] *See Directive 2014/59/EU of the European Parliament and of the Council establishing a framework for the recovery and resolution of credit institutions and investment firms*, Article 94(May 15, 2014)

I want to thank the Subcommittee for allowing me this opportunity to present my views, and, once again, I would appreciate the opportunity to provide further comments on the draft bill to the Subcommittee's staff after the hearing.

I would of course be delighted to answer any questions you may have about my testimony.